

ALLIED CAPITAL CORP
Form 497
August 15, 2006

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Registration Statement No. 333-133755**

**PROSPECTUS SUPPLEMENT
(To Prospectus dated June 22, 2006)**

\$1,000,000,000

This prospectus supplement supplements the prospectus dated June 22, 2006, relating to our offer, from time to time, of up to \$1,000,000,000 in aggregate principal amount in one or more classes or series of debt securities, including notes, debentures, medium-term notes, commercial paper, retail notes or similar obligations evidencing indebtedness in one or more offerings, by providing certain information regarding our recent developments and our second quarter 2006 financial results. As of the date of this prospectus supplement, we have issued debt securities totaling \$400,000,000 of the \$1,000,000,000 of debt securities.

Please read this prospectus supplement, and the accompanying prospectus, before investing, and keep it for future reference. The prospectus supplement and the accompanying prospectus contain important information about us that a prospective investor should know before investing in our common stock. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006, or by telephone at (202) 721-6100 or on our website at www.alliedcapital.com. The SEC also maintains a website at www.sec.gov that contains such information.

You should review the information, including the risk of leverage, set forth under Risk Factors on page 9 of the accompanying prospectus before investing.

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

The date of this prospectus supplement is August 15, 2006

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

TABLE OF CONTENTS
Prospectus Supplement

	Page
Management's Discussion and Analysis of Financial Condition and Results of Operations	S-1
Interim Consolidated Financial Statements	S-36
Notice Regarding Independent Public Accountants' Review Report	S-81
Prospectus	
Prospectus Summary	1
Selected Condensed Consolidated Financial Data	6
Where You Can Find Additional Information	8
Risk Factors	9
Use of Proceeds	19
Management's Discussion and Analysis of Financial Condition and Results of Operations	21
Senior Securities	67
Business	71
Portfolio Companies	88
Determination of Net Asset Value	95
Management	98
Portfolio Management	104
Compensation of Executive Officers and Directors	107
Control Persons and Principal Holders of Securities	118
Certain Relationships and Related Party Transactions	121
Tax Status	122
Certain Government Regulations	123
Stock Trading Plans and Ownership Guidelines	127
Dividend Reinvestment Plan	128
Description of Capital Stock	129
Description of Notes	130
Special Considerations Under Our Charter and Bylaws and Maryland Law	142
Plan of Distribution	148
Legal Matters	149
Custodians, Transfer and Dividend Paying Agent and Registrar	149
Brokerage Allocation and Other Practices	149
Independent Registered Public Accounting Firm	150
Notice Regarding Arthur Andersen LLP	150
Index to Consolidated Financial Statements	F-1

ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, which constitutes a delayed offering in reliance on Rule 415 under the Securities Act of 1933, as amended, we may offer, from time to time, up to \$1,000,000,000 in aggregate principal amount of debt securities on the terms to be determined at the time of the offering. The debt securities may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the debt securities that we may offer. Each time we use this prospectus to offer debt securities, we will provide a prospectus supplement and, if applicable, a pricing supplement that will contain specific information about the terms of that offering. Please carefully read this prospectus and any such supplements together with the additional information described under **Where You Can Find Additional Information** in the **Prospectus Summary** and **Risk Factors** sections before you make an investment decision.

A prospectus supplement and, if applicable, a pricing supplement may also add, update or change information contained in this prospectus.

(i)

**INTERIM MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included herein and in the Company's annual report on Form 10-K for the year ended December 31, 2005. In addition, this quarterly report on Form 10-Q contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth below in the Risk Factors section. Other factors that could cause actual results to differ materially include:

changes in the economy and general economic conditions;

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

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

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

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

OVERVIEW

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our lending and investment activity has generally been focused on private finance and commercial real estate finance, which included primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS, and collateralized debt obligation bonds and preferred shares, which we refer to as CDOs.

On May 3, 2005, we completed the sale of our portfolio of CMBS and real estate related CDO investments. Upon the completion of this transaction, our lending and investment activity has been focused primarily on private finance investments. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in

private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at June 30, 2006 and 2005, and at December 31, 2005, was as follows:

	June 30,		December 31,
	2006	2005	2005
Private finance	96%	95%	96%
Commercial real estate finance	4%	5%	4%

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

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

PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three and six months ended June 30, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2006	2005	2006	2005	2005
(\$ in millions)					
Portfolio at value	\$3,593.5	\$2,714.3	\$3,593.5	\$2,714.3	\$3,606.4
Investments funded ⁽¹⁾	\$ 453.4	\$ 389.3	\$1,251.2	\$ 654.9	\$1,675.8
Change in accrued or reinvested interest and dividends ⁽²⁾	\$ (7.0)	\$ (14.1)	\$ (9.1)	\$ (3.6)	\$ 6.6
Principal collections related to investment repayments or sales	\$ 429.2	\$ 932.6	\$ 769.6	\$1,090.8	\$1,503.4
Yield on interest-bearing investments ⁽³⁾	12.6%	13.2%	12.6%	13.2%	12.8%

⁽¹⁾ Investments funded for the six months ended June 30, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a \$30 million subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS. See discussion below.

⁽²⁾

Includes changes in accrued or reinvested interest of \$0.6 million and \$1.7 million for the three and six months ended June 30, 2006, respectively, related to our investments in money market securities.

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

S-2

Private Finance

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the three and six months ended June 30, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

	At and for the Three Months Ended June 30,				At and for the Six Months Ended June 30,				At and for the Year Ended December 31,	
	2006		2005		2006		2005		2005	
	Value	Yield ⁽²⁾	Value	Yield ⁽²⁾	Value	Yield ⁽²⁾	Value	Yield ⁽²⁾	Value	Yield ⁽²⁾
(\$ in millions)										
Portfolio at value:										
Loans and debt securities:										
Senior loans	\$ 275.9	9.5%	\$ 203.3	10.0%	\$ 275.9	9.5%	\$ 203.3	10.0%	\$ 239.8	9.5%
Unitranche debt	515.0	10.7%	67.3	13.3%	515.0	10.7%	67.3	13.3%	294.2	11.4%
Subordinated debt	1,700.3	13.9%	1,362.4	14.2%	1,700.3	13.9%	1,362.4	14.2%	1,560.9	13.8%
Total loans and debt securities	\$2,491.2	12.7%	\$1,633.0	13.7%	\$2,491.2	12.7%	\$1,633.0	13.7%	\$2,094.9	13.0%
Equity securities	969.2		937.5		969.2		937.5		1,384.4	
Total portfolio	\$3,460.4		\$2,570.5		\$3,460.4		\$2,570.5		\$3,479.3	
Investments funded ⁽¹⁾	\$ 441.5		\$ 298.0		\$1,237.3		\$ 466.3		\$1,462.3	
Change in accrued or reinvested interest and dividends	\$ (7.1)		\$ 6.5		\$ (11.3)		\$ 14.4		\$ 24.6	
Principal collections related to investment repayments or sales	\$ 415.7		\$ 178.8		\$ 752.4		\$ 330.0		\$ 703.9	

(1)

Investments funded for the six months ended June 30, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a \$30 million subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS. See discussion below.

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

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

In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Senior loans at June 30, 2006, included approximately \$30.1 million of senior loans that are currently in the process of being refinanced. Repayments include repayments of senior debt funded by us that was subsequently refinanced or repaid by the portfolio companies.

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. To address the current market, our strategy is to focus on buyout and recapitalization transactions where we can manage risk through the structure and terms of our debt and equity investments and where we can potentially realize more attractive total returns from both current interest and fee income and future capital gains. We are also focusing our debt investing on smaller middle market companies where we can provide both senior and subordinated debt or unitranche

debt, where our combined current yield may be lower than traditional subordinated debt only. We believe that providing both senior and subordinated debt or unitranche debt provides us with greater protection in the capital structures of our portfolio companies.

Investments Funded. Investments funded and the weighted average yield on investments funded for the six months ended June 30, 2006 and 2005, and for the year ended December 31, 2005, consisted of the following:

For the Six Months Ended June 30, 2006

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans ⁽⁴⁾	\$ 149.4	9.3%	\$ 121.6	8.8%	\$ 271.0	9.1%
Unitranche debt ⁽²⁾	255.9	10.6%			255.9	10.6%
Subordinated debt ⁽³⁾	374.8	13.0%	189.1	13.7%	563.9	13.2%
Total loans and debt securities	780.1	11.5%	310.7	11.8%	1,090.8	11.5%
Equity	54.6		91.9		146.5	
Total	\$834.7		\$402.6		\$1,237.3	

For the Six Months Ended June 30, 2005

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 19.5	12.1%	\$ 77.7	5.9%	\$ 97.2	7.1%
Unitranche debt ⁽²⁾	59.2	10.8%			59.2	10.8%
Subordinated debt	140.0	12.9%	110.6	13.2%	250.6	13.0%
Total loans and debt securities	218.7	12.3%	188.3	10.2%	407.0	11.3%
Equity	15.5		43.8		59.3	
Total	\$234.2		\$232.1		\$466.3	

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.
- (2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.
- (3) Debt investments for the six months ended June 30, 2006, included a \$150 million, 12.0% subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a \$30 million, 15.0% subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS. See discussion below.
- (4) Senior loans funded for the six months ended June 30, 2006, included \$163.6 million that was repaid during the six months ended June 30, 2006.

S-4

For the Year Ended December 31, 2005

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans ⁽³⁾	\$ 76.8	10.0%	\$250.2	6.4%	\$ 327.0	7.2%
Unitranche debt ⁽²⁾	259.5	10.5%			259.5	10.5%
Subordinated debt	296.9	12.3%	330.9	12.5%	627.8	12.4%
Total loans and debt securities	633.2	11.3%	581.1	9.9%	1,214.3	10.6%
Equity	82.5		165.5		248.0	
Total	\$715.7		\$746.6		\$1,462.3	

(1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.

(3) Buyout senior loans funded included \$174.9 million that was repaid during the year.

In July 2006, we funded private finance investments totaling \$274.8 million.

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on the number and size of investments that we make or that we exit and many other factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. We believe that merger and acquisition activity in the middle market is strong, which has resulted in an increase in private finance investment opportunities, as well as increased repayments. We continue to have an active pipeline of new investments under consideration. We believe that merger and acquisition activity for middle market companies will remain strong for the remainder of 2006.

Through our wholly owned subsidiary, AC Finance LLC (AC Finance), we generally originate, underwrite and arrange senior loans. Senior loans originated and underwritten by AC Finance may or may not be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus) or funds managed by Callidus, a portfolio company controlled by us. After completion of the sale process, we may or may not

retain a position in these senior loans. AC Finance generally earns a fee on the senior loans originated and underwritten whether or not we fund the underwritten commitment.

Portfolio Yield. The weighted average yield on private finance loans and debt securities was 12.7% at June 30, 2006, as compared to 13.7% and 13.0% at June 30, 2005, and December 31, 2005, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period depending on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not

S-5

accruing and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. The yield on the private finance portfolio has declined partly due to our strategy to pursue more buyout and recapitalization transactions, which may include investing in lower-yielding senior debt, and unitranche investments.

Outstanding Investment Commitments. At June 30, 2006, we had outstanding private finance investment commitments totaling \$352.7 million, including the following:

\$88.3 million in the form of revolving senior debt facilities to nineteen companies.

\$50.7 million in the form of equity to fifteen private equity and venture capital funds.

\$24.2 million in the form of debt to Promo Works, LLC.

\$23.9 million in the form of debt to S.B. Restaurant Company.

\$9.0 million in the form of debt to Integrity Interactive Corp.

\$7.6 million in the form of debt to Carlisle Wide Plank Floors, Inc.

\$6.5 million in co-investment commitments to Pine Creek Equity Partners, LLC.

We have various commitments to Callidus Capital Corporation (Callidus), which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments. Our commitment to Callidus consisted of the following at June 30, 2006:

(\$ in millions)	Committed Amount	Amount Drawn	Amount Available to be Drawn
Subordinated debt to support warehouse facilities & warehousing activities ⁽¹⁾	\$36.0	\$	\$36.0
Revolving line of credit for working capital	4.0	1.6	2.4
Total	\$40.0	\$1.6	\$38.4

⁽¹⁾ Callidus has a secured warehouse credit facility with a third party for up to \$240 million. The facility is used primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate our \$36 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

In addition, at June 30, 2006, we had a commitment to Callidus to purchase preferred equity in future CLO transactions of \$77.0 million.

In addition to these outstanding investment commitments at June 30, 2006, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$194.7 million. See Financial Condition, Liquidity and Capital Resources.

Our largest investment at value at June 30, 2006, was in Business Loan Express, LLC (BLX) and our largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. (Advantage) and BLX.

S-6

Business Loan Express, LLC. At June 30, 2006, our investment in BLX totaled \$293.2 million at cost and \$317.2 million at value, or 7.9% of our total assets, which includes unrealized appreciation of \$24.0 million. We acquired BLX in 2000.

Total interest and related portfolio income earned from the Company's investment in BLX for the six months ended June 30, 2006 and 2005, was as follows:

	2006	2005
(\$ in millions)		
Interest income	\$ 7.8	\$ 6.9
Dividend income		5.0
Fees and other income	4.3	4.7
 Total interest and related portfolio income	 \$12.1	 \$16.6

Interest income from BLX for the six months ended June 30, 2006 and 2005, included interest income of \$3.7 million and \$3.3 million, respectively, which was paid in kind. The interest paid in kind was paid to us through the issuance of additional Class A equity interests. Accrued interest and dividends receivable at June 30, 2006, included accrued interest due from BLX totaling \$2.5 million, of which \$2.1 million was paid in cash in July 2006.

Net change in unrealized appreciation or depreciation included a net decrease in unrealized appreciation on our investment in BLX of \$33.6 million for the six months ended June 30, 2006, and a net increase in unrealized appreciation on our investment in BLX of \$1.3 million for the six months ended June 30, 2005. See Results of Operations for a discussion of the net change in unrealized appreciation or depreciation related to this investment.

BLX is a national, non-bank lender that participates in the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a nationwide preferred lender, as designated by the SBA, and originates, sells, and services small business loans. In addition, BLX originates conventional small business loans and small investment real estate loans. BLX has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, could negatively affect our financial results.

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

At December 31, 2005, BLX had a three-year \$275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, we had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At December 31, 2005, the principal amount of loans outstanding on the revolving credit facility was \$228.2 million and letters of credit issued under the facility were \$41.7 million. The total obligation guaranteed by us at December 31, 2005, was \$135.4 million.

On March 17, 2006, BLX closed on a new three-year \$500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to \$600.0 million at BLX's option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. We have provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At June 30, 2006, the principal amount outstanding on the revolving credit facility was \$238.7 million and letters of credit issued under the facility were \$56.7 million. The total obligation guaranteed by us at June 30, 2006, was \$149.2 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility, which includes certain defaults under our revolving credit facility. BLX has determined it was in compliance with the terms of this facility at June 30, 2006.

At June 30, 2006, we had also provided four standby letters of credit totaling \$32.0 million in connection with four term securitization transactions completed by BLX. In consideration for providing the revolving credit facility guaranty and the standby letters of credit, BLX paid us fees of \$3.1 million and \$3.2 million for the six months ended June 30, 2006 and 2005, respectively, which were included in fees and other income above.

Advantage Sales & Marketing, Inc. At December 31, 2005, our investment in Advantage totaled \$257.7 million at cost and \$660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of \$402.7 million. We completed the purchase of a majority ownership in Advantage in June 2004.

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our \$184 million in subordinated debt outstanding and realized a gain on our equity investment sold of \$433.7 million, subject to post-closing adjustments. As consideration for the common stock sold in the transaction, we received a \$150 million subordinated note, with the balance of the consideration paid in cash. Approximately \$34 million of our cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. In addition, there is potential for us to receive additional consideration through an earn-out payment that would be based on Advantage's 2006 audited results. Our realized gain of \$433.7 million, subject to post-closing adjustments, excludes any earn-out amounts. For tax purposes, the receipt of the \$150 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected. In connection with the transaction, we retained an equity investment in the business valued at \$15 million at closing as a minority shareholder.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest was \$14.1 million for the six months ended June 30, 2006, which included a prepayment premium of \$5.0 million, and \$18.5 million for the six months ended June 30, 2005. In addition, we earned structuring fees of \$2.3 million on our new \$150 million subordinated debt investment in Advantage upon the closing of the sale transaction.

After the sale transaction, our investment in Advantage at June 30, 2006, which was composed of subordinated debt and a minority equity interest, totaled \$152.1 million at cost and \$165.1 million at value, which included unrealized appreciation of \$13.0 million. Subsequent to the completion of the sale transaction, our interest income from our subordinated debt investment in Advantage for the three months ended June 30, 2006, was \$4.6 million.

Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

Commercial Real Estate Finance

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three and six months ended June 30, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

	At and for the Three Months Ended June 30,				At and for the Six Months Ended June 30,				At and for the Year Ended December 31, 2005	
	2006		2005		2006		2005			
	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾
(\$ in millions)										
Portfolio at value:										
Commercial mortgage loans	\$ 96.5	8.1%	\$ 116.1	6.7%	\$ 96.5	8.1%	\$ 116.1	6.7%	\$ 102.6	7.6%
Real estate owned	14.6		16.6		14.6		16.6		13.9	
Equity interests	22.0		11.1		22.0		11.1		10.6	
Total portfolio	\$ 133.1		\$ 143.8		\$ 133.1		\$ 143.8		\$ 127.1	
Investments funded	\$ 11.9		\$ 91.3		\$ 13.9		\$ 188.6		\$ 213.5	
Change in accrued or reinvested interest	\$ (0.5)		\$ (20.6)		\$ 0.5		\$ (18.0)		\$ (18.0)	
Principal collections related to investment repayments or sales ⁽²⁾	\$ 13.5		\$ 753.8		\$ 17.2		\$ 760.8		\$ 799.5	

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

⁽²⁾ Principal collections related to investment repayments or sales for the year ended December 31, 2005, included \$718.1 million related to the sale of our CMBS and CDO portfolio in May 2005.

Our commercial real estate investments funded for the six months ended June 30, 2006 and 2005, and for the year ended December 31, 2005, was as follows:

Face	Amount
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(\$ in millions)	Amount	Discount	Funded
<i>For the Six Months Ended June 30, 2006</i>			
Commercial mortgage loans	\$ 7.4	\$	\$ 7.4
Equity interests	6.5		6.5
Total	\$ 13.9	\$	\$ 13.9
<i>For the Six Months Ended June 30, 2005</i>			
CMBS bonds (4 new issuances) ⁽¹⁾	\$211.5	\$(90.5)	\$121.0
Commercial mortgage loans	67.1	(0.9)	66.2
Equity interests	1.4		1.4
Total	\$280.0	\$(91.4)	\$188.6
<i>For the Year Ended December 31, 2005</i>			
CMBS bonds (4 new issuances) ⁽¹⁾	\$211.5	\$(90.5)	\$121.0
Commercial mortgage loans	88.5	(0.8)	87.7
Equity interests	4.8		4.8
Total	\$304.8	\$(91.3)	\$213.5

(1) The CMBS bonds invested in during 2005 were sold on May 3, 2005.

S-9

At June 30, 2006, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$9.4 million and commitments in the form of standby letters of credit and guarantees related to equity interests of \$6.9 million.

Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares. On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of \$976.0 million and a net realized gain of \$227.7 million, after transaction and other costs of \$7.8 million. Transaction costs included investment banking fees, legal and other professional fees, and other transaction costs. The CMBS and CDO assets sold had a cost basis at closing of \$739.8 million, including accrued interest of \$21.7 million. Upon the closing of the sale, we settled all the hedge positions relating to these assets, which resulted in a net realized loss of \$0.7 million, which was included in the net realized gain on the sale.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWCapital Investments LLC, an affiliate of the Caisse (CWCapital), pursuant to which we agreed to sell certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. Under this agreement, we have agreed not to invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008, subject to certain limitations and excluding our existing portfolio and related activities.

The real estate securities purchase agreement, under which we sold the CMBS and CDO portfolio, and the platform asset purchase agreement contain customary representations and warranties, and require us to indemnify the affiliates of the Caisse that are parties to the agreements for certain liabilities arising under the agreements, subject to certain limitations and conditions.

Hedging Activities

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$17.2 million and \$17.7 million at June 30, 2006, and December 31, 2005, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were \$17.2 million and \$17.7 million at June 30, 2006, and December 31, 2005, respectively. The amount

of the hedge will vary from period to period depending upon the amount of commercial mortgage loans that we own and have hedged as of the balance sheet date.

OTHER ASSETS

Other assets is composed primarily of fixed assets, assets held in deferred compensation trusts, deferred financing and offering costs, and accounts receivable, which includes amounts received in connection with the sale of portfolio companies, including amounts held in escrow, and other receivables from portfolio companies. At June 30, 2006, and December 31, 2005, other assets totaled \$124.4 million and \$87.9 million, respectively. The increase since year end was primarily the result of amounts received in connection with the sales of Advantage and STS Operating, Inc., that are being held in escrow. See Portfolio and Investment Activity Private Finance above.

PORTFOLIO ASSET QUALITY

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

At June 30, 2006, and December 31, 2005, our portfolio was graded as follows:

Grade	2006		2005	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
(\$ in millions)				
1	\$1,241.2	34.5%	\$1,643.0	45.6%
2	2,177.8	60.6	1,730.8	48.0
3	93.1	2.6	149.1	4.1
4	27.4	0.8	26.5	0.7
5	54.0	1.5	57.0	1.6
	\$3,593.5	100.0%	\$3,606.4	100.0%

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

Total Grade 3, 4 and 5 portfolio assets were \$174.5 million and \$232.6 million, respectively, or were 4.9% and 6.4%, respectively, of the total portfolio at value at June 30, 2006, and December 31, 2005.

Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with such companies in order to recover the maximum amount of our investment.

Loans and Debt Securities on Non-Accrual Status. At June 30, 2006, and December 31, 2005, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

	2006	2005
(\$ in millions)		
Loans and debt securities in workout status (classified as Grade 4 or 5) ⁽¹⁾		
Private finance		
Companies more than 25% owned	\$ 17.7	\$ 15.6
Companies 5% to 25% owned	3.3	
Companies less than 5% owned	24.6	11.4
Commercial real estate finance	2.9	12.9
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	40.8	58.0
Companies 5% to 25% owned	6.6	0.5
Companies less than 5% owned	3.9	49.5
Commercial real estate finance	12.8	7.9
Total	\$ 112.6	\$ 155.8
Percentage of total portfolio	3.1%	4.3%

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

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent at value at June 30, 2006, and December 31, 2005, were as follows:

	2006	2005
(\$ in millions)		
Private finance	\$ 47.2	\$ 74.6
Commercial mortgage loans	3.7	6.1
Total	\$ 50.9	\$ 80.7
Percentage of total portfolio	1.4%	2.2%

In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. In addition, interest may not accrue on loans to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. To the extent interest payments are received on a loan that is not accruing interest, we may use such payments to reduce our cost basis in the investment in lieu of recognizing interest income.

As a result of these and other factors, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$50.9 million and \$60.7 million at June 30, 2006, and December 31, 2005, respectively.

PORTFOLIO RETURNS

Since our merger on December 31, 1997, through June 30, 2006, our combined aggregate cash flow Internal Rate of Return (IRR) has been approximately 22% for private finance and

S-12

CMBS/CDO investments exited during this period. The IRR is calculated using the aggregate portfolio cash flow for all investments exited over this period. For investments exited during this period, we invested capital totaling \$3.7 billion. The weighted average holding period of these investments was 35 months. Investments are considered to be exited when the original investment objective has been achieved through the receipt of cash and/or non-cash consideration upon the repayment of our debt investment or sale of an equity investment, or through the determination that no further consideration was collectible and, thus, a loss may have been realized. The aggregate cash flow IRR for private finance investments was approximately 21% and for CMBS/CDO investments was approximately 24% for the same period. The weighted average holding period of the private finance and CMBS/CDO investments was 47 months and 22 months, respectively, for the same period. These IRR results represent historical results. Historical results are not necessarily indicative of future results.

S-13

RESULTS OF OPERATIONS**Comparison of Three and Six Months Ended June 30, 2006 and 2005**

The following table summarizes the Company's operating results for the three and six months ended June 30, 2006 and 2005.

(\$ in thousands, except per share amounts)	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2006	2005	Change	Percentage Change	2006	2005	Change	Percentage Change
	(unaudited)				(unaudited)			
Interest and Related Portfolio Income								
Interest and dividends	\$ 95,433	\$ 71,330	\$ 24,103	34%	\$ 184,314	\$ 156,275	\$ 28,039	18%
Loan prepayment premiums	1,745	853	892	105%	7,031	2,530	4,501	178%
Fees and other income	13,278	14,024	(746)	(5)%	30,122	22,321	7,801	35%
Total interest and related portfolio income	110,456	86,207	24,249	28%	221,467	181,126	40,341	22%
Expenses								
Interest	21,607	19,154	2,453	13%	45,907	39,379	6,528	17%
Employee	20,398	22,877	(2,479)	(11)%	41,826	38,333	3,493	9%
Stock options	4,597		4,597	100%	8,203		8,203	100%
Administrative	9,861	23,048	(13,187)	(57)%	21,380	43,802	(22,422)	(51)%
Total operating expenses	56,463	65,079	(8,616)	(13)%	117,316	121,514	(4,198)	(3)%
Net investment income before income taxes	53,993	21,128	32,865	156%	104,151	59,612	44,539	75%
Income tax expense, including excise tax	3,798	5,861	(2,063)	(35)%	12,656	5,593	7,063	126%
Net investment income	50,195	15,267	34,928	229%	91,495	54,019	37,476	69%

Net Realized and Unrealized Gains (Losses)								
Net realized gains	100,240	207,496	(107,256)	*	533,075	217,781	315,294	*
Net change in unrealized appreciation or depreciation	(116,706)	89,122	(205,828)	*	(491,254)	159,706	(650,960)	*
Total net gains	(16,466)	296,618	(313,084)	*	41,821	377,487	(335,666)	*
Net income	\$ 33,729	\$311,885	\$(278,156)	(89)%	\$ 133,316	\$431,506	\$(2 98,190)	(69)%
Diluted earnings per common share	\$ 0.24	\$ 2.29	\$ (2.05)	(90)%	\$ 0.94	\$ 3.17	\$ (2.23)	(70)%
Weighted average common shares outstanding diluted	143,213	136,381	6,832	5%	142,466	135,982	6,484	5%

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

S-14

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

Interest and Dividends. Interest and dividend income for the three and six months ended June 30, 2006 and 2005, was composed of the following:

(\$ in millions)	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Interest				
Private finance loans and debt securities	\$88.6	\$53.1	\$171.2	\$109.9
CMBS and CDO portfolio		7.3		29.4
Commercial mortgage loans	2.1	2.0	4.8	3.5
Cash and cash equivalents, U.S. Treasury bills and other	2.9	3.6	5.9	4.1
Total interest	93.6	66.0	181.9	146.9
Dividends	1.8	5.3	2.4	9.4
Total interest and dividends	\$95.4	\$71.3	\$184.3	\$156.3

Our interest income from our private finance loans and debt securities has increased period over period as a result of the growth in this portfolio as shown below. In addition, during the six months ended June 30, 2006, we resumed accruing interest on loans to two private finance portfolio companies. Such additional interest income totaled \$2.4 million and \$6.2 million for the three and six months ended June 30, 2006, respectively. In addition, one of these portfolio companies paid off during the second quarter and the accrued interest was collected.

There was no interest income from the CMBS and CDO portfolio in 2006 as we sold this portfolio on May 3, 2005. The CMBS and CDO portfolio sold had a cost basis of \$718.1 million and a weighted average yield on the cost basis of the portfolio of approximately 13.8%. We generally reinvested the principal proceeds from the CMBS and CDO portfolio into our private finance portfolio.

The level of portfolio-related interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the yield on the interest-bearing investments in the portfolio at June 30, 2006 and 2005, were as follows:

(\$ in millions)	2006		2005	
	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾
Private finance loans and debt securities	\$2,491.2	12.7%	\$1,633.0	13.7%
CMBS and CDO portfolio ⁽²⁾				
Commercial mortgage loans	96.5	8.1%	116.1	6.7%
Total	\$2,587.7	12.6%	\$1,749.1	13.2%

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

(2) The CMBS and CDO portfolio was sold on May 3, 2005. See discussion above.

S-15

The private finance portfolio yield at June 30, 2006, of 12.7% as compared to the private finance portfolio yield of 13.7% at June 30, 2005, reflects the mix of debt investments in the private finance portfolio. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption Portfolio and Investment Activity Private Finance.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests. Dividend income for the three and six months ended June 30, 2006, did not include any dividends from BLX. Dividend income for the three and six months ended June 30, 2005, included \$3.0 million and \$5.0 million, respectively, of dividends from BLX on the Class B equity interests held by us, which were paid in cash. See the discussion of BLX above under the caption Portfolio and Investment Activity Private Finance.

Loan Prepayment Premiums. Loan prepayment premiums were \$1.7 million and \$0.9 million for the three months ended June 30, 2006 and 2005, respectively, and \$7.0 million and \$2.5 million for the six months ended June 30, 2006 and 2005, respectively. Loan prepayment premiums for the six months ended June 30, 2006, included \$5.0 million related to the repayment of our subordinated debt in connection with the sale of our majority equity interest in Advantage on March 29, 2006. See Portfolio and Investment Activity above for further discussion. While the scheduled maturities of private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

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

Fees and other income for the three and six months ended June 30, 2006 and 2005, included fees relating to the following:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
	(\$ in millions)			
Structuring and diligence	\$ 8.0	\$ 7.5	\$19.0	\$ 8.9
Management, consulting and other services provided to portfolio companies	2.3	3.6	6.4	6.8
Commitment, guaranty, transaction and other fees from portfolio companies	2.9	2.0	4.6	4.8
Other income	0.1	0.9	0.1	1.8
Total fees and other income	\$13.3	\$14.0	\$30.1	\$22.3

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level of investment activity and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Structuring and diligence fees for the six months ended June 30, 2006, included structuring fees from Advantage Sales and Marketing, Cook Inlet Alternative Risk, CR Brands, Hot Stuff Foods, MHF Logistical Solutions, the Step 2 Company, and 3SI Security Systems totaling \$13.0 million. Structuring and diligence fees may vary substantially from period to period based on the level of new investment originations and the market rates for these types of fees. Private finance investments funded were \$1.2 billion for the six months ended June 30, 2006, as compared to \$466.3 million for the six months ended June 30, 2005.

Management fees for the six months ended June 30, 2006, included \$1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See *Portfolio and Investment Activity* above for further discussion.

Fees and other income related to the CMBS and CDO portfolio for the six months ended June 30, 2005, were \$4.1 million. As noted above, we sold our CMBS and CDO portfolio on May 3, 2005.

BLX and Advantage. BLX was our largest investment at value at June 30, 2006, and represented 7.9% of our total assets. Advantage and BLX were our largest investments at June 30, 2005, and together represented 22.2% of our total assets.

Total interest and related portfolio income from these investments for the three and six months ended June 30, 2006 and 2005, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
(\$ in millions)				
BLX	\$6.0	\$8.8	\$12.1	\$16.6
Advantage ⁽¹⁾	\$	\$9.4	\$14.1	\$18.5

⁽¹⁾ Includes income from the period we held a majority equity interest only. See *Portfolio and Investment Activity* above for further discussion.

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

Interest Expense. The fluctuations in interest expense during the three and six months ended June 30, 2006 and 2005, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and

weighted average cost of debt, including fees and debt financing costs, at and for the three and six months ended June 30, 2006 and 2005, were as follows:

	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,	
	2006	2005	2006	2005
(\$ in millions)				
Total outstanding debt	\$1,208.9	\$ 986.5	\$1,208.9	\$ 986.5
Average outstanding debt	\$1,301.1	\$1,071.0	\$1,395.8	\$1,097.9
Weighted average cost ⁽¹⁾	6.6%	6.8%	6.6%	6.8%

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

In addition, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$0.2 million and \$0.5 million for the three months ended June 30, 2006 and 2005, respectively, and \$0.4 million and \$1.1 million for the six months ended June 30, 2006 and 2005, respectively.

Employee Expense. Employee expenses for the three and six months ended June 30, 2006 and 2005, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
(\$ in millions)				
Salaries and employee benefits	\$17.6	\$11.7	\$35.0	\$23.5
Transition compensation, net		5.5		5.5
Individual performance award (IPA)	2.1	1.9	3.8	3.8
IPA mark to market expense (benefit)	(1.5)	1.8	(0.6)	1.9
Individual performance bonus (IPB)	2.2	2.0	3.6	3.6
Total employee expense	\$20.4	\$22.9	\$41.8	\$38.3
Number of employees at end of period	166	152	166	152

The change in salaries and employee benefits reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Salaries and employee benefits expense has generally increased due to changes in the composition of our employee resources and compensation increases. Salaries and employee benefits include an accrual for employee bonuses, which are generally paid annually after the completion of the fiscal year. The quarterly accrual is based upon an estimate of annual bonuses and is subject to change. The amount of the current year bonuses will be finalized by the Compensation Committee and the Board of Directors at the end of the year. Salaries and employee benefits include accrued bonuses of \$9.0 million and \$3.4 million for the three months ended June 30, 2006 and 2005, respectively, and \$16.9 million and \$7.1 million for

the six months ended June 30, 2006 and 2005, respectively.

Transition compensation costs were \$6.4 million for the six months ended June 30, 2005, including \$3.7 million of costs under retention agreements and \$2.7 million of transition services bonuses awarded to certain employees in the commercial real estate group as a result of the sale of the CMBS and CDO portfolio. Transition compensation expenses were reduced by \$0.9 million for salary reimbursements from CWCapital under the transition services agreement resulting in net expense related to the sale of the CMBS and CDO portfolio of \$5.5 million. See the caption

S-18

Portfolio and Investment Activity Commercial Real Estate Finance for additional information.

The Individual Performance Award (IPA) is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.

As a result of changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting talent in the private equity industry, the Compensation Committee and the Board of Directors determined that for 2005 and 2006 a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB is distributed in cash to award recipients in equal bi-weekly installments (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2006. We currently estimate the IPA and IPB to be approximately \$8.1 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

In connection with our 2006 Annual Meeting of Stockholders, the stockholders approved the issuance of up to 2.5 million shares of our common stock in exchange for the cancellation of vested in-the-money stock options granted to certain officers and directors under our Amended Stock Option Plan. Under the initiative, which has been reviewed and approved by our Board of Directors, all optionees who hold vested stock options with exercise prices below the market value of the stock (or in-the-money options), would be offered the opportunity to receive an Option Cancellation Payment (OCP) equal to the in-the-money value of the stock options cancelled, which would be paid one-half in cash and one-half in shares of our common stock, in exchange for their voluntary cancellation of their vested stock options. As part of this initiative, the Board of Directors has adopted a target ownership structure that establishes minimum ownership levels for our senior officers and continues to further align the interests of our officers with those of our stockholders.

Unlike the accounting treatment typically associated with a stock option exercise, the OCP would be recorded as an expense for financial reporting purposes, and the expense may be significant. Based on the 13 million vested options outstanding and the market price of \$30.50 of our stock on March 10, 2006, the date used for disclosure in our 2006 proxy, the expense related to the OCP would be approximately \$106 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. As of June 30, 2006, there were 17 million vested options outstanding, of which 13 million options were in-the-money. Using the market price of \$28.77 of our stock on June 30, 2006, the expense related to the OCP would be approximately \$86 million if all option holders chose to cancel all vested in-the-money options in exchange for the OCP. For income tax purposes, our tax expense resulting from the OCP would be similar to the tax expense that would result from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market would be limited by Section 162(m) of the Code for persons subject to Section 162(m).

Employee Stock Options Expense. In December 2004, the FASB issued Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement), which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement was effective January 1, 2006, and it applies to our stock option plan. Our stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the related service period. With respect to options granted prior to January 1, 2006, we have used the modified prospective method for adoption of the Statement. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006. With respect to options granted on or after January 1, 2006, compensation cost is recognized in the statement of operations over the service period. The effect of this adoption for the six months ended June 30, 2006, was as follows:

	For the Three Months Ended June 30, 2006	For the Six Months Ended June 30, 2006
(\$ in millions)		
Employee Stock Option Expense:		
Previously awarded, unvested options as of January 1, 2006	\$3.3	\$6.7
Options granted on or after January 1, 2006	1.3	1.5
 Total stock option expense	 \$4.6	 \$8.2

In addition to the employee stock option expense, for the three and six months ended June 30, 2006, administrative expense included \$0.2 million of expense related to options granted to directors during the period. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

We estimate that the employee-related stock option expense under the Statement that will be recorded in our statement of operations will be approximately \$16.1 million, \$10.1 million, and \$3.2 million for the years ended December 31, 2006, 2007, and 2008, respectively, which includes approximately \$2.6 million, \$1.4 million, and \$0.7 million, respectively, related to options granted in the first and second quarters of 2006. This estimate may change if our assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant.

Administrative Expense. Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, stock record expenses, directors' fees, and various other expenses. Administrative expenses for the three and six months ended June 30, 2006 and 2005, were as follows:

	For the Three Months Ending June 30,		For the Six Months Ending June 30,	
	2006	2005	2006	2005
(\$ in millions)				
Administrative expenses	\$9.4	\$ 9.6	\$18.0	\$18.1
Investigation related costs	0.5	13.5	3.4	25.7
 Total administrative expenses	 \$9.9	 \$23.1	 \$21.4	 \$43.8

Investigation related costs include costs associated with requests for information in connection with two government investigations. These expenses remain difficult to predict. See **Legal Proceedings** in the accompanying prospectus.

S-20

Income Tax Expense, Including Excise Tax. Income tax expense for the three and six months ended June 30, 2006 and 2005, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
(\$ in millions)				
Income tax expense, net	\$0.6	\$1.9	\$ 1.1	\$1.6
Excise tax expense	3.2	4.0	11.6	4.0
Income tax expense, including excise tax	\$3.8	\$5.9	\$12.7	\$5.6

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period. In addition, our estimated annual taxable income for 2006 currently exceeds our estimated dividend distributions to shareholders from such taxable income in 2006, and such estimated excess taxable income will be distributed in 2007. Therefore, we will be required to pay a 4% excise tax on the excess of 98% of our taxable income over the amount of actual distributions from such taxable income. Accordingly, we have accrued an estimated excise tax of \$3.2 million and \$11.6 million for the three and six months ended June 30, 2006, respectively, based upon our estimated excess taxable income earned for the period. We currently expect that the excise tax accrual in the first half of the year, which included accruals for the estimated taxable income earned from the gains realized on the sale of our equity investments in Advantage and STS Operating, Inc., will be materially higher than that accrued in the second half of the year. See Financial Condition, Liquidity and Capital Resources.

Realized Gains and Losses. Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the three and six months ended June 30, 2006 and 2005, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
(\$ in millions)				
Realized gains	\$101.0	\$244.7	\$537.5	\$259.4
Realized losses	(0.8)	(37.2)	(4.4)	(41.6)
Net realized gains	\$100.2	\$207.5	\$533.1	\$217.8

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

2006 and 2005, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

(\$ in millions)	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Reversal of previously recorded unrealized appreciation associated with realized gains	\$(95.6)	\$(16.6)	\$(489.2)	\$(26.5)
Reversal of previously recorded unrealized depreciation associated with realized losses	0.5	37.1	3.2	41.9
Total reversal	\$(95.1)	\$ 20.5	\$(486.0)	\$ 15.4

Realized gains for the three months ended June 30, 2006 and 2005, were as follows:

(\$ in millions)

2006

Portfolio Company	Amount
Private Finance:	
STS Operating, Inc.	\$ 94.8
United Site Services, Inc.	3.3
MHF Logistical Solutions, Inc.	1.2
Advantage Sales & Marketing, Inc.	0.6
Other	1.1
Total private finance	101.0
Total gross realized gains	\$101.0

(\$ in millions)

2005

Portfolio Company	Amount
Private Finance:	
Master Plan, Inc.	\$ 3.7
Ginsey Industries, Inc.	2.8
E-Talk Corporation	1.6
Professional Paint, Inc.	1.0
Other	1.0

Total private finance	10.1
Commercial Real Estate:	
CMBS/CDO asset net ⁽¹⁾	227.7
Other	6.9
Total commercial real estate	234.6
Total gross realized gains	\$244.7

⁽¹⁾ Net of net realized losses from related hedges of \$0.7 million for the three months ended June 30, 2005.

STS Operating, Inc. In the second quarter of 2006, we completed the sale of STS Operating, Inc. (STS). We were repaid our \$6.8 million in subordinated debt outstanding and we realized a gain on the sale of our common stock in STS of \$94.8 million, subject to post-closing adjustments. The cost basis of our equity was \$3.5 million. As part of the consideration for the sale of our equity investment, we received a \$30 million subordinated note. Approximately \$11.2 million of our proceeds are subject to certain holdback provisions and post-closing adjustments. For tax purposes, the receipt of the \$30 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected.

S-22

Realized losses for the three months ended June 30, 2006 and 2005, were as follows:
(\$ in millions)

2006

Portfolio Company	Amount
Private Finance:	
Other	\$0.3
Total private finance	0.3
Commercial Real Estate:	
Other	0.5
Total commercial real estate	0.5
Total gross realized losses	\$0.8

(\$ in millions)

2005

Portfolio Company	Amount
Private Finance:	
Norstan Apparel Shops, Inc.	\$18.5
E-Talk Corporation	9.0
Garden Ridge Corporation	7.1
Other	0.3
Total private finance	34.9
Commercial Real Estate:	
Other	2.3
Total commercial real estate	2.3
Total gross realized losses	\$37.2

Realized gains for the six months ended June 30, 2006 and 2005, were as follows:
(\$ in millions)

2006

Portfolio Company	Amount
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Private Finance:	
Advantage Sales & Marketing, Inc.	\$433.7
STS Operating, Inc.	94.8
United Site Services, Inc.	3.3
Nobel Learning Communities, Inc.	1.5
MHF Logistical Solutions, Inc.	1.2
The Debt Exchange, Inc.	1.1
Other	1.3
Total private finance	536.9
Commercial Real Estate:	
Other	0.6
Total commercial real estate	0.6
Total gross realized gains	\$537.5

(\$ in millions)

2005

Portfolio Company	Amount
Private Finance:	
Polaris Pool System, Inc.	\$ 7.4
Master Plan, Inc.	3.7
U.S. Security Holdings, Inc.	3.3
Ginsey Industries, Inc.	2.8
E-Talk Corporation	1.6
Professional Paint, Inc.	1.0
Oriental Trading Company, Inc.	1.0
Other	3.5
Total private finance	24.3
Commercial Real Estate:	
CMBS/CDO assets, net ⁽¹⁾	227.7
Other	7.4
Total commercial real estate	235.1
Total gross realized gains	\$259.4

⁽¹⁾ Net of net realized losses from related hedges of \$0.7 million for the six months ended June 30, 2005.

S-23

Realized losses for the six months ended June 30, 2006 and 2005, were as follows:
 (\$ in millions)

2006

Portfolio Company	Amount
Private Finance:	
Aspen Pet Products, Inc.	\$1.6
Nobel Learning Communities, Inc.	1.4
Other	0.6
Total private finance	3.6
Commercial Real Estate:	
Other	0.8
Total commercial real estate	0.8
Total gross realized losses	\$4.4

(\$ in millions)

2005

Portfolio Company	Amount
Private Finance:	
Norstan Apparel Shops, Inc.	\$18.5
E-Talk Corporation	9.0
Garden Ridge Corporation	7.1
Alderwoods Group, Inc.	0.8
Other	0.7
Total private finance	36.1
Commercial Real Estate:	
Other	5.5
Total commercial real estate	5.5
Total gross realized losses	\$41.6

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and

assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At June 30, 2006, portfolio investments recorded at fair value were approximately 90% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

As a business development company, we have invested in illiquid securities including debt and equity securities of companies. The structure of each debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments may be subject to certain restrictions on resale and generally have no

established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

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

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

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

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

As a participant in the private equity business, we invest primarily in private middle market companies for which there is generally no publicly available information. Because of the private nature of these businesses, there is a need to maintain the confidentiality of the financial and other information that we have for the private companies in our portfolio. We believe that maintaining this confidence is important, as disclosure of such information could disadvantage our portfolio companies and could put us at a disadvantage in attracting new investments. Therefore, we do not intend to disclose financial or other information about our portfolio companies, unless required, because we believe doing so may put them at an economic or competitive disadvantage, regardless of our level of ownership or control.

We will continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis. In addition, we may receive third-party assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these third-party valuation resources, when applicable, is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

For 2006 and 2005, we received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey) for our private finance portfolio as follows:

	2006		2005	
	Q1	Q2	Q1	Q2
Number of private finance portfolio companies reviewed	78	78	36	72
Percentage of private finance portfolio reviewed at value	87.0%	89.6%	74.5%	83.0%

Professional fees for third-party valuation assistance were \$1.4 million for the year ended December 31, 2005, and are estimated to be approximately \$1.5 million for 2006.

Valuation Methodology CDO and CLO Bonds and Preferred Shares/Income Notes (CDO/CLO Assets). CDO/CLO Assets 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 bonds and preferred shares/income notes, when available. We recognize unrealized appreciation or depreciation on our CDO/CLO Assets as comparable yields in the market change and/ or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We determine the fair value of our CDO/CLO Assets on an individual security-by-security basis. If we were to sell a group of these CDO/CLO Assets in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual bonds or preferred shares/income notes.

Net Change in Unrealized Appreciation or Depreciation. Net change in unrealized appreciation or depreciation for the three and six months ended June 30, 2006 and 2005, consisted of the following:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006 ⁽¹⁾	2005 ⁽¹⁾	2006 ⁽¹⁾	2005 ⁽¹⁾
	(\$ in millions)			
Net unrealized appreciation or depreciation	\$ (21.6)	\$ 68.6	\$ (5.3)	\$ 144.3
Reversal of previously recorded unrealized appreciation associated with realized gains	(95.6)	(16.6)	(489.2)	(26.5)
Reversal of previously recorded unrealized depreciation associated with realized losses	0.5	37.1	3.2	41.9
Net change in unrealized appreciation or depreciation	\$ (116.7)	\$ 89.1	\$ (491.3)	\$ 159.7

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

At June 30, 2006, our largest investment was in BLX. The following is a summary of the methodology that we used to determine the fair value of this investment.

Business Loan Express, LLC. To determine the value of our investment in BLX at June 30, 2006, we performed four separate valuation analyses to determine a range of values: (1) analysis of comparable public company trading multiples, (2) analysis of BLX's value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. We received valuation assistance from Duff & Phelps for our investment in BLX at June 30, 2006, and December 31, 2005.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at June 30, 2006, was made up of CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at March 31, 2006, and December 31, 2005.

Our investment in BLX at June 30, 2006, was valued at \$317.2 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was \$24.0 million at June 30, 2006. We decreased unrealized appreciation for the three and six months ended June 30, 2006, by \$10.9 million and \$33.6 million, respectively. The decrease resulted from a reduction in enterprise value at June 30, 2006, of approximately 6% as compared to the enterprise value at December 31, 2005. BLX has experienced higher loan prepayments in recent months, which BLX management believes is due to a robust economy and increased competition from banks. BLX management has scaled back their traditional loan originations to remain selective in this competitive lending environment, and is also developing new loan products.

Per Share Amounts. All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 143.2 million and 136.4 million for the three months ended June 30, 2006 and 2005, respectively, and were 142.5 million and 136.0 million for the six months ended June 30, 2006 and

2005, respectively.

S-27

OTHER MATTERS

Regulated Investment Company Status. We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis.

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

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

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Dividends and Distributions

Dividends to common shareholders for the six months ended June 30, 2006 and 2005, were \$166.6 million and \$152.3 million, respectively, or \$1.19 per common share for the first half of 2006 and \$1.14 per common share for the first half of 2005. An extra cash dividend of \$0.03 per common share was declared during 2005 and was paid to shareholders on January 27, 2006.

The Board of Directors has declared a dividend of \$0.61 per common share for the third quarter of 2006.

Dividends are generally determined based upon an estimate of annual taxable income and the amount of taxable income carried over from the prior year for distribution in the current year.

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

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared based upon our estimate of annual taxable income available for distribution to shareholders and the amount of taxable income carried over from the prior year for distribution in the current year. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid from such taxable income for the year, we may carry over the excess taxable income into the next year and such excess taxable income will be available for distribution in the next year as permitted under the Internal Revenue Code of 1986. Excess taxable income carried over and paid out in the next year is generally subject to a 4% excise tax. See *Other Matters* *Regulated Investment Company Status* above. We believe that carrying over excess taxable income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend. We currently estimate that the taxable income carried over from 2005 for distribution to shareholders in 2006 is \$163.8 million. However, our taxable income for 2005 is an estimate and will not be finally determined until we file our 2005 tax return in September 2006, and therefore, the amount of excess taxable income carried over from 2005 into 2006 may be different from this estimate.

We currently expect that our estimated annual taxable income for 2006 will be in excess of our estimated dividend distributions to shareholders in 2006 from such taxable income, and, therefore, we expect to carry over excess taxable income for distribution to shareholders in 2007. We expect that we will generally be required to pay a 4% excise tax on the excess of 98% of our taxable income for 2006 over the amount of actual distributions from such taxable income in 2006. Accordingly, for the six months ended June 30, 2006, we have accrued an excise tax of \$11.6 million. Excise taxes are accrued based upon estimated excess taxable income as estimated taxable income is earned, therefore, the excise tax accrued to date in 2006 may be adjusted as appropriate in the remainder of 2006 to reflect changes in our estimate of the carry over amount and additional excise tax may be accrued during the remainder of 2006 as additional excess taxable income is earned, if any. Our ability to earn the estimated annual taxable income for 2006 depends on many factors, including our ability to make new investments at attractive yields, the level of repayments in the portfolio, the realization of gains or losses from portfolio exits, and the level of operating expenses incurred. See *Management's Discussion and Analysis of Financial Condition and Results of Operations* and *Risk Factors*.

In addition to excess taxable income available to be carried over from the current tax year for distribution in the following tax year, we currently estimate that we have deferred taxable income related to installment sale gains of approximately \$33 million as of December 31 2005, and approximately \$170 million for the six months ended June 30, 2006, for a total of approximately \$203 million as of June 30, 2006. These gains have been recognized for financial reporting purposes in the respective years they were realized, but will be deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. These installment

sale gains are estimates and will not be finally determined until we file our tax returns for the respective years. See Other Matters Regulated Investment Company Status above.

Because we are a regulated investment company, we distribute our taxable income and, therefore, from time to time we will raise new debt or equity capital in order to fund our investments and operations.

Liquidity and Capital Resources

At June 30, 2006, and December 31, 2005, our liquidity portfolio (see below), cash and investments in money market and other securities, total assets, total debt outstanding, total shareholders' equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

(\$ in millions)	2006	2005
Liquidity portfolio (including money market and other securities: 2006-\$75.3; 2005-\$100.0)	\$ 201.2	\$ 200.3
Cash and investments in money market and other securities (including money market and other securities: 2006-\$22.5; 2005-\$22.0)	\$ 25.6	\$ 53.3
Total assets	\$4,011.2	\$4,025.9
Total debt outstanding	\$1,208.9	\$1,284.8
Total shareholders' equity	\$2,690.0	\$2,620.5
Debt to equity ratio	0.45	0.49
Asset coverage ratio ⁽¹⁾	326%	309%

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

We have a liquidity portfolio that is composed of U.S. Treasury bills, money market securities and a certificate of deposit. At June 30, 2006, and December 31, 2005, the value and yield of the securities in the liquidity portfolio were as follows:

(\$ in millions)	2006		2005	
	Value	Yield	Value	Yield
U.S. Treasury bills ⁽¹⁾	\$125.9	4.9%	\$100.3	4.3%
Money market securities	55.3	5.0%	100.0	4.1%
Certificate of Deposit ⁽¹⁾	20.0	5.6%		
Total	\$201.2	5.0%	\$200.3	4.2%

⁽¹⁾ The Treasury bills and certificate of deposit mature in 2006.

The liquidity portfolio was established to provide a pool of liquid assets within our balance sheet. Our investment portfolio is primarily composed of private, illiquid assets for which there is no readily available market. Our portfolio's liquidity was reduced when we sold our portfolio of CMBS assets in May 2005, particularly BB rated bonds, which were generally more liquid than assets in our private finance portfolio. We will assess the amount held in and the composition of the liquidity portfolio throughout the year.

We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term securities. We place our cash

with financial institutions and, at times, cash held in checking accounts in financial institutions may be in excess of the Federal Deposit Insurance Corporation insured limit.

S-30

During the six months ended June 30, 2006, we sold equity of \$83.0 million. We did not sell new equity in a public offering during the six months ended June 30, 2005, or for the year ended December 31, 2005. In addition, shareholders equity increased by \$15.9 million, \$17.1 million and \$77.5 million through the exercise of employee options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the six months ended June 30, 2006 and 2005, and the year ended December 31, 2005, respectively.

We employ an asset-liability management approach that focuses on matching the estimated maturities of our investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$882.5 million on June 30, 2006. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate investment portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

On July 24, 2006, we sold 4.5 million shares of our common stock for proceeds of \$118.1 million, net of underwriting discounts and estimated offering expenses. In addition, on August 1, 2006, we sold 0.7 million shares of our common stock for proceeds of \$17.8 million, net of underwriting discounts and estimated offering expenses, pursuant to the underwriters over-allotment option related to the sale of the 4.5 million shares.

On July 25, 2006, we completed a public issuance of \$400 million of five-year, unsecured notes with a fixed interest rate of 6.625%. This debt matures on July 15, 2011. We have the option to redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes. We have certain financial and operating covenants that will be required by this public debt issuance, including that we will maintain a minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding.

The net proceeds from the debt and equity issuances were used to reduce borrowings under our revolving line of credit, with the remainder being used to fund new portfolio investments and for general corporate purposes. We currently have no borrowings outstanding on our revolving line of credit.

As a result of the equity and debt issuances in the third quarter of 2006, we expect that our leverage ratio will increase by the end of the third quarter of 2006 from the 0.45:1.00 level at June 30, 2006. We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.70:1.00 because we believe that it is prudent to operate with a larger equity capital base and less leverage.

At June 30, 2006, we had outstanding debt as follows:

(\$ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost ⁽¹⁾	Annual Return to Cover Interest Payments ⁽²⁾
Notes payable and debentures:				
Unsecured notes payable	\$1,190.6	\$1,190.6	6.2%	1.9%
SBA debentures	16.5	16.5	7.4%	
Total notes payable and debentures	1,207.1	1,207.1	6.2%	1.9%
Revolving line of credit	922.5	1.8	6.4% ⁽³⁾	0.1%
Total debt	\$2,129.6	\$1,208.9	6.6% ⁽⁴⁾	2.0%

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

(2) The annual portfolio return to cover interest payments is calculated as the June 30, 2006, annualized cost of debt per class of financing outstanding divided by total assets at June 30, 2006.

(3) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees, other facility fees and the amortization of debt financing costs of \$3.8 million at June 30, 2006.

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

Unsecured Notes Payable. We have issued unsecured long-term notes to institutional investors, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2006 and generally have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity.

On May 1, 2006, we issued \$50.0 million of long-term debt with a fixed interest rate of 6.75%. This debt matures in May 2013. The proceeds of this issuance were used to repay \$25 million of 7.49% unsecured long-term debt that matured on May 1, 2006, with the remainder being used to fund new portfolio investments and for general corporate purposes.

Small Business Administration Debentures. Through our small business investment company subsidiary, we have debentures payable to the Small Business Administration (SBA) with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. During the first half of 2006 and 2005, we repaid \$12.0 million and \$31.0 million, respectively, of this outstanding debt. We intend to repay the SBA in the third quarter of 2006 for the remaining outstanding borrowings of \$16.5 million. The prepayment penalty upon repayment will be approximately \$0.2 million. We currently do not have plans to borrow additional amounts from the SBA.

Revolving Line of Credit. At December 31, 2005, we had an unsecured revolving line of credit with a committed amount of \$772.5 million that expires on September 30, 2008. In May 2006, we expanded the committed amount to 922.5 million. The revolving line of credit is now fully committed. The revolving line of credit generally bears interest at a rate equal to (i) LIBOR (for the period we select) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount. The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

At June 30, 2006, there was \$1.8 million outstanding on our unsecured revolving line of credit. The amount available under the line at June 30, 2006, was \$882.5 million, net of amounts committed

S-32

for standby letters of credit of \$38.3 million. Net repayments under the revolving line of credit for the six months ended June 30, 2006, were \$90.0 million.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures outstanding at June 30, 2006. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. Our credit facilities also limit our ability to declare dividends if we default under certain provisions. As of June 30, 2006, we were in compliance with these covenants.

The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of June 30, 2006.

	Payments Due By Year						
	Total	2006	2007	2008	2009	2010	After 2010
(\$ in millions)							
Notes payable and debentures:							
Unsecured long-term notes payable	\$1,190.6	\$150.0	\$	\$153.0	\$268.1	\$408.0	\$211.5
SBA debentures	16.5						16.5
Revolving line of credit ⁽¹⁾	1.8			1.8			
Operating leases	26.7	2.2	4.4	4.5	4.6	4.4	6.6
Total contractual obligations	\$1,235.6	\$152.2	\$4.4	\$159.3	\$272.7	\$412.4	\$234.6

⁽¹⁾ At June 30, 2006, \$882.5 million remained unused and available, net of amounts committed for standby letters of credit of \$38.3 million issued under the credit facility.

Off-Balance Sheet Arrangements

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of June 30, 2006.

	Amount of Commitment Expiration Per Year						
	Total	2006	2007	2008	2009	2010	After 2010
(\$ in millions)							
Guarantees	\$163.3	\$2.5	\$0.7	\$3.0	\$151.6	\$	\$5.5
Standby letters of credit ⁽¹⁾	38.3	0.1		38.2			
Total commitments	\$201.6	\$2.6	\$0.7	\$41.2	\$151.6	\$	\$5.5

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

will expire contemporaneously with the expiration of our line of credit in September 2008.

In addition, we had outstanding commitments to fund investments totaling \$362.1 million at June 30, 2006. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

CRITICAL ACCOUNTING POLICIES

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

S-33

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

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

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. The value of loan and debt securities may be greater than our cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than our cost basis.

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

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

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

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

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

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

We recognize income from the amortization of original issue discount using the effective interest method using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CDO/ CLO Assets from the date the estimated yield was 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 primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

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

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

	June 30, 2006	December 31, 2005
(in thousands, except per share amounts)		
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2006-\$1,282,768; 2005-\$1,489,782)	\$1,188,131	\$1,887,651
Companies 5% to 25% owned (cost: 2006-\$371,550; 2005-\$168,373)	371,156	158,806
Companies less than 5% owned (cost: 2006-\$1,933,932; 2005-\$1,448,268)	1,901,139	1,432,833
Total private finance (cost: 2006-\$3,588,250; 2005-\$3,106,423)	3,460,426	3,479,290
Commercial real estate finance (cost: 2006-\$127,748; 2005-\$131,695)	133,051	127,065
Total portfolio at value (cost: 2006-\$3,715,998; 2005-\$3,238,118)	3,593,477	3,606,355
U.S. Treasury bills	125,940	100,305
Investments in money market and other securities	97,810	121,967
Deposits of proceeds from sales of borrowed Treasury securities	17,156	17,666
Accrued interest and dividends receivable	49,270	60,366
Other assets	124,448	87,858
Cash	3,106	31,363
Total assets	\$4,011,207	\$4,025,880
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures (maturing within one year: 2006-\$150,000; 2005-\$175,000)	\$1,207,137	\$1,193,040
Revolving line of credit	1,750	91,750
Obligations to replenish borrowed Treasury securities	17,156	17,666
Accounts payable and other liabilities	95,145	102,878
Total liabilities	1,321,188	1,405,334
Commitments and contingencies		
Shareholders' equity:		
Common stock, \$0.0001 par value, 200,000 shares authorized; 140,312 and 136,697 shares issued and outstanding at June 30, 2006, and December 31, 2005, respectively	14	14

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Additional paid-in capital	2,284,117	2,177,283
Common stock held in deferred compensation trust	(24,003)	(19,460)
Notes receivable from sale of common stock	(3,370)	(3,868)
Net unrealized appreciation (depreciation)	(136,929)	354,325
Undistributed earnings	570,190	112,252
Total shareholders equity	2,690,019	2,620,546
Total liabilities and shareholders equity	\$4,011,207	\$4,025,880
Net asset value per common share	\$ 19.17	\$ 19.17

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

S-36

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF OPERATIONS

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
(in thousands, except per share amounts)				
	(unaudited)		(unaudited)	
Interest and Related Portfolio Income:				
Interest and dividends				
Companies more than 25% owned	\$ 23,419	\$ 30,199	\$ 53,565	\$ 58,450
Companies 5% to 25% owned	11,419	5,597	17,069	11,518
Companies less than 5% owned	60,595	35,534	113,680	86,307
Total interest and dividends	95,433	71,330	184,314	156,275
Loan prepayment premiums				
Companies more than 25% owned	134		5,094	
Companies 5% to 25% owned				
Companies less than 5% owned	1,611	853	1,937	2,530
Total loan prepayment premiums	1,745	853	7,031	2,530
Fees and other income				
Companies more than 25% owned	5,515	7,877	12,642	12,758
Companies 5% to 25% owned	1,282	55	3,998	125
Companies less than 5% owned	6,481	6,092	13,482	9,438
Total fees and other income	13,278	14,024	30,122	22,321
Total interest and related portfolio income	110,456	86,207	221,467	181,126
Expenses:				
Interest	21,607	19,154	45,907	39,379
Employee	20,398	22,877	41,826	38,333
Stock options	4,597		8,203	
Administrative	9,861	23,048	21,380	43,802
Total operating expenses	56,463	65,079	117,316	121,514
Net investment income before income taxes	53,993	21,128	104,151	59,612
Income tax expense, including excise tax	3,798	5,861	12,656	5,593
Net investment income	50,195	15,267	91,495	54,019
Net Realized and Unrealized Gains (Losses):				
Net realized gains (losses)				

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Companies more than 25% owned	95,212	(17,884)	528,399	(17,485)
Companies 5% to 25% owned	(74)	4,711	(417)	4,708
Companies less than 5% owned	5,102	220,669	5,093	230,558
Total net realized gains	100,240	207,496	533,075	217,781
Net change in unrealized appreciation or depreciation	(116,706)	89,122	(491,254)	159,706
Total net gains (losses)	(16,466)	296,618	41,821	377,487
Net increase in net assets resulting from operations	\$ 33,729	\$ 311,885	\$ 133,316	\$ 431,506
Basic earnings per common share	\$ 0.24	\$ 2.33	\$ 0.96	\$ 3.23
Diluted earnings per common share	\$ 0.24	\$ 2.29	\$ 0.94	\$ 3.17
Weighted average common shares outstanding basic	140,024	133,701	139,395	133,493
Weighted average common shares outstanding diluted	143,213	136,381	142,466	135,982

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

S-37

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

	For the Six Months Ended June 30,	
	2006	2005
(in thousands, except per share amounts)		
	(unaudited)	
Operations:		
Net investment income	\$ 91,495	\$ 54,019
Net realized gains	533,075	217,781
Net change in unrealized appreciation or depreciation	(491,254)	159,706
Net increase in net assets resulting from operations	133,316	431,506
Shareholder distributions:		
Common stock dividends	(166,632)	(152,329)
Net decrease in net assets resulting from shareholder distributions	(166,632)	(152,329)
Capital share transactions:		
Sale of common stock	82,970	
Issuance of common stock for portfolio investments		7,200
Issuance of common stock in lieu of cash distributions	7,199	4,163
Issuance of common stock upon the exercise of stock options	8,226	12,689
Stock option expense	8,439	
Net decrease in notes receivable from sale of common stock	498	200
Purchase of common stock held in deferred compensation trust	(4,649)	(3,976)
Distribution of common stock held in deferred compensation trust	106	
Other		2,056
Net increase in net assets resulting from capital share transactions	102,789	22,332
Total increase in net assets	69,473	301,509
Net assets at beginning of period	2,620,546	1,979,778
Net assets at end of period	\$2,690,019	\$2,281,287
Net asset value per common share	\$ 19.17	\$ 17.01
Common shares outstanding at end of period	140,312	134,131

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,	
(in thousands)	2006	2005
	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$ 133,316	\$ 431,506
Adjustments:		
Portfolio investments	(1,071,243)	(647,248)
Principal collections related to investment repayments or sales	769,598	1,090,813
Change in accrued or reinvested interest and dividends	9,064	3,567
Amortization of discounts and fees	(3,094)	(3,334)
Redemption of (investments in) U.S. Treasury bills	(22,875)	
Redemption of (investments in) money market securities	25,581	(74,200)
Stock option expense	8,439	
Changes in other assets and liabilities	(1,410)	8,136
Depreciation and amortization	870	963
Realized gains from the receipt of notes and other securities as consideration from sale of investments, net of collections	(217,086)	(916)
Realized losses	4,405	41,643
Net change in unrealized (appreciation) or depreciation	491,254	(159,706)
 Net cash provided by (used in) operating activities	 126,819	 691,224
Cash flows from financing activities:		
Sale of common stock	82,970	
Sale of common stock upon the exercise of stock options	8,226	12,689
Collections of notes receivable from sale of common stock	498	200
Borrowings under notes payable and debentures	50,000	
Repayments on notes payable and debentures	(37,000)	(76,700)
Net borrowings under (repayments on) revolving line of credit	(90,000)	(112,000)
Purchase of common stock held in deferred compensation trust	(4,649)	(3,976)
Other financing activities	(1,590)	(1,958)
Common stock dividends and distributions paid	(163,531)	(150,826)
 Net cash provided by (used in) financing activities	 (155,076)	 (332,571)
 Net increase (decrease) in cash	 (28,257)	 358,653
Cash at beginning of period	31,363	57,160
 Cash at end of period	 \$ 3,106	 \$ 415,813

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS

June 30, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
(unaudited)				
Companies More Than 25% Owned				
Acme Paging, L.P. ⁽⁴⁾ (Telecommunications)	Senior Loan (6.0%, Due 12/07) ⁽⁶⁾ Subordinated Debt (10.0%, Due 1/08) ⁽⁶⁾ Common Stock (23,513 shares)	\$ 3,750 881	\$ 3,750 881 27	\$
Alaris Consulting, LLC (Business Services)	Senior Loan (16.5%, Due 12/05 12/07) ⁽⁹⁾ Equity Interests Guaranty (\$1,100)	27,055	27,018 5,305	
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Senior Loan (0.7%, Due 12/04 12/05) ⁽⁶⁾	4,997	4,599	4,329
Avborne, Inc. ⁽⁷⁾ (Business Services)	Preferred Stock (12,500 shares) Common Stock (27,500 shares)		658	773
Avborne Heavy Maintenance, Inc. ⁽⁷⁾ (Business Services)	Preferred Stock (1,568 shares) Common Stock (2,750 shares) Guaranty (\$2,401)		2,401	
Business Loan Express, LLC (Financial Services)	Class A Equity Interests Class B Equity Interests Class C Equity Interests Guaranty (\$149,162 See Note 3) Standby Letters of Credit (\$32,000 See Note 3)	64,427	64,427 119,436 109,301	64,427 130,890 121,900
Callidus Capital Corporation (Financial Services)	Senior Loan (12.0%, Due 12/06) Subordinated Debt (18.0%, Due 10/08)	1,650 5,276	1,650 5,276	1,650 5,276

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	Common Stock (10 shares)		2,058	12,093
Cambridge Capital Partners ⁽⁵⁾	Senior Loan (8.0%, Due 5/09) ⁽⁶⁾	250	250	250
(Financial Services)	Equity Interests		1,751	1,751
CR Brands, Inc.	Subordinated Debt (16.6%, Due 2/13)	38,898	38,712	38,712
(Consumer Products)	Common Stock (37,200,551 shares)		33,321	37,431
Diversified Group Administrators, Inc.	Preferred Stock (1,000,000 shares)		700	728
(Business Services)	Preferred Stock (1,451,380 shares)		841	841
	Common Stock (1,451,380 shares)			322
Financial Pacific Company	Subordinated Debt (17.4%, Due 2/12 8/12)	70,878	70,630	70,630
(Financial Services)	Preferred Stock (10,964 shares)		10,276	14,460
	Common Stock (14,735 shares)		14,819	44,418
ForeSite Towers, LLC	Equity Interests		7,620	12,818
(Tower Leasing)				

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

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

June 30, 2006				
Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	(unaudited)	
			Cost	Value
Global Communications, LLC (Business Services)	Senior Loan (10.7%, Due 9/02 11/07) ⁽⁶⁾	\$15,957	\$15,957	\$15,957
	Subordinated Debt (17.0%, Due 12/03 9/05) ⁽⁹⁾	11,339	11,336	9,648
	Preferred Equity Interest		14,067	
	Options		1,639	
Gordian Group, Inc. (Business Services)	Senior Loan (10.0%, Due 6/06 12/08) ⁽⁶⁾	11,792	11,812	
	Common Stock (1,000 shares)		6,762	
Healthy Pet Corp. (Consumer Services)	Senior Loan (9.5%, Due 8/10)	15,938	15,938	15,938
	Subordinated Debt (15.0%, Due 8/10)	43,286	43,125	43,125
	Common Stock (30,142 shares)		30,142	28,152
HMT, Inc. (Energy Services)	Preferred Stock (554,052 shares)		2,637	2,637
	Common Stock (300,000 shares)		3,000	7,942
	Warrants		1,155	3,058
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			870
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt (16.1%, Due 9/12)	59,284	59,067	59,067
	Preferred Stock (25,000 shares)		25,000	26,249
	Common Stock (620,000 shares)		6,325	218
Jakel, Inc. (Industrial Products)	Subordinated Debt (15.5%, Due 3/08) ⁽⁶⁾	14,442	14,442	2,533
	Preferred Stock (6,460 shares)		6,460	
	Common Stock (158,061 shares)		9,347	
Legacy Partners Group, LLC (Financial Services)	Senior Loan (14.0%, Due 5/09) ⁽⁶⁾	7,646	7,646	5,048
	Subordinated Debt (18.0%, Due 5/09) ⁽⁶⁾	2,952	2,952	
	Equity Interests		4,248	
Litterer Beteiligungs-GmbH ⁽⁴⁾ (Business Services)	Subordinated Debt (8.0%, Due 3/07)	658	658	658
	Equity Interest		1,809	1,615

Mercury Air Centers, Inc.	Subordinated Debt (16.0%, Due 4/09)			
(Business Services)	11/12)	48,369	48,198	48,198
	Common Stock (57,970 shares)		35,053	93,188
	Standby Letters of Credit (\$1,968)			
MVL Group, Inc.	Senior Loan (12.0%, Due 10/07 7/09)	26,498	26,324	26,324
(Business Services)	Subordinated Debt (14.5%, Due 6/09)	34,354	33,921	33,921
	Common Stock (648,661 shares)		643	1,262
Powell Plant Farms, Inc.	Senior Loan (15.0%, Due 12/06)	30,490	21,642	21,642
(Consumer Products)	Subordinated Debt (20.0%, Due 6/03) ⁽⁶⁾	19,291	19,223	
	Preferred Stock (1,483 shares)			
	Warrants			

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- (3) Public company.
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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

		June 30, 2006			
Private Finance Portfolio Company (in thousands, except number of shares)		Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
			(unaudited)		
Service Champ, Inc. (Business Services)	Subordinated Debt (15.5%, Due 4/12) Common Stock (63,888 shares)		\$ 27,384	\$ 27,260 13,662	\$ 27,260 16,322
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt (13.5%, Due 1/07) ⁽⁶⁾ Preferred Stock (439,600 shares) Common Stock (69,773 shares) Warrants Guaranty (\$1,300)		5,987	5,987 4,968 50 10	1,160
Startec Global Communications Corporation (Telecommunications)	Senior Loan (10.0%, Due 5/07 5/09) Common Stock (19,180,000 shares)		21,926	21,926 37,255	21,926 6,480
Triview Investments, Inc. ⁽⁸⁾ (Broadcasting & Cable/ Consumer Products)	Senior Loan (9.4%, Due 6/07) Subordinated Debt (15.0%, Due 7/12) Subordinated Debt (16.8%, Due 7/08 7/12) ⁽⁶⁾ Common Stock (202 shares) Guaranty (\$800) Standby Letter of Credit (\$200)		14,325 37,877 19,600	14,301 37,687 19,520 93,907	14,301 37,687 19,520 32,526
Total companies more than 25% owned				\$1,282,768	\$1,188,131

Companies 5% to 25% Owned

Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt (12.0%, Due 3/14) Equity Interests		\$150,775	\$ 150,056 2,048	\$ 150,056 15,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan (8.7%, Due 3/11 3/12) Subordinated Debt (14.0%, Due 11/12) Equity Interests		1,584 34,646	1,512 34,590 3,470	1,512 34,590 4,200

Amerex Group, LLC (Consumer Products)	Subordinated Debt (12.0%, Due 1/13) Equity Interests	8,400	8,400 3,583	8,400 3,583
BB&T Capital Partners/Windsor Mezzanine Fund, LLC ⁽⁵⁾ (Private Equity Fund)	Equity Interests		5,867	5,867
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt (14.5%, Due 8/12) Common Stock (5,073 shares)	23,939	23,850 5,813	23,850 2,400
BI Incorporated (Business Services)	Subordinated Debt (13.5%, Due 2/14) Common Stock (40,000 shares)	30,000	29,856 4,000	29,856 4,000

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (8) Triview Investments, Inc. holds investments in Longview Cable & Data, LLC (Broadcasting & Cable) with a cost of \$66.5 million and value of \$14.3 million and Triax Holdings, LLC (Consumer Products) with a cost of \$98.9 million and a value of \$89.7 million. The guaranty and standby letter of credit relate to Longview Cable & Data, LLC.

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

		June 30, 2006		
Private Finance		(unaudited)		
Portfolio Company	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
(in thousands, except number of shares)				
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan (4.0%, Due 8/09) ⁽⁶⁾ Subordinated Debt (10.0%, Due 8/14) ⁽⁶⁾ Convertible Subordinated Debt (2.0%, Due 8/14) ⁽⁶⁾ Equity Interests	\$ 7,164 5,184 2,970	\$ 7,164 5,184 984 1,306	\$ 6,595
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt (14.5%, Due 6/09) Equity Interests	10,805	10,781 1,742	10,781 1,730
Pres Air Trol LLC (Industrial Products)	Unitranche Debt (12.0%, Due 4/10) ⁽⁶⁾ Equity Interests	5,911	5,593 1,361	3,312
Progressive International Corporation (Consumer Products)	Subordinated Debt (16.0%, Due 12/09) Preferred Stock (500 shares) Common Stock (197 shares) Warrants	7,476	7,454 500 13	7,454 920 500
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan (11.1%, Due 6/12) Unitranche Debt (11.1%, Due 6/12) Equity Interests	1,000 20,000	980 19,900 1,500	980 19,900 1,500
SGT India Private Limited ⁽⁴⁾ (Business Services)	Common Stock (109,524 shares)		3,608	3,608
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt (11.7%, Due 11/10) Equity Interests	16,500	15,505 2,163	15,505 2,400
Universal Environmental Services, LLC (Business Services)	Unitranche Debt (13.5%, Due 2/09) Equity Interests	10,989	10,956 1,811	10,956 1,701
Total companies 5% to 25% owned			\$371,550	\$371,156

**Companies Less Than 5%
Owned**

3SI Security Systems, Inc. (Consumer Products)	Senior Loan (10.9%, Due 2/12 2/13) Subordinated Debt (14.4%, Due 8/13)	\$ 1,650 26,377	\$ 1,640 26,252	\$ 1,640 26,252
Anthony, Inc. (Industrial Products)	Subordinated Debt (13.2%, Due 8/11 9/12)	14,743	14,688	14,688
Benchmark Medical, Inc. (Healthcare Services)	Warrants		18	
Border Foods, Inc. (Consumer Products)	Subordinated Debt (13.0%, Due 12/10) ⁽⁶⁾ Preferred Stock (140,214 shares) Common Stock (1,810 shares) Warrants	13,428	12,721 2,893 45 910	
Broadcast Electronics, Inc. (Business Services)	Senior Loan (8.9%, Due 7/12)	4,988	4,953	4,953

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

		June 30, 2006		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
		(unaudited)		
C&K Market, Inc. (Retail)	Subordinated Debt (14.0%, Due 12/08)	\$25,744	\$25,651	\$25,651
Callidus Debt Partners CDO Fund I, Ltd. ⁽⁴⁾⁽⁹⁾ (Senior Debt Fund)	Class C Notes (12.9%, Due 12/13) Class D Notes (17.0%, Due 12/13)	18,800 9,400	18,962 9,481	18,962 9,481
Callidus Debt Partners CLO Fund III, Ltd. ⁽⁴⁾⁽⁹⁾ (Senior Debt Fund)	Preferred Shares (23,600,000 shares)		23,804	23,804
Callidus Debt Partners CLO Fund IV, Ltd. ⁽⁴⁾⁽⁹⁾ (Senior Debt Fund)	Income Notes		12,883	12,883
Callidus MAPS CLO Fund I LLC ⁽⁹⁾ (Senior Debt Fund)	Class E Notes (10.9%, Due 12/17) Income Notes	17,000	17,000 50,584	17,000 50,584
Camden Partners Strategic Fund II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,142	3,273
Carlisle Wide Plank Floors, Inc. (Consumer Products)	Unitranche Debt (10.5%, Due 6/11) Preferred Stock (400,000 Shares)	14,000	13,889 400	13,889 400
Catterton Partners V, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		3,065	3,150
Centre Capital Investors IV, LP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,753	1,655
Commercial Credit Group, Inc. (Financial Services)	Subordinated Debt (14.8%, Due 2/11) Preferred Stock (32,500 shares) Warrants	5,000	4,954 3,900	4,954 3,900

Community Education Centers, Inc. (Education Services)	Subordinated Debt (16.0%, Due 12/10)	33,643	33,540	33,540
Component Hardware Group, Inc. (Industrial Products)	Preferred Stock (18,000 shares)		2,605	3,000
	Common Stock (2,000 shares)		200	3,001
Cook Inlet Alternative Risk, LLC (Business Services)	Unitranche Debt (10.5%, Due 4/12) Equity Interests	74,800	74,412 2,000	74,412 2,000
Cooper Natural Resources, Inc. (Industrial Products)	Subordinated Debt (0%, Due 11/07)	559	559	866
	Preferred Stock (6,316 shares)		1,424	20
	Warrants		830	
Coverall North America, Inc. (Business Services)	Subordinated Debt (14.6%, Due 2/11)	27,664	27,621	27,621
	Preferred Stock (6,500 shares)		6,500	7,073
	Warrants		2,950	3,890
Deluxe Entertainment Services Group, Inc. (Business Services)	Subordinated Debt (13.7%, Due 7/11)	30,000	30,000	30,000

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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (9) The fund is managed by Callidus Capital, a portfolio company of Allied Capital.

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

June 30, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	(unaudited)		
		Principal	Cost	Value
Distant Lands Trading Co. (Consumer Products)	Senior Loan (9.2%, Due 1/11)	\$ 500	\$ 477	\$ 477
	Unitranche Debt (10.3%, Due 1/11)	25,000	24,888	24,888
	Common Stock (1,500 shares)		1,500	1,500
Drilltec Patents & Technologies Company, Inc. (Energy Services)	Subordinated Debt (18.0%, Due 8/06)	4,119	4,119	4,119
	Subordinated Debt (10.0%, Due 8/06) ⁽⁶⁾	10,994	10,918	16,018
DVS VideoStream, LLC (Business Services)	Unitranche Debt (11.0%, Due 2/12)	19,529	19,413	19,413
	Convertible Subordinated Debt (10.0%, Due 2/16)	3,551	3,534	3,534
Dynamic India Fund IV ⁽⁴⁾⁽⁵⁾ (Private Equity Fund)	Equity Interests		3,850	3,850
eCentury Capital Partners, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		5,649	194
Elexis Beta GmbH ⁽⁴⁾ (Industrial Products)	Options		426	50
Event Rentals, Inc. (Consumer Services)	Senior Loan (10.8%, Due 11/11)	23,739	23,631	23,631
Farley s & Sathers Candy Company, Inc. (Consumer Products)	Subordinated Debt (11.6%, Due 3/11)	20,000	19,905	19,905
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	320
Garden Ridge Corporation (Retail)	Subordinated Debt (7.0%, Due 5/12) ⁽⁶⁾	22,500	22,500	8,455
Geotrace Technologies, Inc. (Energy Services)	Subordinated Debt (10.0%, Due 6/09)	24,844	23,235	23,235
	Warrants		2,350	2,100

Ginsey Industries, Inc. (Consumer Products)	Subordinated Debt (12.5%, Due 3/07)	3,225	3,225	3,225
Grant Broadcasting Systems II (Broadcasting & Cable)	Subordinated Debt (5.0%, Due 6/09)	2,896	2,896	2,896
Grotech Partners, VI, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		8,279	5,695
Havco Wood Products LLC (Industrial Products)	Senior Loan (11.3%, Due 8/11) Unitranche Debt (10.7%, Due 8/11) Equity Interests	2,000 24,054	1,978 22,950 1,049	1,978 22,950 1,800
Haven Eldercare of New England, LLC ⁽¹⁰⁾ (Healthcare Services)	Subordinated Debt (12.0%, Due 8/09) ⁽⁶⁾	3,573	3,573	3,573
Haven Healthcare Management, LLC ⁽¹⁰⁾ (Healthcare Services)	Subordinated Debt (18.0%, Due 4/07) ⁽⁶⁾	76	160	125
HealthASPex Services Inc. (Business Services)	Senior Loan (4.0%, Due 7/08)	500	500	468

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

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

		June 30, 2006		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	(unaudited)		Value
		Principal	Cost	
The Hillman Companies, Inc. ⁽³⁾ (Consumer Products)	Subordinated Debt (10.0%, Due 9/11)	\$44,496	\$44,327	\$44,327
Homax Holdings, Inc. (Consumer Products)	Subordinated Debt (12.0%, Due 8/11)	14,000	13,110	13,110
	Preferred Stock (89 shares)		89	77
	Common Stock (28 shares)		6	6
	Warrants		1,106	1,261
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan (8.7%, Due 2/11-2/12)	47,080	47,080	47,080
	Subordinated Debt (13.9%, Due 8/12 2/13)	72,967	72,688	72,688
	Common Stock (375,000 shares) ⁽¹¹⁾		37,445	8,791
	Warrants			
Integrity Interactive Corporation (Business Services)	Unitranche Debt (10.5%, Due 2/12)	30,000	29,795	29,795
International Fiber Corporation (Industrial Products)	Subordinated Debt (14.0%, Due 6/12)	21,764	21,685	21,685
	Preferred Stock (25,000 shares)		2,500	2,100
Kodiak Fund LP ⁽⁵⁾ (Private Equity Fund)	Equity Interests		4,975	4,975
Line-X, Inc. (Consumer Products)	Senior Loan (9.0%, Due 8/11)	3,000	2,978	2,978
	Unitranche Debt (10.0% Due 8/11)	50,225	50,001	50,001
	Standby Letter of Credit (\$1,500)			
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares)		2,049	3,485
	Warrants			200
Meineke Car Care Centers, Inc. (Consumer Services)	Senior Loan (8.8%, Due 6/11)	28,000	27,877	27,877
	Subordinated Debt (11.9%, Due 6/12 6/13)	72,000	71,705	71,705
			26,985	23,152

	Common Stock (10,696,308 shares) ⁽¹¹⁾ Warrants			
MHF Logistical Solutions, Inc. (Business Services)	Subordinated Debt (13.2%, Due 6/12 6/13) Common Stock (21,425 shares) ⁽¹¹⁾ Warrants	45,075	44,853 21,425	44,853 21,425
Mid-Atlantic Venture Fund IV, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		6,600	2,908
Mogas Energy, LLC (Energy Services)	Subordinated Debt (9.5%, Due 3/12 4/12) Warrants	16,570	15,259 1,774	15,259 2,900
Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (10.5%, Due 12/11) Convertible Subordinated Debt (9.8%, Due 12/15)	38,060 12,000	38,283 12,072	38,283 12,072
N.E.W. Customer Service Companies, Inc. (Business Services)	Subordinated Debt (11.6%, Due 7/12)	40,000	40,013	40,013
Norwesco, Inc. (Industrial Products)	Subordinated Debt (12.6%, Due 1/12 7/12) Common Stock (559,603 shares) ⁽¹¹⁾ Warrants	82,271	81,925 38,313	81,925 55,992
Novak Biddle Venture Partners III, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,595	1,700

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- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (11) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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

S-46

		June 30, 2006		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	(unaudited)	
			Cost	Value
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		\$ 239	\$ 1,200
Odyssey Investment Partners Fund III, LP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,832	1,688
Opinion Research Corporation ⁽³⁾ (Business Services)	Warrants		996	166
Oriental Trading Company, Inc. (Consumer Products)	Common Stock (13,820 shares)			6,995
Palm Coast Data, LLC (Business Services)	Senior Loan (8.5%, Due 8/10)	\$ 15,569	15,501	15,501
	Subordinated Debt (15.5%, Due 8/12 8/15)	30,126	29,997	29,997
	Common Stock (21,743 shares) ⁽¹¹⁾		21,743	19,003
	Warrants			
Passport Health Communications, Inc. (Healthcare Services)	Subordinated Debt (14.0%, Due 4/12)	10,000	9,952	9,952
	Preferred Stock (651,381 shares)		2,000	2,000
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	150
Pro Mach, Inc. (Industrial Products)	Subordinated Debt (13.8%, Due 6/12)	14,471	14,396	14,396
	Equity Interests		1,500	2,650
Promo Works, LLC (Business Services)	Senior Loan (9.1%, Due 12/11)	3,000	2,953	2,953
	Unitranche Debt (10.3%, Due 12/11)	31,000	30,751	30,751
	Guaranty (\$1,500)			
Red Hawk Industries, LLC (Business Services)	Unitranche Debt (11.0%, Due 4/11)	56,342	56,088	56,088

S.B. Restaurant Company (Retail)	Unitranche Debt (10.3%, Due 4/11)	33,501	33,088	33,088
	Preferred Stock (54,125 shares)		135	135
	Warrants		619	1,200
	Standby Letters of Credit (\$2,611)			
SBBUT, LLC (Consumer Products)	Equity Interests			
Soff-Cut Holdings, Inc. (Industrial Products)	Preferred Stock (300 shares)		300	300
	Common Stock (2,000 shares)		200	114
SPP Mezzanine Fund, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,594	2,675
STS Operating, Inc. (Industrial Products)	Subordinated Debt (15.0%, Due 1/13)	30,000	29,854	29,854

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

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

		June 30, 2006		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	(unaudited) Cost	Value
The Step2 Company, LLC (Consumer Products)	Unitranche Debt (10.5%, Due 4/12) Equity Interests	\$68,000	\$ 67,517 2,000	\$ 67,517 2,000
Tradesmen International, Inc. (Business Services)	Subordinated Debt (12.0%, Due 12/09) Warrants	15,000	14,393 710	14,393 2,900
TransAmerican Auto Parts, LLC (Consumer Products)	Subordinated Debt (14.0%, Due 11/12) Equity Interests	12,818	12,760 1,190	12,760 1,039
TransTechnology Corporation ⁽³⁾ (Industrial Products)	Senior Loan (9.9%, Due 4/11)	10,000	10,000	10,000
Universal Air Filter Company (Industrial Products)	Unitranche Debt (11.0%, Due 11/11)	19,617	19,518	19,518
Universal Tax Systems, Inc. (Business Services)	Subordinated Debt (14.5%, Due 10/13)	19,310	19,243	19,243
Udata Venture Partners II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		5,077	4,898
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest		42	42
Venturehouse Group, LLC ⁽⁵⁾ (Private Equity Fund)	Equity Interest		598	407
VICORP Restaurants, Inc. ⁽³⁾ (Retail)	Warrants		33	33
Walker Investment Fund II, LLLP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,330	521

Wear Me Apparel Corporation (Consumer Products)	Subordinated Debt (15.0%, Due 12/10) Warrants	40,000	39,190 1,219	39,190 2,900
Wilton Industries, Inc. (Consumer Products)	Subordinated Debt (16.0%, Due 6/08)	4,800	4,800	4,800
Woodstream Corporation (Consumer Products)	Subordinated Debt (13.4%, Due 11/12 5/13) Common Stock (180 shares) Warrants	52,753	52,617 673	52,617 3,352 2,348
York Insurance Services Group, Inc. (Business Services)	Subordinated Debt (14.5%, Due 10/13) Common Stock (10,000 shares)	19,000	18,907 1,000	18,907 1,000
Other companies	Other debt investments ⁽⁶⁾ Other equity investments Guaranty (\$159)	453	453 8	334
Total companies less than 5% owned			\$1,933,932	\$1,901,139
Total private finance (131 portfolio companies)			\$3,588,250	\$3,460,426

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

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

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

			June 30, 2006	
	Interest Rate Ranges	Number of Loans	(unaudited)	
			Cost	Value
Commercial Mortgage Loans				
	Up to 6.99%	3	\$ 20,314	\$ 19,481
	7.00% 8.99%	25	48,798	49,024
	9.00% 10.99%	3	21,781	21,781
	11.00% 14.99%	1	2,291	2,291
	15.00% and above	2	3,970	3,970
Total commercial mortgage loans ⁽¹²⁾		34	\$ 97,154	\$ 96,547
Real Estate Owned			\$ 13,090	\$ 14,553
Equity Interests⁽²⁾ Companies more than 25% owned (Guarantees \$6,871)			\$ 17,504	\$ 21,951
Total commercial real estate finance			\$ 127,748	\$ 133,051
Total portfolio			\$3,715,998	\$3,593,477

	Yield	Cost	Value
Liquidity Portfolio			
U.S. Treasury bills (Due October 2006)	4.9%	\$ 24,996	\$ 25,067
U.S. Treasury bills (Due December 2006)	4.9%	100,004	100,873
SEI Daily Income Tr Prime Obligation Fund ⁽¹³⁾	5.0%	55,292	55,292
Certificate of Deposit (Due September 2006) ⁽¹³⁾	5.6%	20,000	20,000
Total liquidity portfolio		\$200,292	\$201,232
Other Investments in Money Market Securities⁽¹³⁾			
Columbia Treasury Reserves Money Market Fund	5.2%	\$ 19,280	\$ 19,280
PNC Bank Corporate Money Market Deposit Account	4.8%	\$ 524	\$ 524
Columbia Money Market Reserves	5.0%	\$ 2,714	\$ 2,714

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (12) Commercial mortgage loans totaling \$15.7 million at value were on non-accrual status and therefore were considered non-income producing.
- (13) Included in investments in money market and other securities on the accompanying Consolidated Balance Sheet.

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

S-49

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

(Information at and for the three and six months ended June 30, 2006 and 2005 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, Allied Investments L.P. (Allied Investments), 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 that are single member limited liability companies established primarily to hold real estate properties. ACC also has a subsidiary, A.C. Corporation (AC Corp), that generally provides diligence and structuring services as well as structuring, transaction, management, consulting and other services to the Company and its portfolio companies. AC Corp has a wholly-owned subsidiary, AC Finance LLC (AC Finance), that generally originates, underwrites and arranges senior loans.

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 has primarily invested in companies in a variety of industries.

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2005 balances to conform with the 2006 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2006, the results of operations for the three and six months ended June 30, 2006 and 2005, and changes in net assets and cash flows for the six months ended June 30, 2006 and 2005. The results of operations for the three and six months ended June 30, 2006, 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.

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

Valuation Of Portfolio Investments

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

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. The value of loan and debt securities may be greater than the Company's cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than the Company's cost basis.

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

Note 2. Summary of Significant Accounting Policies, continued

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. In general, interest is not accrued if the Company has doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status that are 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 capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. 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 plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Equity Securities

The Company's equity securities in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio 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, liquidation events, or other events. The determined equity values are generally discounted to account for restrictions on resale or minority ownership positions.

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

Dividend income on preferred equity securities is recorded as dividend income on an accrual basis to the extent that such amounts are expected to be collected and to the extent that the Company has the option to receive the dividend in cash. Dividend income on common equity

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

Note 2. Summary of Significant Accounting Policies, continued

securities is recorded on the record date for private companies or on the ex-dividend date for publicly traded companies.

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

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

The Company recognizes 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 CDO/ CLO Assets from the date the estimated yield was 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 primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

Fee Income

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

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

Note 2. Summary of Significant Accounting Policies, continued

Guarantees

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

Financing Costs

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

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company has a stock-based employee compensation plan. See Note 9. Effective January 1, 2006, the Company adopted the provisions of Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement). With respect to options granted prior to January 1, 2006, the Company has used the modified prospective method for adoption of the Statement. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006. With respect to options granted on or after January 1, 2006, compensation cost is recognized over the related service period in the statement of operations. The effect of this adoption for the three and six months ended June 30, 2006, was as follows:

	For the Three Months Ended June 30, 2006	For the Six Months Ended June 30, 2006
(\$ in millions, except per share amounts)		
Employee Stock Option Expense:		
Previously awarded, unvested options as of January 1, 2006	\$ 3.3	\$ 6.7
Options granted on or after January 1, 2006	1.3	1.5
 Total stock option expense	 \$ 4.6	 \$ 8.2
 Per basic share	 \$0.03	 \$0.06
Per diluted share	\$0.03	\$0.06

In addition to the employee stock option expense, for the three and six months ended June 30, 2006, administrative expense included \$0.2 million of expense related to options granted to directors during the period. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

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

Note 2. Summary of Significant Accounting Policies, continued

Prior to January 1, 2006, the Company accounted for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Prior to January 1, 2006, no stock-based compensation cost was 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 compensation for the three and six months ended June 30, 2005.

	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2005
(\$ in millions, except per share amounts)		
Net increase in net assets resulting from operations as reported	\$311.9	\$431.5
Less total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(4.1)	(7.0)
Pro forma net increase in net assets resulting from operations available to common shareholders	\$307.8	\$424.5
Basic earnings per common share:		
As reported	\$ 2.33	\$ 3.23
Pro forma	\$ 2.30	\$ 3.18
Diluted earnings per common share:		
As reported	\$ 2.29	\$ 3.17
Pro forma	\$ 2.26	\$ 3.12

The stock option expense for 2006 and the pro forma expense for 2005 shown in the tables above were based on the underlying value of the options granted by the Company. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following assumptions were used to calculate the fair value of options granted during the three and six months ended June 30, 2006 and 2005:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Risk-free interest rate	5.0%	4.1%	4.8%	4.1%
Expected life (in years)	5.0	5.0	5.0	5.0
Expected volatility	29.6%	35.5%	29.6%	35.5%
Dividend yield	9.0%	9.0%	9.0%	9.0%
Weighted average fair value per option	\$3.65	\$3.87	\$3.54	\$3.87

The risk free rate was based on the U.S. Treasury bond yield curve at the date of grant. The expected life of the options granted represents the period of time that such options are expected to be outstanding. To determine the expected life of the options, the Company used historical data to

S-55

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

Note 2. Summary of Significant Accounting Policies, continued

estimate option exercise time frames and option forfeitures, including considering employee terminations. Expected volatilities were determined based on the historical volatility of the Company's common stock. The dividend yield was determined based on the Company's historical dividend yield.

The Company estimates that the employee-related stock option expense under the Statement that will be recorded in the Company's statement of operations will be approximately \$16.1 million, \$10.1 million, and \$3.2 million for the years ended December 31, 2006, 2007, and 2008, respectively, which includes approximately \$2.6 million, \$1.4 million, and \$0.7 million, respectively, related to options granted in the first and second quarters of 2006. This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant. The aggregate total stock option expense remaining as of June 30, 2006, is expected to be recognized over an estimated weighted-average period of 1.38 years.

Federal and State Income Taxes and Excise Tax

The Company intends to comply with the requirements of the Internal Revenue Code (Code) that are applicable to regulated investment companies (RIC) and real estate investment trusts (REIT). ACC and any subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of their annual taxable income to shareholders; therefore, the Company has made no provision for income taxes for these entities. Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

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

Per Share Information

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

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

Note 2. Summary of Significant Accounting Policies, continued

Use of Estimates in the Preparation of Financial Statements

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

The consolidated financial statements include portfolio investments at value of \$3.6 billion at both June 30, 2006, and December 31, 2005. At both June 30, 2006, and December 31, 2005, 90% of the Company's total assets represented portfolio investments whose fair values have been determined by the Board of Directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the Board of Directors' determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

Note 3. Portfolio

Private Finance

At June 30, 2006, and December 31, 2005, the private finance portfolio consisted of the following:

	2006			2005		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in thousands)						
Loans and debt securities:						
Senior loans	\$ 322,041	\$ 275,874	9.5%	\$ 284,680	\$ 239,838	9.5%
Unitranche debt ⁽²⁾	517,287	515,006	10.7%	294,201	294,201	11.4%
Subordinated debt	1,769,369	1,700,324	13.9%	1,610,228	1,560,851	13.8%
Total loans and debt securities ⁽³⁾	2,608,697	2,491,204	12.7%	2,189,109	2,094,890	13.0%
Equity securities	979,553	969,222		917,314	1,384,400	
Total	\$3,588,250	\$3,460,426		\$3,106,423	\$3,479,290	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At June 30, 2006, and December 31, 2005, the cost and value of subordinated debt include the Class A equity interests in BLX and the guaranteed dividend yield on these equity interests is included in interest income. The weighted average yield is computed as of the balance sheet date.

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

(3) The total principal balance outstanding on loans and debt securities was \$2,637.0 million and \$2,216.3 million at June 30, 2006, and December 31, 2005, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$28.3 million

and \$27.2 million at June 30, 2006, and December 31, 2005, respectively.

The Company's private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. The Company's private finance

S-57

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

Note 3. Portfolio, continued

investments are generally issued by private companies and are generally illiquid and may be subject to certain restrictions on resale.

The Company's private finance debt investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. The annual stated interest rate is only one factor in pricing the investment relative to the Company's rights and priority in the portfolio company's capital structure, and will vary depending on many factors, including if the Company has received nominal cost equity or other components of investment return, such as loan origination fees or market discount. The stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity.

At June 30, 2006, 86% of the private finance loans and debt securities had a fixed rate of interest and 14% had a floating rate of interest. At December 31, 2005, 87% of the private finance loans and debt securities had a fixed rate of interest and 13% had a floating rate of interest. Senior loans generally carry a floating rate of interest, usually set as a spread over LIBOR. Senior loans generally have contractual maturities of three to six years and interest is generally paid to the Company monthly or quarterly. Loans other than senior loans generally carry a fixed rate of interest with contractual maturities of five to ten years. Loan and debt securities generally have interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest is generally paid to the Company quarterly.

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

The Company's largest investment at value at June 30, 2006, was in Business Loan Express, LLC (BLX). The Company's largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. (Advantage) and BLX. On March 29, 2006, the Company sold its majority equity interest in Advantage.

Business Loan Express, LLC. The Company's investment in BLX totaled \$293.2 million at cost and \$317.2 million at value at June 30, 2006, and \$299.4 million at cost and \$357.1 million at value

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

Note 3. Portfolio, continued

at December 31, 2005. BLX is a small business lender that participates in the U.S. Small Business Administration's 7(a) Guaranteed Loan Program. At June 30, 2006, and December 31, 2005, the Company owned 94.9% of the voting Class C equity interests. BLX has an equity appreciation rights plan for management which will dilute the value available to the Class C equity interest holders. BLX is headquartered in New York, NY.

Total interest and related portfolio income earned from the Company's investment in BLX for the three and six months ended June 30, 2006 and 2005, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
(\$ in millions)				
Interest income on subordinated debt and Class A equity interests	\$4.0	\$3.5	\$ 7.8	\$ 6.9
Dividend income on Class B equity interests		3.0		5.0
Fees and other income	2.0	2.3	4.3	4.7
 Total interest and related portfolio income	 \$6.0	 \$8.8	 \$12.1	 \$16.6

Interest income from BLX for the three and six months ended June 30, 2006 included interest income of \$1.9 million and \$3.7 million, respectively, which was paid in kind. Interest income from BLX for the three and six months ended June 30, 2005, included interest income of \$1.7 million and \$3.3 million, respectively, which was paid in kind. The interest paid in kind was paid to the Company through the issuance of additional Class A equity interests.

Net change in unrealized appreciation or depreciation included a net decrease in unrealized appreciation on the Company's investment in BLX of \$10.9 million and \$33.6 million for the three and six months ended June 30, 2006, respectively. Net change in unrealized appreciation or depreciation for the three and six months ended June 30, 2005, included a net increase in unrealized appreciation of \$7.6 million and \$1.3 million, respectively, on the Company's investment in BLX.

At December 31, 2005, the Company had a commitment to BLX of \$30.0 million in the form of a subordinated revolving credit facility to provide working capital to BLX. There was \$10.0 million outstanding under this facility at December 31, 2005. Outstanding borrowings under this facility were repaid in full and this facility matured on April 30, 2006.

As a limited liability company, BLX's taxable income flows through directly to its members. BLX's annual taxable income generally differs from its book income for the fiscal year due to temporary and permanent differences in the recognition of income and expenses. The Company holds all of BLX's Class A and Class B interests, and 94.9% of the Class C interests. BLX's taxable income is first allocated to the Class A interests to the extent that dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and Class C interests. BLX may declare dividends on its Class B interests. If declared, BLX would determine the amount of such dividend considering its estimated annual taxable income allocable to such interests.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company in 2003, for tax purposes BLX had a built-in gain representing the aggregate fair market value of its assets in excess of the tax basis of its assets. As a RIC, the Company will be

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

Note 3. Portfolio, continued

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

At June 30, 2006, and December 31, 2005, the Company considered the increase in fair value of its investment in BLX due to BLX's tax attributes as an LLC and has also considered the reduction in fair value of its investment due to these estimated built-in gain taxes in determining the fair value of its investment in BLX. At June 30, 2006, the Company estimated that the built-in gain tax liability would be approximately \$16 million.

At December 31, 2005, BLX had a three-year \$275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, the Company had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. The total obligation guaranteed by the Company at December 31, 2005, was \$135.4 million.

On March 17, 2006, BLX closed on a new three-year \$500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to \$600.0 million at BLX's option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. The Company has provided an unconditional guaranty to these BLX credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) on this facility. The amount guaranteed by the Company at June 30, 2006, was \$149.2 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility, which includes certain defaults under the Company's revolving credit facility. BLX has determined it was in compliance with the terms of this facility at June 30, 2006.

At June 30, 2006, the Company had also provided four standby letters of credit totaling \$32.0 million in connection with four term securitization transactions completed by BLX. In consideration for providing the revolving credit facility guaranty and the standby letters of credit, BLX paid the Company fees of \$1.6 million and \$1.5 million for the three months ended June 30, 2006 and 2005, respectively, and \$3.1 million and \$3.2 million for the six months ended June 30, 2006 and 2005, respectively.

Advantage Sales and Marketing, Inc. In June 2004, the Company completed the purchase of a majority voting ownership in Advantage, which was subject to dilution by a management option pool.

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

Note 3. Portfolio, continued

Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

At December 31, 2005, the Company's investment in Advantage totaled \$257.7 million at cost and \$660.4 million at value, which included unrealized appreciation of \$402.7 million.

On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company was repaid its \$184 million in subordinated debt outstanding and realized a gain on its equity investment sold of \$433.7 million, subject to post-closing adjustments. As consideration for the common stock sold in the transaction, the Company received a \$150 million subordinated note, with the balance of the consideration paid in cash. Approximately \$34 million of the Company's cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. In addition, there is potential for the Company to receive additional consideration through an earn-out payment that would be based on Advantage's 2006 audited results. The Company's realized gain of \$433.7 million, subject to post-closing adjustments, excludes any earn-out amounts. In connection with the transaction, the Company retained an equity investment in the business valued at \$15 million at closing as a minority shareholder.

After the sale transaction, the Company's investment in Advantage at June 30, 2006, which was composed of subordinated debt and a minority equity interest, totaled \$152.1 million at cost and \$165.1 million at value. This investment was included in companies 5% to 25% owned in the consolidated financial statements as the Company continues to hold a seat on Advantage's board of directors.

Total interest and related portfolio income earned from the Company's investment in Advantage while the Company held a majority equity interest for the six months ended June 30, 2006 and 2005, was \$14.1 million and \$18.5 million, respectively.

There was no net change in unrealized appreciation or depreciation for the three months ended June 30, 2006, related to the Company's investment in Advantage. Net change in unrealized appreciation or depreciation for the six months ended June 30, 2006, included the reversal of \$389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of the Company's majority equity interest in Advantage and for the three and six months ended June 30, 2005, included an increase in unrealized appreciation of \$51.0 million and \$119.9 million, respectively, related to the Company's investment in Advantage.

Collateralized Loan Obligations (CLOs) and Collateralized Debt Obligations (CDOs) At June 30, 2006, and December 31, 2005, the Company owned bonds and preferred shares/income

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

Note 3. Portfolio, continued

notes in collateralized loan obligations (CLOs) and a collateralized debt obligation (CDO) as follows:

	2006		2005	
	Cost	Value	Cost	Value
(\$ in millions)				
Callidus Debt Partners CDO Fund I, Ltd.	\$ 28.4	\$ 28.4	\$ 28.5	\$ 28.5
Callidus Debt Partners CLO Fund III, Ltd.	23.8	23.8	24.2	24.2
Callidus Debt Partners CLO Fund IV, Ltd.	12.9	12.9		
Callidus MAPS CLO Fund I LLC	67.6	67.6	65.1	65.1
Total	\$132.7	\$132.7	\$117.8	\$117.8

These CLO and CDO investments are managed by Callidus Capital, a portfolio company controlled by the Company.

The bonds, preferred shares and income notes of the CLOs and CDO in which the Company has invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes would bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes.

At both June 30, 2006 and December 31, 2005, the face value of the CLO and CDO bonds held by the Company were subordinate to approximately 82% to 85% of the face value of the securities issued in these CLOs and CDO. At both June 30, 2006 and December 31, 2005, the face value of the CLO preferred shares/income notes held by the Company were subordinate to approximately 86% to 91% of the face value of the securities issued in these CLOs.

At June 30, 2006, and December 31, 2005, the underlying collateral assets of these CLO and CDO investments, consisting primarily of senior debt, were issued by 413 issuers and 336 issuers, respectively, and had balances as follows:

	2006	2005
(\$ in millions)		
Bonds	\$ 242.8	\$ 230.7
Syndicated Loans	1,304.9	704.0
Cash ⁽¹⁾	126.0	238.4
Total underlying collateral assets	\$1,673.7	\$1,173.1

⁽¹⁾ Includes undrawn liability amounts.

At June 30, 2006, and December 31, 2005, there were no delinquencies in the underlying collateral assets of the CLO and CDO issuances owned by the Company.

The initial yields on the CLO and CDO bonds, preferred shares and income notes are based on the estimated future cash flows from the underlying collateral assets expected to be paid to these CLO and CDO classes. As each CLO and CDO bond, preferred share or income note ages, the

S-62

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

Note 3. Portfolio, continued

estimated future cash flows are updated based on the estimated performance of the underlying collateral assets, and the respective yield is adjusted as necessary. As future cash flows are subject to uncertainties and contingencies that are difficult to predict and are subject to future events that may alter current assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

Loans and Debt Securities on Non-Accrual Status. At June 30, 2006, and December 31, 2005, private finance loans and debt securities at value not accruing interest were as follows:

	2006	2005
(\$ in thousands)		
Loans and debt securities in workout status (classified as Grade 4 or 5)		
Companies more than 25% owned	\$17,670	\$ 15,622
Companies 5% to 25% owned	3,312	
Companies less than 5% owned	24,598	11,417
Loans and debt securities not in workout status		
Companies more than 25% owned	40,775	58,047
Companies 5% to 25% owned	6,595	534
Companies less than 5% owned	3,922	49,458
Total	\$96,872	\$135,078

Industry and Geographic Compositions. The industry and geographic compositions of the private finance portfolio at value at June 30, 2006, and December 31, 2005, were as follows:

	2006	2005
Industry		
Business services	31%	42%
Consumer products	24	14
Financial services	14	14
Industrial products	9	10
Consumer services	7	6
Healthcare services	3	2
Retail	2	3
Energy services	2	2
Other ⁽¹⁾	8	7
Total	100%	100%

⁽¹⁾ Includes investments in senior debt CDO and CLO funds. These funds invest in senior debt representing a variety of industries.

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

Note 3. Portfolio, continued

Geographic Region⁽¹⁾		
Mid-Atlantic	34%	29%
Midwest	26	21
West	20	34
Southeast	16	12
Northeast	4	4
Total	100%	100%

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

Commercial Real Estate Finance

At June 30, 2006, and December 31, 2005, the commercial real estate finance portfolio consisted of the following:

	2006			2005		
	Cost	Value	Yield⁽¹⁾	Cost	Value	Yield⁽¹⁾
(\$ in thousands)						
Commercial mortgage loans	\$ 97,154	\$ 96,547	8.1%	\$ 103,878	\$ 102,569	7.6%
Real estate owned	13,090	14,553		14,240	13,932	
Equity interests	17,504	21,951		13,577	10,564	
Total	\$ 127,748	\$ 133,051		\$ 131,695	\$ 127,065	

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

Commercial Mortgage Loans and Equity Interests. The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At both June 30, 2006, and December 31, 2005, approximately 97% and 3% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. At June 30, 2006, and December 31, 2005, loans with a value of \$15.7 million and \$20.8 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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

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

Note 3. Portfolio, continued

The property types and the geographic composition securing the commercial mortgage loans and equity interests at value at June 30, 2006, and December 31, 2005, were as follows:

	2006	2005
Property Type		
Hospitality	36%	37%
Housing	27	30
Office	18	11
Retail	15	16
Other	4	6
Total	100%	100%
Geographic Region		
Mid-Atlantic	33%	31%
Southeast	30	25
West	16	18
Midwest	15	21
Northeast	6	5
Total	100%	100%

Note 4. Debt

At June 30, 2006, and December 31, 2005, the Company had the following debt:

	2006			2005		
	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾
(\$ in thousands)						
Notes payable and debentures:						
Unsecured notes payable	\$1,190,637	\$1,190,637	6.2%	\$1,164,540	\$1,164,540	6.2%
SBA debentures	16,500	16,500	7.4%	28,500	28,500	7.5%
Total notes payable and debentures	1,207,137	1,207,137	6.2%	1,193,040	1,193,040	6.3%
Revolving line of credit	922,500	1,750	6.4% ⁽²⁾	772,500	91,750	5.6% ⁽²⁾
Total debt	\$2,129,637	\$1,208,887	6.6%⁽³⁾	\$1,965,540	\$1,284,790	6.5%⁽³⁾

- (1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus the annual amortization of commitment fees, other facility fees and amortization of debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.
- (2) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$3.8 million and \$3.3 million at June 30, 2006, and December 31, 2005, respectively.
- (3) The annual interest cost for total debt includes the annual cost of commitment fees, other facility fees and amortization of debt financing costs on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

S-65

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

Note 4. Debt, continued*Notes Payable and Debentures*

Unsecured Notes Payable. The Company has issued unsecured long-term notes to institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At June 30, 2006, the notes had maturities from October 2006 to May 2013. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

On May 1, 2006, the Company issued \$50 million of seven-year, unsecured notes with a fixed interest rate of 6.75%. This debt matures in May 2013. The proceeds from the issuance of the notes were used to repay \$25 million of 7.49% unsecured long-term notes that matured on May 1, 2006, with the remainder being used to fund new portfolio investments and for general corporate purposes.

On July 25, 2006, the Company completed a public issuance of \$400 million of five-year, unsecured notes with a fixed interest rate of 6.625%. This debt matures on July 15, 2011. The Company has the option to redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes. The Company has certain financial and operating covenants that will be required by this public debt issuance, including that the Company will maintain a minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding.

SBA Debentures. At June 30, 2006, and December 31, 2005, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 6.3% and 5.9% to 6.4%, respectively. At June 30, 2006, the debentures had remaining maturities of five to six years. 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 the fifth anniversary date of the notes. During the first half of 2006 and 2005, the Company repaid \$12.0 million and \$31.0 million, respectively, of the SBA debentures.

Scheduled Maturities. Scheduled future maturities of notes payable and debentures at June 30, 2006, were as follows:

Year	Amount Maturing
	(\$ in thousands)
2006	\$ 150,000
2007	
2008	153,000
2009	268,137
2010	408,000
Thereafter	228,000
Total	\$ 1,207,137

Revolving Line of Credit

At December 31, 2005, the Company had an unsecured revolving line of credit with a committed amount of \$772.5 million that expires on September 30, 2008. In May 2006, the Company expanded the committed amount to \$922.5 million. The revolving line of credit is now fully

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

Note 4. Debt, continued

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

The annual cost of commitment fees, other facility fees and amortization of debt financing costs was \$3.8 million and \$3.3 million at June 30, 2006 and December 31, 2005, respectively.

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

The average debt outstanding on the revolving line of credit was \$201.7 million and \$64.4 million for the six months ended June 30, 2006 and 2005, respectively. The maximum amount borrowed under this facility and the weighted average stated interest rate for the six months ended June 30, 2006 and 2005, were \$540.3 million and 6.0%, respectively, and \$263.3 million and 4.4%, respectively. As of June 30, 2006, the amount available under the revolving line of credit was \$882.5 million, net of amounts committed for standby letters of credit of \$38.3 million issued under the credit facility.

Covenant Compliance

The Company has various financial and operating covenants required by the notes payable and debentures and the revolving line of credit outstanding at June 30, 2006. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of June 30, 2006, and December 31, 2005, the Company was in compliance with these covenants.

Note 5. Guarantees and Commitments

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. All standby letters of credit have been issued through Bank of America, N.A. As of June 30, 2006, and December 31, 2005, the Company had issued guarantees of debt, rental obligations, and lease obligations aggregating \$163.3 million and \$148.6 million, respectively, and had extended standby letters of credit aggregating \$38.3 million and \$37.1 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of potential future payments was \$201.6 million and \$185.7 million at June 30, 2006, and December 31, 2005, respectively. At June 30, 2006, and December 31, 2005, \$2.6 million and \$2.5 million, respectively,

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

Note 5. Guarantees, continued

had been recorded as a liability for the Company's guarantees and no amounts had been recorded as a liability for the Company's standby letters of credit.

As of June 30, 2006, the guarantees and standby letters of credit expire as follows:

(in millions)	Total	2006	2007	2008	2009	2010	After 2010
Guarantees	\$163.3	\$2.5	\$0.7	\$ 3.0	\$151.6	\$	\$5.5
Standby letters of credit ⁽¹⁾	38.3	0.1		38.2			
Total	\$201.6	\$2.6	\$0.7	\$41.2	\$151.6	\$	\$5.5

⁽¹⁾ Standby letters of credit are issued under the Company's revolving line of credit that expires in September 2008.

Therefore, unless a standby letter of credit is set to expire at an earlier date, it is assumed that the standby letters of credit will expire contemporaneously with the expiration of the Company's line of credit in September 2008.

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

At June 30, 2006, the Company had outstanding commitments to fund investments totaling \$362.1 million, including \$352.7 million related to private finance investments and \$9.4 million related to commercial real estate finance investments. In addition, during the fourth quarter of 2004 and the first quarter of 2005, the Company sold certain commercial mortgage loans that the Company may be required to repurchase under certain circumstances. These recourse provisions expire by April 2007. The aggregate outstanding principal balance of these sold loans was \$11.2 million at June 30, 2006.

Note 6. Shareholders' Equity

Sales of common stock for the six months ended June 30, 2006 and 2005, were as follows:

(in thousands)	2006	2005 ⁽¹⁾
Number of common shares	3,000	
Gross proceeds	\$87,750	\$
Less costs, including underwriting fees	4,780	
Net proceeds	\$82,970	\$

⁽¹⁾ The Company did not sell any common stock during the six months ended June 30, 2005.

On July 24, 2006, the Company sold 4.5 million shares of its common stock for proceeds of \$118.1 million, net of underwriting discounts and estimated offering expenses. On August 1, 2006, the Company completed the sale of 0.7 million shares of common stock pursuant to the underwriter's over-allotment option for net proceeds, after the underwriting discount and estimated offering expenses, of \$17.8 million.

The Company issued 0.3 million shares of common stock with a value of \$7.2 million as consideration for an additional investment in Mercury Air Centers, Inc. during the six months ended June 30, 2005.

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

Note 6. Shareholders Equity, continued

The Company issued 0.4 million and 0.6 million shares of common stock upon the exercise of stock options during the six months ended June 30, 2006 and 2005, respectively.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive trading days immediately prior to the dividend payment date. For the six months ended June 30, 2006 and 2005, the Company issued new shares in order to satisfy dividend reinvestment requests.

Dividend reinvestment plan activity for the six months ended June 30, 2006 and 2005, was as follows:

	For the Six Months Ended June 30,	
(in thousands, except per share amounts)	2006	2005
Shares issued	243	151
Average price per share	\$29.63	\$27.58

Note 7. Earnings Per Common Share

Earnings per common share for the three and six months ended June 30, 2006 and 2005, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
(in thousands, except per share amounts)	2006	2005	2006	2005
Net increase in net assets resulting from operations available to common shareholders	\$ 33,729	\$ 311,885	\$ 133,316	\$ 431,506
Weighted average common shares outstanding basic	140,024	133,701	139,395	133,493
Dilutive options outstanding	3,189	2,680	3,071	2,489
Weighted average common shares outstanding diluted	143,213	136,381	142,466	135,982
Basic earnings per common share	\$ 0.24	\$ 2.33	\$ 0.96	\$ 3.23
Diluted earnings per common share	\$ 0.24	\$ 2.29	\$ 0.94	\$ 3.17

Note 8. Employee Compensation Plans

The Company has a deferred compensation plan. Amounts deferred by participants under the deferred compensation plan are funded to a trust, which is administered by trustees. The accounts of the deferred compensation trust are consolidated with the Company's accounts. The assets of the

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

Note 8. Employee Compensation Plans, continued

trust are classified as other assets and the liability to the plan participants is included in other liabilities in the accompanying financial statements. The deferred compensation plan accounts at June 30, 2006, and December 31, 2005, totaled \$17.1 million and \$16.6 million, respectively.

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

The IPA is generally determined annually at the beginning of each year but may be adjusted throughout the year. The IPA is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the DCP II to require the trustee to use the cash to purchase shares of the Company s common stock in the open market. During both the six months ended June 30, 2006 and 2005, 0.2 million shares were purchased in the DCP II.

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

During any period of time in which a participant has an account in the DCP II, any dividends declared and paid on shares of the Company s common stock allocated to the participant s account shall be reinvested by the trustee as soon as practicable in shares of the Company s common stock purchased in the open market.

The IPA amounts are contributed into the DCP II trust and invested in the Company s common stock. The accounts of the DCP II are consolidated with the Company s accounts. The common stock is classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represents the amount owed to the employees, is included in other liabilities. Changes in the value of the Company s common stock held in the deferred compensation trust are not recognized. However, the liability is marked to market

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

Note 8. Employee Compensation Plans, continued

with a corresponding charge or credit to employee compensation expense. At June 30, 2006, and December 31, 2005, common stock held in DCP II was \$24.0 million and \$19.5 million, respectively, and the IPA liability was \$26.4 million and \$22.3 million, respectively. At June 30, 2006, and December 31, 2005, the DCP II held 0.9 million and 0.7 million shares, respectively, of the Company's common stock.

The IPA expenses for the three and six months ended June 30, 2006 and 2005, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
(\$ in millions)				
IPA contributions	\$ 2.1	\$ 1.9	\$ 3.8	\$ 3.8
IPA mark to market expense (benefit)	(1.5)	1.8	(0.6)	1.9
Total IPA expense	\$ 0.6	\$ 3.7	\$ 3.2	\$ 5.7

The Company also has an individual performance bonus (IPB) plan which is distributed in cash to award recipients in equal bi-weekly installments as long as the recipient remains employed by the Company. If a recipient terminated employment during the year, any remaining cash payments under the IPB would be forfeited. For the three months ended June 30, 2006 and 2005, the IPB expense was \$2.2 million and \$2.0 million, respectively. For both the six months ended June 30, 2006 and 2005, the IPB expense was \$3.6 million. The IPA and IPB expenses are included in employee expenses.

Note 9. Stock Option Plan

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

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

There are 32.2 million shares authorized under the Option Plan. At June 30, 2006, and December 31, 2005, the number of shares available to be granted under the Option Plan was 1.8 million and 3.0 million, respectively.

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

Note 9. Stock Option Plan, continued

Information with respect to options granted, exercised and forfeited under the Option Plan for the six months ended June 30, 2006, was as follows:

	Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Remaining Term (Years)	Aggregate Intrinsic Value at June 30, 2006 ⁽¹⁾
(in thousands, except per share amounts)				
Options outstanding at January 1, 2006	22,259	\$24.52		
Granted	1,505	\$29.75		
Exercised	(373)	\$22.09		
Forfeited	(277)	\$27.68		
Outstanding at June 30, 2006	23,114	\$24.86	6.78	\$92,792
Exercisable at June 30, 2006	16,848	\$23.71	6.11	\$86,399
Exercisable and expected to be exercisable at June 30, 2006 ⁽²⁾	22,442	\$24.77	6.73	\$92,101

⁽¹⁾ Represents the difference between the market value of the options at June 30, 2006, and the cost for the option holders to exercise the options.

⁽²⁾ The amount of options expected to be exercisable at June 30, 2006, is calculated based on an estimate of expected forfeitures.

The fair value of the shares vested during the six months ended June 30, 2006 and 2005, was \$16.1 million for both periods. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005, was \$2.9 million and \$4.1 million, respectively.

Note 10. Dividends and Distributions and Taxes

The Company's Board of Directors declared and the Company paid a dividend of \$0.59 and \$0.60 per common share for the first and second quarters of 2006, respectively, and \$0.57 per common share for each of the first and second quarters of 2005. These dividends totaled \$166.6 million and \$152.3 million for the six months ended June 30, 2006 and 2005, respectively. The Company declared an extra cash dividend of \$0.03 per share during 2005 and this was paid to shareholders on January 27, 2006.

The Company's Board of Directors also declared a dividend of \$0.61 per common share for the third quarter of 2006.

The Company will generally be required to pay a nondeductible excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions for the year. The Company currently estimates that its 2006 annual taxable income will be in excess of its dividend distributions from such taxable income in 2006, and that such estimated excess taxable income will be carried over for distribution in 2007. The Company accrues an excise tax on the estimated excess taxable income earned for the respective periods. For the three and six months

ended June 30, 2006, the Company accrued an excise tax of \$3.2 million and \$11.6 million, respectively. There was no excise tax accrual for the three months ended March 31, 2005, and the Company accrued an excise tax of \$4.0 million for the three months ended June 30, 2005.

S-72

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

Note 11. Supplemental Disclosure of Cash Flow Information

For the six months ended June 30, 2006 and 2005, the Company paid \$46.0 million and \$40.1 million, respectively, for interest.

Principal collections related to investment repayments or sales included the collection of discounts previously amortized into interest income and added to the cost basis of a loan or debt security totaling \$0.2 million and \$7.6 million for the six months ended June 30, 2006 and 2005, respectively.

Non-cash operating activities for the six months ended June 30, 2006, included the following:

a note received as consideration from the sale of the Company's equity investment in Advantage of \$150.0 million;

a note received as consideration from the sale of the Company's equity investment in STS Operating, Inc. of \$30.0 million;

the exchange of existing debt securities and accrued interest of S.B. Restaurant Company with a cost basis of \$29.2 million for new debt securities; and

the exchange of existing preferred stock and common stock of Redox Brands, Inc. with a cost basis of \$10.2 million for common stock in CR Brands, Inc.

Non-cash operating activities for the six months ended June 30, 2005, included the following:

the exchange of existing subordinated debt securities and accrued interest of BLX with a cost basis of \$44.8 million for additional Class B equity interests;

the exchange of debt securities and accrued interest of Coverall North America, Inc. with a cost basis of \$24.2 million for new debt securities and warrants with a total cost basis of \$26.8 million;

the exchange of debt securities of Garden Ridge Corporation with a cost basis of \$25.0 million for a new loan with a cost basis of \$22.5 million; and

the contribution to capital of existing debt securities of GAC Investments, Inc. (GAC) with a cost basis of \$11.0 million, resulting in a decrease in the Company's debt cost basis and an increase in the Company's common stock cost basis in GAC. During the third quarter of 2005, GAC changed its name to Triview Investments, Inc.

For the six months ended June 30, 2006 and 2005, the Company's non-cash financing activities included \$7.2 million and \$4.2 million, respectively, related to the issuance of common stock in lieu of cash distributions. In addition, the non-cash financing activities for the six months ended June 30, 2005, also included the issuance of \$7.2 million of the Company's common stock as consideration for an additional investment in Mercury Air Centers, Inc.

Note 12. Hedging Activities

The Company has invested in commercial mortgage loans that were purchased at prices that were based in part on comparable Treasury rates. The Company has entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of these

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

Note 12. Hedging Activities, continued

commercial mortgage loans. These transactions, referred to as short sales, involve the Company receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities at value, including accrued interest payable on the obligations, as of June 30, 2006, and December 31, 2005, consisted of the following:

(\$ in thousands)	2006	2005
Description of Issue		
5-year Treasury securities, due April 2010	\$17,156	\$17,666

As of June 30, 2006, and December 31, 2005, the total obligations to replenish borrowed Treasury securities had decreased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized appreciation on the obligations of \$0.9 million and \$0.4 million, respectively.

The net proceeds related to the sales of the borrowed Treasury securities were \$17.9 million at both June 30, 2006, and December 31, 2005. Under the terms of the transactions, the Company had received cash payments of \$0.7 million and \$0.2 million at June 30, 2006, and December 31, 2005, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities.

The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with Wachovia Capital Markets, LLC under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of June 30, 2006, the repurchase agreements were due on July 5, 2006, and had an interest rate of 4.6%. The interest rate on the repurchase agreements as of December 31, 2005, was 3.3%.

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

Note 13. Financial Highlights

	At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2006 ⁽¹⁾	2005	2005
Per Common Share Data			
Net asset value, beginning of period	\$ 19.17	\$ 14.87	\$ 14.87
Net investment income ⁽²⁾	0.64	0.40	1.00
Net realized gains ⁽²⁾⁽³⁾	3.74	1.60	1.99
Net investment income plus net realized gains ⁽²⁾	4.38	2.00	2.99
Net change in unrealized appreciation or depreciation ⁽²⁾⁽³⁾	(3.44)	1.17	3.37
Net increase in net assets resulting from operations ⁽²⁾	0.94	3.17	6.36
Net decrease in net assets from shareholder distributions	(1.19)	(1.14)	(2.33)
Net increase in net assets from capital share transactions ⁽²⁾	0.25	0.11	0.27
Net asset value, end of period	\$ 19.17	\$ 17.01	\$ 19.17
Market value, end of period	\$ 28.77	\$ 29.11	\$ 29.37
Total return ⁽⁴⁾	1.9%	17.4%	23.5%
Ratios and Supplemental Data			
(\$ and shares in thousands, except per share amounts)			
Ending net assets	\$2,690,019	\$2,281,287	\$2,620,546
Common shares outstanding at end of period	140,312	134,131	136,697
Diluted weighted average common shares outstanding	142,466	135,982	137,274
Employee, stock option and administrative expenses/average net assets	2.66%	3.91%	6.58%
Total operating expenses/average net assets	4.38%	5.79%	9.99%
Net investment income/average net assets	3.41%	2.57%	6.08%
Net increase in net assets resulting from operations/ average net assets	4.97%	20.57%	38.68%
Portfolio turnover rate	21.20%	21.76%	47.72%
Average debt outstanding	\$1,395,791	\$1,097,851	\$1,087,118
Average debt per share ⁽²⁾	\$ 9.80	\$ 8.07	\$ 7.92

- (1) The results for the six months ended June 30, 2006, are not necessarily indicative of the operating results to be expected for the full year.
- (2) Based on diluted weighted average number of common shares outstanding for the period.
- (3) Net realized gains and net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.
- (4) Total return assumes the reinvestment of all dividends paid for the periods presented.

Note 14. Litigation

On June 23, 2004, the Company was notified by the SEC that the SEC is conducting an informal investigation of the Company. On December 22, 2004, the Company received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding the Company and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to the Company at this time, the inquiries appear to

S-75

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

Note 14. Litigation, continued

primarily pertain to matters related to portfolio valuation and the Company's portfolio company, Business Loan Express, LLC. To date, the Company has produced materials in response to requests from both the SEC and the U.S. Attorney's office, and certain current and former employees have provided testimony and have been interviewed by the staff of the SEC and the U.S. Attorney's Office. The Company is voluntarily cooperating with these investigations.

In addition, the Company is party to certain 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 the outcome of these proceedings will have a material effect upon the Company's financial condition or results of operations.

S-76

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Allied Capital Corporation:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of June 30, 2006, the related consolidated statements of operations for the three- and six-month periods ended June 30, 2006 and 2005, and the consolidated statement of changes in net assets and cash flows and the financial highlights (included in Note 13) for the six-month periods ended June 30, 2006 and 2005. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of December 31, 2005, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights, for the year then ended; and in our report dated March 9, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Washington, D.C.

August 9, 2006

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

PRIVATE FINANCE		Amount of Interest or Dividends		December 31, 2005	Gross	Gross	June 30, 2006
Portfolio Company	Investment(1)	to Income(6)					
(in thousands)							
Companies More Than 25% Owned							
Acme Paging, L.P. (Telecommunications)	Senior Loan(5) Subordinated Debt(5) Common Stock			\$	\$	\$	\$
Advantage Sales & Marketing, Inc.(7) (Business Services)	Subordinated Debt Subordinated Debt Common Stock	\$ 1,712 5,555		59,787 124,000 476,578	213 374	(60,000) (124,374) (476,578)	
Alaris Consulting, LLC (Business Services)	Senior Loan(5) Equity Interests	(32)			32	(32)	
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Senior Loan(5)	\$ 1		4,097	328	(96)	4,329
Avborne, Inc. (Business Services)	Preferred Stock Common Stock			892		(119)	773
Avborne Heavy Maintenance, Inc. (Business Services)	Preferred Stock Common Stock						

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Business Loan Express, LLC (Financial Services)	Subordinated Debt	38	10,000	15,000	(25,000)	
	Class A Equity Interests	7,807	60,693	3,734		64,427
	Class B Equity Interests		146,910		(16,020)	130,890
	Class C Equity Interests		139,521		(17,621)	121,900
Callidus Capital Corporation (Financial Services)	Senior Loan	399	600	8,705	(7,655)	1,650
	Subordinated Debt	464	4,832	444		5,276
	Common Stock		7,968	4,125		12,093
Cambridge Capital Partners (Financial Services)	Senior Debt(5)			250		250
	Equity Interests			1,751		1,751
CR Brands, Inc. (Consumer Products)	Senior Loan	1,109		37,219	(37,219)	
	Subordinated Debt	2,344		38,712		38,712
	Common Stock			37,431		37,431
Diversified Group Administrators, Inc. (Business Services)	Preferred Stock	33	728	14	(14)	728
	Preferred Stock		841			841
	Common Stock	68	502	69	(249)	322
Financial Pacific Company (Financial Services)	Subordinated Debt	6,176	69,904	726		70,630
	Preferred Stock		13,116	1,344		14,460
	Common Stock		44,180	749	(511)	44,418
ForeSite Towers, LLC (Tower Leasing)	Equity Interests	161	9,750	3,068		12,818
Global Communications, LLC (Business Services)	Senior Loan(5)		15,957			15,957
	Subordinated Debt(5)		11,198	138	(1,688)	9,648

	Preferred Equity Interest Options		4,303		(4,303)	
Gordian Group, Inc. (Business Services)	Senior Loan(5) Common Stock	(10)	4,161	400	(4,561)	
				220	(220)	
Healthy Pet Corp. (Consumer Services)	Senior Loan Subordinated Debt Common Stock	772 3,258	4,086 38,535 25,766	12,652 4,776 5,174	(800) (186) (2,788)	15,938 43,125 28,152
HMT, Inc. (Energy Services)	Preferred Stock Common Stock Warrants		2,637 5,343 2,057			2,637 7,942 3,058
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate		742	128		870

See related footnotes at the end of this schedule.

PRIVATE FINANCE		Amount of		December	Gross	Gross	June 30,
		Interest or	Dividends				
Portfolio Company		Credited		31, 2005	Additions(3)	Reductions(4)	2006
(in thousands)	Investment(1)	to	Other(2)	Value			Value
		Income(6)					
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt Preferred Stock Common Stock	\$ 4,790		\$ 58,298 26,791 236	\$ 769 1,473 218	\$ (2,015) (236)	\$ 59,067 26,249 218
Jakel, Inc. (Industrial Products)	Subordinated Debt(5) Preferred Stock Common Stock				2,533		2,533
Legacy Partners Group, LLC (Financial Services)	Senior Loan (5) Subordinated Debt(5) Equity Interests			5,029	93 18	(74) (18)	5,048
Litterer Beteiligungs-GmbH (Business Services)	Subordinated Debt Equity Interest	21		621 2,226	37 763	(1,374)	658 1,615
Mercury Air Centers, Inc. (Business Services)	Senior Loan Subordinated Debt Common Stock	1,231 4,028		31,720 46,519 88,898	4,000 4,679 4,702	(35,720) (3,000) (412)	48,198 93,188
MVL Group, Inc. (Business Services)	Senior Loan Subordinated Debt Common Stock	1,742 2,506		27,218 32,417 3,211	79 1,504	(973)	26,324 33,921 1,262
Pennsylvania Avenue				1,864	1,193	(3,057)	

Investors, L.P. (Private Equity Fund)	Equity Interests					
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan	2,390	23,792	6,075	(8,225)	21,642
	Subordinated Debt(5)		7,364	1,093	(8,457)	
	Preferred Stock Warrants					
Redox Brands, Inc. (Consumer Products)	Preferred Stock Warrants	363	12,097 500	1,708 84	(13,805) (584)	
Service Champ, Inc. (Business Services)	Subordinated Debt Common Stock	2,138	26,906 13,319	354 3,003		27,260 16,322
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt(5) Preferred Stock Common Stock Warrants	\$355	6,343 1,812		(5,183) (1,812)	1,160
Startec Global Communications Corporation (Telecommunications)	Senior Loan Common Stock	1,197	21,685	3,540 6,480	(3,299)	21,926 6,480
STS Operating, Inc. (Industrial Products)	Subordinated Debt Common Stock Options	328	6,593 64,963 560	123 32,039 292	(6,716) (97,002) (852)	
Triview Investments, Inc. (Broadcasting & Cable/ Consumer Products)	Senior Loan Subordinated Debt Subordinated Debt(5) Common Stock	587 2,390	7,449 30,845 19,520 29,171	6,852 6,842		14,301 37,687 19,520 32,526

Total companies more than 25% owned	\$53,565	\$1,887,651	\$	\$1,188,131
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Companies 5% to 25% Owned

Advantage Sales & Marketing, Inc.(7) (Business Services)	Subordinated Debt Equity Interests	\$ 4,732		\$ 150,056 15,000	\$	\$ 150,056 15,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan Subordinated Debt Equity Interests	714 2,145 1,694		1,512 42,267 4,025		1,512 34,950 (42,627) 2,372 (2,197) 4,200
Amerex Group, LLC (Consumer Products)	Subordinated Debt Equity Interests	154		8,400 3,583		8,400 3,583
Aspen Pet Products, Inc. (Consumer Products)	Subordinated Debt Preferred Stock Common Stock Warrants	1,130 29	19,959 1,638 17	399 516 123	(20,358) (2,154) (140)	
BB&T Capital Partners/Windsor Mezzanine Fund, LLC (Private Equity Fund)	Equity Interests			5,867		5,867
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt Common Stock	1,747	23,543 2,200	307 900	(700)	23,850 2,400

See related footnotes at the end of this schedule.

PRIVATE FINANCE Portfolio Company (in thousands)	Investment(1)	Amount of Interest or Dividends		December 31, 2005 Value	Gross Additions(3)	Gross Reductions(4)	June 30, 2006 Value
		Credited to Income(6)	Other(2)				
BI Incorporated (Business Services)	Senior Loan Subordinated Debt Common Stock	\$ 125 1,390		\$ 29,856 4,000	\$15,000 29,856 4,000	\$(15,000)	\$ 29,856 4,000
The Debt Exchange Inc. (Business Services)	Preferred Stock			3,219		(3,219)	
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan(5) Subordinated Debt(5) Convertible Subordinated Debt(5) Equity Interests			7,093 534	1,512 1,364 501	(2,010) (1,898) (501)	6,595
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt Equity Interests	788		10,588 1,367	193 363		10,781 1,730
Pres Air Trol LLC (Industrial Products)	Unitranche Debt(5) Equity Interests		\$ 184	5,820 318	10 11	(2,518) (329)	3,312
Progressive International Corporation (Consumer Products)	Subordinated Debt Preferred Stock	603		7,376 884 13	78 36 487		7,454 920 500

Common
Stock
Warrants

Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan Unitranche Debt Equity Interests			980 19,900 1,500		980 19,900 1,500
SGT India Private Limited (Business Services)	Common Stock			3,608		3,608
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt Equity Interests	959	13,447	2,058		15,505 2,400
Universal Environmental Services, LLC (Business Services)	Unitranche Debt Equity Interests	859	10,862	94		10,956 1,701
Total companies 5% to 25% owned		\$17,069	\$158,806		(278)	\$371,156

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

- (1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of June 30, 2006.
- (2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.
- (3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company into this category from a different category. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.

- (4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company out of this category into a different category. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.
- (5) Loan or debt security is on non-accrual status at June 30, 2006, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the period may or may not have been on non-accrual status for the full period.
- (6) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.
- (7) Included in the companies more than 25% owned category while the Company held a majority equity interest. On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company's investment in Advantage after the sale transaction is included in the companies 5% to 25% owned category. See Note 3 to the consolidated financial statements for further information.

S-80

**NOTICE REGARDING INDEPENDENT PUBLIC ACCOUNTANTS
REVIEW REPORT**

With respect to the unaudited interim financial information as of June 30, 2006, and for the three-month and six-month periods ended June 30, 2006 and 2005, included herein, KPMG LLP has reported that they applied limited procedures in accordance with professional standards for a review of such information. However, their separate report included herein states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. The accountants are not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited interim financial information because that report is not a report or a part of the registration statement prepared or certified by the accountants within the meaning of Sections 7 and 11 of the Securities Act of 1933.

S-81

PROSPECTUS

\$1,000,000,000
Debt Securities

We may offer, from time to time, up to an aggregate principal amount of \$1,000,000,000 of one or more classes or series of debt securities, including notes, debentures, medium-term notes, commercial paper, retail notes or similar obligations evidencing indebtedness in one or more offerings.

The debt securities may be offered at prices and on terms to be described in one or more supplements to this prospectus.

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

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

Please read this prospectus, the accompanying prospectus supplement, if any, and the pricing supplement, if any, before investing in our debt securities and keep it for future reference. The prospectus contains and the accompanying prospectus supplement, if any, and the pricing supplement, if any, will contain important information about us that a prospective investor should know before investing in our debt securities. We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 or by telephone at (202) 721-6100 or on our website at www.alliedcapital.com. The SEC also maintains a website at www.sec.gov that contains such information.

You should review the information set forth under Risk Factors on page 9 of this prospectus before investing in our debt securities.

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

This prospectus may not be used to consummate sales of our debt securities unless accompanied by a prospectus supplement and, if applicable, a pricing supplement.

June 22, 2006

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

TABLE OF CONTENTS

	Page
Summary	1
Selected Condensed Consolidated Financial Data	6
Where You Can Find Additional Information	8
Risk Factors	9
Use of Proceeds	19
Management's Discussion and Analysis of Financial Condition and Results of Operations	21
Senior Securities	67
Business	71
Portfolio Companies	88
Determination of Net Asset Value	95
Management	98
Portfolio Management	104
Compensation of Executive Officers and Directors	107
Control Persons and Principal Holders of Securities	118
Certain Relationships and Related Party Transactions	121
Tax Status	122
Certain Government Regulations	123
Stock Trading Plans and Ownership Guidelines	127
Dividend Reinvestment Plan	128
Description of Capital Stock	129
Description of Notes	130
Special Considerations Under our Charter and Bylaws and Maryland Law	142
Plan of Distribution	148
Legal Matters	149
Custodians, Transfer and Dividend Paying Agent and Registrar	149
Brokerage Allocation and Other Practices	149
Independent Registered Public Accounting Firm	150
Notice Regarding Arthur Andersen LLP	150
Index to Consolidated Financial Statements	F-1

ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, which constitutes a delayed offering in

reliance on Rule 415 under the Securities Act of 1933, as amended, we may offer, from time to time, up to \$1,000,000,000 in aggregate principal amount of debt securities on the terms to be determined at the time of the offering. The debt securities may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the debt securities we may offer. Each time we use this prospectus to offer debt securities, we will provide a prospectus supplement and, if applicable, a pricing supplement that will contain specific information about the terms of that offering. Please carefully read this prospectus and any such supplements together with the additional information described under **Where You Can Find Additional Information** in the **Prospectus Summary** and **Risk Factors** sections before you make an investment decision.

A prospectus supplement and, if applicable, a pricing supplement may also add to, update or change information contained in this prospectus.

(i)

PROSPECTUS SUMMARY

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

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

BUSINESS (Page 71)

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

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

We primarily invest in the American entrepreneurial economy. Our private finance portfolio includes investments in over 100 companies with aggregate annual revenue of over \$12 billion and employ more than 90,000 people.

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

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

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

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

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

We provide managerial assistance to our portfolio companies, including management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters.

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

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

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

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

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

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

**DETERMINATION OF
NET ASSET VALUE (Page 94)**

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

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

of these portfolio investments pursuant to our valuation policy and consistently applied valuation process.

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

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

PLAN OF DISTRIBUTION *(Page 146)*

We may offer, from time to time, up to \$1,000,000,000 aggregate principal amount of debt securities, including notes, debentures, medium-term notes, commercial paper, retail notes or similar obligations evidencing indebtedness, on terms to be determined at the time of the offering.

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

We may not sell debt securities pursuant to this prospectus without delivering a prospectus supplement and, if applicable, a pricing supplement describing the method and terms of the offering of such debt securities.

USE OF PROCEEDS *(Page 19)*

We intend to use the net proceeds from selling debt securities for general corporate purposes, which includes investing in debt or equity securities in primarily privately negotiated transactions, repayment of indebtedness, acquisitions and other general corporate purposes.

The supplements to this prospectus relating to any offering of debt securities will more fully identify the use of proceeds from such offering.

RISK FACTORS (Page 9)

Investment in our debt securities involves a number of significant risks relating to our business and our investment objective that you should consider before investing in our debt securities.

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

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

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

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

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

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

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

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

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

The market value of our debt securities may be volatile due to market factors that may be beyond our control.

RATIOS OF EARNINGS TO FIXED CHARGES (Page 17)

Our ratio of earnings to fixed charges for the five years ended December 31, 2005, was 12.4, 4.3, 3.4, 4.2 and 4.0, respectively, and was 5.4 for the three months ended March 31, 2006. For more information, see the section entitled Ratios of Earnings to Fixed Charges in this prospectus.

SENIOR SECURITIES (Page 67)

At March 31, 2006, we had \$1.3 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.5%. If our portfolio fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due, which could give rise to a default on and acceleration of our indebtedness. In order for us to cover annual interest payments on indebtedness, we had to achieve annual returns on our assets of at least 2.0% as of March 31, 2006, which returns were achieved.

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included herein. Financial information at and for the years ended December 31, 2005, 2004, 2003, and 2002, has been derived from our financial statements that were audited by KPMG LLP. Financial information at and for the year ended December 31, 2001, has been derived from our financial statements that were audited by Arthur Andersen LLP. For important information about Arthur Andersen LLP, see the section entitled Notice Regarding Arthur Andersen LLP. Quarterly financial information is derived from unaudited financial data, but in the opinion of management, reflects all adjustments (consisting only of normal recurring adjustments) which are necessary to present fairly the results for such interim periods. Interim results at and for the three months ended March 31, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. See **Management's Discussion and Analysis of Financial Condition and Results of Operations** below for more information.

(in thousands, except per share data)	Three Months Ended March 31,		Year Ended December 31,				
	2006	2005	2005	2004	2003	2002	2001
	(unaudited)						
Operating Data:							
Interest and related portfolio income:							
Interest and dividends	\$ 88,881	\$ 84,945	\$317,153	\$319,642	\$290,719	\$264,042	\$240,464
Loan prepayment premiums	5,286	1,677	6,250	5,502	8,172	2,776	2,504
Fees and other income	16,844	8,297	50,749	41,946	30,338	43,110	46,142
Total interest and related portfolio income	111,011	94,919	374,152	367,090	329,229	309,928	289,110
Expenses:							
Interest	24,300	20,225	76,798	75,650	77,233	70,443	65,104
Employee	21,428	15,456	78,300	53,739	36,945	33,126	29,656
Stock options	3,606						
Administrative	11,519	20,754	70,267	34,686	22,387	21,504	15,299
Total operating expenses	60,853	56,435	225,365	164,075	136,565	125,073	110,059
Net investment income before income taxes	50,158	38,484	148,787	203,015	192,664	184,855	179,051
Income tax expense (benefit), including excise tax	8,858	(268)	11,561	2,057	(2,466)	930	(412)
Net investment income	41,300	38,752	137,226	200,958	195,130	183,925	179,463

Net realized and
unrealized gains (losses):

Net realized gains	432,835	10,285	273,496	117,240	75,347	44,937	661
Net change in unrealized appreciation or depreciation	(374,548)	70,584	462,092	(68,712)	(78,466)	(571)	20,603
Total net gains (losses)	58,287	80,869	735,588	48,528	(3,119)	44,366	21,264

Net increase in net assets
resulting from operations

\$ 99,587	\$ 119,621	\$ 872,814	\$ 249,486	\$ 192,011	\$ 228,291	\$ 200,727
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Per Share:

Diluted earnings per common share	\$ 0.70	\$ 0.88	\$ 6.36	\$ 1.88	\$ 1.62	\$ 2.20	\$ 2.16
Dividends per common share ⁽¹⁾	\$ 0.59	\$ 0.57	\$ 2.33	\$ 2.30	\$ 2.28	\$ 2.23	\$ 2.01
Weighted average common shares outstanding diluted	141,738	135,579	137,274	132,458	118,351	103,574	93,003

(in thousands, except per share data)	At March 31,		At December 31,			
	2006	2005	2004	2003	2002	2001
Balance Sheet Data:						
Portfolio at value	\$3,691,002	\$3,606,355	\$3,013,411	\$2,584,599	\$2,488,167	\$2,329,590
Total assets	4,121,225	4,025,880	3,260,998	3,019,870	2,794,319	2,460,713
Total debt outstanding ⁽²⁾	1,274,245	1,284,790	1,176,568	954,200	998,450	1,020,806
Preferred stock issued to Small Business Administration ⁽²⁾				6,000	7,000	7,000
Shareholders equity	2,729,813	2,620,546	1,979,778	1,914,577	1,546,071	1,352,123
Shareholders equity per common share (net asset value) ⁽³⁾	\$ 19.50	\$ 19.17	\$ 14.87	\$ 14.94	\$ 14.22	\$ 13.57
Common shares outstanding at end of year	139,984	136,697	133,099	128,118	108,698	99,607
Asset coverage ratio ⁽⁴⁾	317%	309%	280%	322%	270%	245%
Debt to equity ratio	0.47	0.49	0.59	0.50	0.65	0.75

	Three Months Ended March 31,		Year Ended December 31,			
	2006	2005	2004	2003	2002	2001
Other Data:						
Investments funded	\$797,851	\$1,675,773	\$1,524,523	\$931,450	\$506,376	\$680,329
Principal collections related to investment repayments or sales	340,410	1,503,388	909,189	788,328	356,641	204,441
Realized gains	436,486	343,061	267,702	94,305	95,562	10,107
Realized losses	(3,651)	(69,565)	(150,462)	(18,958)	(50,625)	(9,446)

(in thousands, except per share data)	2006		2005		2004				
	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1
Quarterly Data (unaudited):									
Total interest and related portfolio income	\$111,011	\$ 98,169	\$ 94,857	\$ 86,207	\$ 94,919	\$100,962	\$96,863	\$87,500	\$81,765
Net investment income	41,300	37,073	46,134	15,267	38,752	54,678	52,745	48,990	44,545
Net increase in net assets resulting from	99,587	328,140	113,168	311,885	119,621	47,837	85,999	95,342	20,308

operations

Diluted earnings per common share	\$	0.70	\$	2.36	\$	0.82	\$	2.29	\$	0.88	\$	0.35	\$	0.66	\$	0.73	\$	0.15
Dividends declared per common share ⁽⁵⁾		0.59		0.61		0.58		0.57		0.57		0.59		0.57		0.57		0.57
Net asset value per common share ⁽³⁾		19.50		19.17		17.37		17.01		15.22		14.87		14.90		14.77		14.60

- (1) Dividends are based on taxable income, which differs from income for financial reporting purposes.
- (2) See *Senior Securities* for more information regarding our level of indebtedness.
- (3) We determine net asset value per common share as of the last day of the period presented. The net asset values shown are based on outstanding shares at the end of each period presented.
- (4) As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.
- (5) Dividends declared per common share for the fourth quarter of 2004 included the regular quarterly dividend of \$0.57 per common share and an extra dividend of \$0.02 per common share. Dividends declared per common share for the fourth quarter of 2005 included the regular quarterly dividend of \$0.58 per common share and an extra dividend of \$0.03 per common share.

**WHERE YOU CAN FIND
ADDITIONAL INFORMATION**

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

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission under the Securities Exchange Act of 1934. You can inspect any materials we file with the Securities and Exchange Commission, without charge, at the Securities and Exchange Commission's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the Public Reference Room. The Securities and Exchange Commission maintains a web site that contains reports, proxy statements and other information regarding registrants, including us, that file such information electronically with the Securities and Exchange Commission. The address of the Securities and Exchange Commission's web site is www.sec.gov. Information contained on the Securities and Exchange Commission's web site about us is not incorporated into this prospectus and you should not consider information contained on the Securities and Exchange Commission's web site to be part of this prospectus.

RISK FACTORS

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

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

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

Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments. At March 31, 2006, portfolio investments recorded at fair value were 90% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis and record unrealized depreciation for an investment that we believe has become impaired, including

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

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

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

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

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

Our borrowers may default on their payments, which may have a negative effect on our financial performance. We primarily make long-term unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources, may be highly leveraged and may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. A portfolio company's failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of its loans or foreclosure on its secured assets, which could trigger cross defaults under other agreements and jeopardize our portfolio company's ability to meet its obligations under the loans or debt securities that we hold. In addition, our portfolio companies may have, or may be permitted to incur, other debt that ranks senior to or equally with our securities. This means that payments on such senior-ranking securities may have to be made before we receive any payments on our loans or debt securities. Deterioration in a borrower's financial condition and prospects

may be accompanied by deterioration in any related collateral and may have a negative effect on our financial results.

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

Our financial results could be negatively affected if a significant portfolio investment fails to perform as expected. Our total investment in companies may be significant individually or in the aggregate. As a result, if a significant investment in one or more companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies. At March 31, 2006, our largest investment at value was in Business Loan Express, LLC (BLX) and represented 7.9% of our total assets and 5.5% of our total interest and related portfolio income for the three months ended March 31, 2006. BLX is a lender under the Small Business Administration 7(a) Guaranteed Loan Program. Our financial results could be negatively affected if government funding for, or regulations related to, this program change.

We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us. Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. The debt securities we may issue pursuant to this prospectus, the prospectus supplement, and the applicable pricing supplement, if any, are a form of such borrowings. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders or investors. Holders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique. We and, indirectly, our shareholders will bear the cost associated with our leverage activity. Our revolving line of credit, notes payable and debentures contain financial and operating covenants that could restrict our business activities, including our ability to declare dividends if we default under certain provisions.

At March 31, 2006, we had \$1.3 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.5%. If our portfolio of investments fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due. In order for us to cover annual interest payments on indebtedness, we had to achieve annual returns on our assets of at least 2.0% as of March 31, 2006, which returns were achieved.

Illustration. The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) \$4,121.2 million in total assets, (ii) an average cost of funds of 6.5%, (iii) \$1,274.2 million in debt outstanding and (iv) \$2,729.8 million of shareholders' equity.

	Assumed Return on Our Portfolio (net of expenses)						
	-20%	-10%	-5%	0%	5%	10%	20%
Corresponding return to shareholder	-33.23%	-18.13%	-10.58%	-3.03%	4.51%	12.06%	27.16%

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders or investors on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of March 31, 2006, our asset coverage for senior indebtedness was 317%.

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

Assuming that the balance sheet as of March 31, 2006, were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected net income by approximately 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

We will continue to need additional capital to grow because we must distribute our income. We will continue to need capital to fund growth in our investments. Historically, we have borrowed from financial institutions and have issued equity securities to grow our

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

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

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

the requirement to distribute at least 90% of our investment company taxable income to obtain tax benefits as a regulated investment company.

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

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

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

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

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

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

In November 2004, the SEC issued proposed rules to correct the unintended consequence of the Federal Reserve's 1998 margin rule amendments of apparently limiting

the investment opportunities of business development companies. In general, the SEC's proposed rules would define an eligible portfolio company as any company that does not have securities listed on a national securities exchange or association. We currently do not believe that these proposed rules will have a material adverse effect on our operations.

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

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

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

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

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

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

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

the time remaining to the maturity of these debt securities;

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

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

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

the level, direction and volatility of market interest rates generally; and

market rates of interest higher or lower than rates borne by the debt securities.

You should also be aware that there may be a limited number of buyers when you decide to sell your debt securities. This too may materially adversely affect the market value of the debt securities or the trading market for the debt securities.

Terms relating to redemption may materially adversely affect your return on the debt securities. If your debt securities are redeemable at our option, we may choose to redeem your debt securities at times when prevailing interest rates are lower than the interest rate paid on your debt securities. In addition, if your debt securities are subject to mandatory redemption, we may be required to redeem your debt securities also at times when prevailing interest rates are lower than the interest rate paid on your debt securities. In this circumstance, you may not be able to reinvest the redemption proceeds in a comparable security at an effective interest rate as high as your debt securities being redeemed.

Our credit ratings may not reflect all risks of an investment in the debt securities. Our credit ratings are an assessment of our ability to pay our obligations. Consequently, real or anticipated changes in our credit ratings will generally affect the market value of the publicly issued debt securities. Our credit ratings, however, may not reflect the potential impact of risks related to market conditions generally or other factors discussed above on the market value of or trading market for the publicly issued debt securities.

RATIOS OF EARNINGS TO FIXED CHARGES

For the three months ended March 31, 2006, and the five years ended December 31, 2005, the ratios of earnings to fixed charges of the Company, computed as set forth below, were as follows:

	Three Months Ended March 31,	Year Ended December 31,				
	2006⁽¹⁾	2005	2004	2003	2002	2001
Earnings to Fixed Charges*	5.4	12.4	4.3	3.4	4.2	4.0

For purposes of computing the ratios of earnings to fixed charges, earnings represent net increase in net assets resulting from operations plus (or minus) income tax expense (benefit) plus excise tax expense plus fixed charges. Fixed charges include interest expense, a portion of rent expense and preferred stock dividend expense. We have assumed that one-third of the annual rent expense represents fixed charges.

* Earnings include the net change in unrealized appreciation or depreciation. Net change in unrealized appreciation or depreciation can vary substantially from year to year. Excluding the net change in unrealized appreciation or depreciation, the earnings to fixed charges ratio would be 20.6 for the three months ended March 31, 2006⁽¹⁾, and 6.4, 5.2, 4.4, 4.2 and 3.7 for the five years ended December 31, 2005, respectively.

⁽¹⁾ The results for the three months ended March 31, 2006, are not necessarily indicative of the operating results to be expected for the full year.

Disclosure Regarding Forward-Looking Statements

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

changes in the economy and general economic conditions;

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

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

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

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

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

USE OF PROCEEDS

We intend to use the net proceeds from selling debt securities for general corporate purposes, which may include investing in debt or equity securities in primarily privately negotiated transactions, repayment of indebtedness, acquisitions and other general corporate purposes. Because our primary business is to provide long-term debt and equity capital to primarily middle-market companies, we are continuously identifying, reviewing and, to the extent consistent with our investment objective, funding new investments. As a result, we typically raise equity capital or issue debt as we deem appropriate to fund such new investments.

We anticipate that substantially all of the net proceeds of any offering of debt securities will be used as described above or in any prospectus supplement and pricing supplement, if any, accompanying this prospectus. Pending investment, we intend to invest the net proceeds of any offering of debt securities in time deposits, income-producing securities with maturities of three months or less that are issued or guaranteed by the federal government or an agency of the federal government, high quality debt securities maturing in one year or less from the time of investment or other qualifying investments. Our ability to achieve our investment objective may be limited to the extent that the net proceeds of any offering of debt securities, pending full investment, are held in lower-yielding time deposits and other short-term instruments.

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On June 20, 2006, the last reported closing sale price of our common stock was \$29.41 per share.

	NAV ⁽¹⁾	Closing Sales Price		Premium of High Sales Price to NAV ⁽²⁾	Premium of Low Sales Price to NAV ⁽²⁾	Declared Dividends
		High	Low			
<i>Year ending December 31, 2004</i>						
First Quarter	\$ 14.60	\$30.85	\$27.15	211%	186%	\$0.57
Second Quarter	\$ 14.77	\$30.25	\$23.06	205%	156%	\$0.57
Third Quarter	\$ 14.90	\$25.80	\$22.22	173%	149%	\$0.57
Fourth Quarter	\$ 14.87	\$28.47	\$24.46	191%	164%	\$0.57
Extra Dividend						\$0.02
<i>Year ended December 31, 2005</i>						
First Quarter	\$ 15.22	\$27.84	\$24.89	183%	164%	\$0.57
Second Quarter	\$ 17.01	\$29.29	\$25.83	172%	152%	\$0.57
Third Quarter	\$ 17.37	\$29.17	\$26.92	168%	155%	\$0.58
Fourth Quarter	\$ 19.17	\$30.80	\$26.11	161%	136%	\$0.58
Extra Dividend						\$0.03
<i>Year ended December 31, 2006</i>						
First Quarter	\$ 19.50	\$30.68	\$28.51	157%	146%	\$0.59
Second Quarter (through June 20, 2006)	*	\$31.32	\$29.36	*	*	\$0.60

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

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

* Not determinable at the time of filing.

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

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

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

**MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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

changes in the economy and general economic conditions;

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

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

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

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

OVERVIEW

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our lending and investment activity has generally been focused on private finance and commercial real estate finance, which included primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS, and collateralized debt obligation bonds and preferred shares, which we refer to as CDOs.

On May 3, 2005, we completed the sale of our portfolio of CMBS and real estate related CDO investments. Upon the completion of this transaction, our lending and investment activity has been focused primarily on private finance investments. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at March 31, 2006 and 2005, and December 31, 2005, 2004, and 2003, was as follows:

	March 31,		December 31,		
	2006	2005	2005	2004	2003
Private finance	96%	74%	96%	76%	74%
Commercial real estate finance	4%	26%	4%	24%	26%

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

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

PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2006 and 2005, and at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,		
	2006	2005	2005	2004	2003
(\$ in millions)					
Portfolio at value	\$3,691.0	\$3,195.0	\$3,606.4	\$3,013.4	\$2,584.6
Investments funded ⁽¹⁾	\$ 797.9	\$ 265.6	\$1,675.8	\$1,524.5	\$ 931.5
Change in accrued or reinvested interest and dividends ⁽²⁾	\$ (2.1)	\$ 10.5	\$ 6.6	\$ 52.2	\$ 45.0
Principal collections related to investment repayments or sales	\$ 340.4	\$ 158.3	\$1,503.4	\$ 909.2	\$ 788.3
Yield on interest-bearing investments ⁽³⁾	12.3%	13.6%	12.8%	14.0%	14.7%

(1) Investments funded for the three months ended March 31, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

(2) Includes a change in accrued or reinvested interest of \$1.1 million for the three months ended March 31, 2006, related to our investments in money market securities.

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

Private Finance

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the three months ended March 31, 2006 and 2005, and at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

	At and for the Three Months Ended March 31,				At and for the Year Ended December 31,					
	2006		2005		2005		2004		2003	
	Value	Yield ⁽²⁾	Value	Yield ⁽²⁾	Value	Yield ⁽²⁾	Value	Yield ⁽²⁾	Value	Yield ⁽²⁾
(\$ in millions)										
Portfolio at value:										
Loans and debt										

securities:										
Senior loans	\$ 420.1	9.3%	\$ 253.5	8.6%	\$ 239.8	9.5%	\$ 234.6	8.5%	\$ 165.5	9.2%
Unitranche debt	362.7	11.1%	44.2	14.8%	294.2	11.4%	43.9	14.8%	24.9	15.6%
Subordinated debt	1,747.2	13.6%	1,258.7	14.9%	1,560.9	13.8%	1,324.4	14.9%	1,024.5	16.0%
Total loans and debt securities	\$2,530.0	12.5%	\$1,556.4	13.8%	\$2,094.9	13.0%	\$1,602.9	13.9%	\$1,214.9	15.0%
Equity securities	1,031.6		822.1		1,384.4		699.2		687.8	
Total portfolio	\$3,561.6		\$2,378.5		\$3,479.3		\$2,302.1		\$1,902.7	
Investments funded ⁽¹⁾	\$ 795.9		\$ 168.2		\$1,462.3		\$1,140.8		\$ 498.0	
Change in accrued or reinvested interest and dividends	\$ (4.2)		\$ 7.9		\$ 24.6		\$ 45.6		\$ 41.8	
Principal collections related to investment repayments or sales	\$ 336.6		\$ 151.2		\$ 703.9		\$ 551.9		\$ 318.6	

(1) Investments funded for the three months ended March 31, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

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

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

In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Senior loans at March 31, 2006, included approximately \$200 million of senior loans that are in various stages of being refinanced. Repayments include repayments of senior debt funded by us that was subsequently refinanced or repaid by the portfolio companies.

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. Recently, we believe many junior debt financing opportunities in the market have become less attractive from a risk/return perspective. To address the current market, our strategy is to focus on buyout and recapitalization transactions where we can manage risk through the structure and terms of our debt and equity investments and where we can potentially realize more attractive total returns from both current interest and fee income and future capital gains. We are also focusing our debt investing on smaller middle market companies where we can provide both senior and subordinated debt or unitranche debt, where our current yield may be lower than traditional subordinated debt. We believe that providing both senior and subordinated debt or unitranche debt provides greater protection in the capital structures of our portfolio companies.

Investments Funded. Investments funded and the weighted average yield on investments funded at and for the three months ended March 31, 2006, and at and for the years ended December 31, 2005, 2004, and 2003, consisted of the following:

For the Three Months Ended March 31, 2006

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 85.0	9.1%	\$ 117.8	8.9%	\$ 202.8	9.0%
Unitranche debt ⁽²⁾	75.0	10.6%			75.0	10.6%
Subordinated debt ⁽³⁾	279.3	12.5%	145.4	13.9%	424.7	13.0%
Total loans and debt securities	439.3	11.5%	263.2	11.6%	702.5	11.6%
Equity	24.6		68.8		93.4	
Total	\$463.9		\$332.0		\$795.9	

2005 Investments Funded

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans ⁽⁴⁾	\$ 76.8	10.0%	\$250.2	6.4%	\$ 327.0	7.2%
Unitranche debt ⁽²⁾	259.5	10.5%			259.5	10.5%
Subordinated debt	296.9	12.3%	330.9	12.5%	627.8	12.4%
Total loans and debt securities	633.2	11.3%	581.1	9.9%	1,214.3	10.6%
Equity	82.5		165.5		248.0	
Total	\$715.7		\$746.6		\$1,462.3	

2004 Investments Funded

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 25.1	9.1%	\$140.8	7.2%	\$ 165.9	7.5%
Unitranche debt ⁽²⁾	18.9	13.0%			18.9	13.0%
Subordinated debt	396.4	13.4%	320.1	15.5%	716.5	14.4%
Total loans and debt securities	440.4	13.2%	460.9	13.0%	901.3	13.1%
Equity	72.3		167.2		239.5	
Total	\$512.7		\$628.1		\$1,140.8	

2003 Investments Funded

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						

Loans and debt securities:						
Senior loans	\$ 44.6	9.4%	\$28.6	2.6%	\$ 73.2	6.7%
Unitranche debt ⁽²⁾	25.0	15.5%			25.0	15.5%
Subordinated debt	354.8	14.6%	1.2	25.0%	356.0	14.6%
Total loans and debt securities	424.4	14.1%	29.8	3.5%	454.2	13.4%
Equity	15.6		28.2		43.8	
Total	\$440.0		\$58.0		\$498.0	

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.
- (2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.
- (3) Debt investments for the three months ended March 31, 2006, included a \$150 million, 12.0% subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.
- (4) Buyout senior loans funded include \$174.9 million which was repaid during the year. In April 2006, we funded private finance investments totaling \$254.9 million.

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on the number and size of investments that we make or that we exit and many other factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. We believe that merger and acquisition activity in the middle market was strong in 2004 and 2005 and has continued into 2006, which has resulted in an increase in private finance investment opportunities, as well as increased repayments. We continue to have an active pipeline of new investments under consideration. We believe that merger and acquisition activity for middle market companies will remain strong in 2006.

Portfolio Yield. The yield on the private finance loans and debt securities was 12.5% at March 31, 2006, 13.8% at March 31, 2005, and 13.0%, 13.9%, and 15.0% at December 31, 2005, 2004, and 2003, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period depending on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not accruing and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. The yield on the private finance portfolio has declined partly due to our strategy to pursue more buyout and recapitalization transactions, which may include investing in lower-yielding senior debt, as well as pursue unitranche investments.

Outstanding Investment Commitments. At March 31, 2006, we had outstanding private finance investment commitments totaling \$316.3 million, including the following:

\$33.3 million in the form of debt to Promo Works, LLC.

\$30.0 million in the form of debt to Business Loan Express, LLC.

\$29.9 million in the form of equity to eleven private equity and venture capital funds.

\$14.0 million in the form of debt to S.B. Restaurant Company.

\$14.0 million in the form of debt to Integrity Interactive Corp.

\$9.6 million in the form of debt to 3SI Security Systems Inc.

\$8.3 million in the form of debt to Hot Stuff Foods, LLC.

\$7.8 million in the form of debt to Mercury Air Centers, Inc.

\$6.5 million in co-investment commitments to Pine Creek Equity Partners, LLC.

We have various commitments to Callidus Capital Corporation (Callidus), which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset

management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments. Our commitment to Callidus consisted of the following at March 31, 2006:

(\$ in millions)	Committed Amount	Amount Drawn	Amount Available to be Drawn
Subordinated debt to support warehouse facilities & warehousing activities ⁽¹⁾	\$40.0	\$	\$40.0
Revolving line of credit facility to support warehousing activities ⁽²⁾	50.0	3.7	46.3
Revolving line of credit for working capital	4.0	3.8	0.2
Total	\$94.0	\$7.5	\$86.5

(1) Callidus has a secured warehouse credit facilities with a third party for up to \$400 million. The facility is used primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate our \$40 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

(2) This facility supports Callidus purchase of middle market senior loans pending the sale of such loans to its warehouse credit facilities.

In addition, at March 31, 2006, we had a commitment to Callidus to purchase preferred equity in future CLO transactions of \$32.4 million.

In addition to these outstanding investment commitments at March 31, 2006, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$184.7 million. See Financial Condition, Liquidity and Capital Resources.

Our largest investment at value at March 31, 2006, was in Business Loan Express, LLC (BLX) and our largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. and BLX. See Results of Operations for a discussion of the net change in unrealized appreciation or depreciation related to these investments.

Business Loan Express, LLC. At March 31, 2006, our investment in BLX totaled \$291.3 million at cost and \$326.2 million at value, or 7.9% of our total assets, which included unrealized appreciation of \$35.0 million. At December 31, 2005, our investment in BLX totaled \$299.4 million at cost and \$357.1 million at value, or 8.9% of our total assets, which included unrealized appreciation of \$57.7 million. We acquired BLX in 2000.

Total interest and related portfolio income earned from the Company's investment in BLX for the three months ended March 31, 2006 and 2005, and for the years ended December 31, 2005, 2004, and 2003, was as follows:

(\$ in millions)	Three Months Ended March 31,		Year Ended December 31,		
	2006	2005	2005	2004	2003
Interest income	\$3.9	\$3.4	\$14.3	\$23.2	\$21.9
Dividend income		2.0	14.0	14.8	7.8
Loan prepayment premiums					0.1

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Fees and other income	2.2	2.4	9.2	12.0	16.9
Total	\$6.1	\$7.8	\$37.5	\$50.0	\$46.7

Interest and dividend income from BLX for the three months ended March 31, 2006 and 2005, and for the years ended December 31, 2005, 2004, and 2003, included interest and dividend income of \$1.8 million, \$1.6 million, \$8.9 million, \$25.4 million, and \$17.5 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to us through the issuance of additional debt or equity interests. Accrued interest and dividends receivable and other assets at March 31, 2006, included accrued interest and fees due from BLX totaling \$3.4 million, of which \$2.2 million was paid in cash in the second quarter of 2006.

Net change in unrealized appreciation or depreciation included a net decrease in unrealized appreciation on our investment in BLX of \$22.7 million and \$6.3 million for the three months ended March 31, 2006 and 2005, respectively. Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on our investment in BLX of \$2.9 million for the year ended December 31, 2005, a net decrease in unrealized appreciation of \$32.3 million for the year ended December 31, 2004, and a net increase in unrealized appreciation of \$51.7 million for the year ended December 31, 2003. See Results of Operations for a discussion of the net change in unrealized appreciation or depreciation related to this investment.

BLX is a national, non-bank lender that participates in the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a nationwide preferred lender, as designated by the SBA, and originates, sells, and services small business loans. In addition, BLX originates conventional small business loans and small investment real estate loans. BLX has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, could negatively affect our financial results.

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

We had a commitment to BLX of \$30.0 million in the form of a subordinated revolving credit facility to provide working capital to the company that expired on April 30, 2006. There were no amounts outstanding under this facility at March 31, 2006.

At December 31, 2005, BLX had a three-year \$275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, we had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At December 31, 2005, the principal amount of loans outstanding on the revolving credit facility was \$228.2 million and letters of credit issued under the facility were \$41.7 million. The total obligation guaranteed by us at December 31, 2005, was \$135.4 million.

On March 17, 2006, BLX closed on a new three-year \$500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to \$600.0 million at BLX's option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. We have provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At March 31, 2006, the principal amount outstanding on the revolving credit facility was \$240.2 million and letters of credit issued under the facility were \$41.7 million. The total obligation guaranteed by us at March 31, 2006, was \$141.1 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility, which includes certain defaults under our revolving credit facility. BLX was in compliance with the terms of this facility at March 31, 2006. At March 31, 2006, we had also provided four standby letters of credit totaling \$34.1 million in connection with four term securitization transactions completed by BLX.

Advantage Sales & Marketing, Inc. At December 31, 2005, our investment in Advantage totaled \$257.7 million at cost and \$660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of \$402.7 million. We completed the purchase of a majority ownership in Advantage in June 2004.

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our \$184 million in subordinated debt outstanding and realized a gain on our equity investment sold of \$433.1 million, subject to post-closing adjustments. As consideration for the common stock sold in the transaction, we received a \$150 million subordinated note, with the balance of the consideration paid in cash. Approximately \$34 million of our cash proceeds from the sale of the common stock have been held in escrow, subject to certain holdback provisions. In addition, there is potential for us to receive additional consideration through an earn-out payment that would be based on Advantage's 2006 audited results. Our realized gain of \$433.1 million excludes any earn-out amounts. For tax purposes, the receipt of the \$150 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected. In connection with the transaction, we retained an equity investment in the business valued at \$15 million as a minority shareholder.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest for the three months ended March 31, 2006 and 2005, and for the years ended December 31, 2005 and 2004, was as follows:

	Three Months Ended March 31,		Year Ended December 31,	
	2006	2005	2005	2004
(\$ in millions)				
Interest income	\$ 7.3	\$7.7	\$30.9	\$15.5
Loan prepayment premiums	5.0			
Fees and other income	1.8	1.5	6.5	5.8
Total interest and related portfolio income	\$14.1	\$9.2	\$37.4	\$21.3

In addition, we earned structuring fees of \$2.3 million on our new \$150 million subordinated debt investment in Advantage upon the closing of the sale transaction.

After the completion of the sale transaction, our investment in Advantage at March 31, 2006, which was composed of subordinated debt and a minority equity interest, totaled \$151.3 million at cost and \$164.3 million at value, which included unrealized appreciation of \$13.0 million. Subsequent to the completion of the sale transaction, we estimate that our interest income from our subordinated debt investment in Advantage will be approximately \$4.5 million per quarter.

Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

STS Operating, Inc. On May 1, 2006, we announced the completion of the sale of STS Operating, Inc. (STS). We were repaid our \$6.8 million in subordinated debt outstanding and we realized a gain on the sale of our common stock in STS of approximately \$94 million, subject to post-closing adjustments. The cost basis of our equity was \$3.5 million. As part of the consideration for the sale of our equity, we received a \$30 million subordinated note. Approximately \$10.7 million of our proceeds are subject to certain holdback provisions and post-closing adjustments. For tax purposes, the receipt of the \$30 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected.

The Hillman Companies, Inc. On March 31, 2004, we sold our control investment in The Hillman Companies, Inc. (Hillman) for a total transaction value of \$510 million, including the repayment of outstanding debt and adding the value of Hillman's outstanding trust preferred shares. We were repaid our existing \$44.6 million in outstanding debt. Total consideration to us from this sale, including the repayment of debt, was \$245.6 million, which included net cash proceeds of \$198.1 million and the receipt of a new subordinated debt instrument of \$47.5 million. During the second quarter of 2004, we sold a \$5.0 million participation in our subordinated debt in Hillman to a third party, which reduced our investment, and no gain or loss resulted from the transaction. For the year ended December 31, 2004, we realized a gain of \$150.3 million on the transaction.

Commercial Real Estate Finance

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2006 and 2005, and at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

	At and for the Three Months Ended March 31,				At and for the Years Ended December 31,					
	2006		2005		2005		2004		2003	
	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾
(\$ in millions)										
Portfolio at value:										
CMBS bonds	\$		\$466.1	13.0%	\$		\$373.8	14.6%	\$394.0	14.1%
CDO bonds and preferred shares			227.1	15.8%			212.6	16.8%	186.6	16.7%
Commercial mortgage loans	102.7	7.6%	89.7	6.4%	102.6	7.6%	95.0	6.8%	83.6	8.6%
Real estate owned	15.0		18.4		13.9		16.9		12.8	
Equity interests	11.7		15.2		10.6		13.0		4.9	
Total portfolio	\$129.4		\$816.5		\$127.1		\$711.3		\$681.9	
Investments funded	\$ 2.0		\$ 97.4		\$213.5		\$383.7		\$433.5	
Change in accrued or reinvested interest ⁽²⁾	\$ 1.0		\$ 2.6		\$ (18.0)		\$ 6.6		\$ 3.2	
Principal collections related to investment repayments or sales ⁽²⁾	\$ 3.8		\$ 7.1		\$799.5		\$357.3		\$469.7	

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

(2) Principal collections related to investment repayments or sales for the year ended December 31, 2005, included \$718.1 million related to the sale of our CMBS and CDO portfolio in May 2005. Change in accrued or reinvested interest for the year ended December 31, 2005, included the collection of \$21.7 million related to the sale of this portfolio.

Our commercial real estate investments funded for the three months ended March 31, 2006, and for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)	Face Amount	Discount	Amount Funded
<i>For the Three Months Ended March 31, 2006</i>			
Commercial mortgage loans	\$ 0.6	\$	\$ 0.6
Equity interests	1.4		1.4
Total	\$ 2.0	\$	\$ 2.0
<i>For the Year Ended December 31, 2005</i>			
CMBS bonds (4 new issuances) ⁽²⁾	\$211.5	\$ (90.5)	\$121.0
Commercial mortgage loans	88.5	(0.8)	87.7
Equity interests	4.8		4.8
Total	\$304.8	\$ (91.3)	\$213.5
<i>For the Year Ended December 31, 2004</i>			
CMBS bonds (13 new issuances) ⁽¹⁾	\$419.1	\$(183.7)	\$235.4
CDO bonds and preferred shares (3 issuances)	40.5	(0.1)	40.4
Commercial mortgage loans	112.1	(8.2)	103.9
Equity interests	4.0		4.0
Total	\$575.7	\$(192.0)	\$383.7

(\$ in millions)	Face Amount	Discount	Amount Funded
<i>For the Year Ended December 31, 2003</i>			
CMBS bonds (15 new issuances ⁽¹⁾)	\$508.5	\$(225.9)	\$282.6
CDO bonds and preferred shares (3 issuances)	145.8	(0.4)	145.4
Commercial mortgage loans	3.0		3.0
Equity interests	2.5		2.5
 Total	 \$659.8	 \$(226.3)	 \$433.5

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

(2) The CMBS bonds invested in during the year ended December 31, 2005, were sold on May 3, 2005.

At March 31, 2006, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$13.6 million and commitments in the form of standby letters of credit and guarantees related to equity interests of \$7.0 million.

Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares. On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of \$976.0 million and a net realized gain of \$227.7 million, after transaction and other costs of \$7.8 million, in the second quarter of 2005. Transaction costs included investment banking fees, legal and other professional fees, and other transaction costs. The CMBS and CDO assets sold had a cost basis at closing of \$739.8 million, including accrued interest of \$21.7 million. Upon the closing of the sale, we settled all the hedge positions relating to these assets, which resulted in a net realized loss of \$0.7 million, which was included in the net realized gain on the sale.

For tax purposes, we estimate that the net gain from the sale of the CMBS and CDO portfolio will be approximately \$244 million, after transaction and other costs of \$7.8 million. The difference between the net gain for book and tax purposes results from temporary differences in the recognition of income and expenses related to these assets.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWCapital Investments LLC, an affiliate of the Caisse (CWCapital), pursuant to which we agreed to sell certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. This transaction was completed on July 13, 2005, and we received total cash proceeds of approximately \$5.3 million. No gain or loss resulted from the transaction. Under this agreement, we have agreed not to invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008, subject to certain limitations and excluding our existing portfolio and related activities.

The real estate securities purchase agreement, under which we sold the CMBS and CDO portfolio, and the platform asset purchase agreement contain customary representations and warranties, and require us to indemnify the affiliates of the Caisse that are parties to the agreements for certain liabilities arising under the agreements, subject to certain limitations and conditions.

We also entered into a transition services agreement with CWCapital pursuant to which we provided certain transition services to CWCapital for a limited transition period to facilitate the transfer of various servicing and other rights related to the CMBS and

CDO portfolio. During the transition period, we agreed, among other things, to continue to act as servicer or special servicer with respect to the CMBS and CDO portfolio. Services provided under the transition services agreement, except for certain information technology services, were completed on July 13, 2005. For the year ended December 31, 2005, we received a total of \$1.4 million under the transition services agreement as reimbursement for employee and administrative expenses. These amounts reduced our employee expenses by \$1.1 million and administrative expenses by \$0.3 million.

Hedging Activities

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$17.5 million, \$17.7 million and \$38.2 million at March 31, 2006, and December 31, 2005 and 2004, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were \$17.5 million, \$17.7 million and \$38.2 million at March 31, 2006, and December 31, 2005 and 2004, respectively. The hedge at March 31, 2006, and December 31, 2005, related to commercial mortgage loans and the hedge at December 31, 2004, related primarily to CMBS and CDO bonds. The amount of the hedge will vary from period to period depending upon the amount of commercial real estate assets that we own and have hedged as of the balance sheet date.

Accrued Interest and Dividends Receivable

Accrued interest and dividends receivable as of March 31, 2006, and December 31, 2005 and 2004, was as follows:

	2006	2005	2004
(\$ in millions)			
Private finance	\$47.5	\$58.7	\$59.8
Commercial real estate finance			
CMBS and CDO bonds			18.9
Commercial mortgage loans and other	2.5	1.7	0.8
Total	\$50.0	\$60.4	\$79.5

Total accrued interest and dividends receivable declined from December 31, 2004, to December 31, 2005, primarily as a result of the sale of our portfolio of CMBS and CDO assets on May 3, 2005. See [Commercial Real Estate Finance](#) above.

Portfolio Asset Quality

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

At March 31, 2006, and December 31, 2005 and 2004, our portfolio was graded as follows:

Grade	2006		2005		2004	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value ⁽¹⁾	Percentage of Total Portfolio
(\$ in millions)						
1	\$1,287.9	34.9%	\$1,643.0	45.6%	\$ 952.5	31.6%
2	2,183.2	59.2	1,730.8	48.0	1,850.5	61.4
3	89.1	2.4	149.1	4.1	121.2	4.0
4	64.5	1.7	26.5	0.7	11.7	0.4
5	66.3	1.8	57.0	1.6	77.5	2.6
	\$3,691.0	100.0%	\$3,606.4	100.0%	\$3,013.4	100.0%

⁽¹⁾ The value of the CMBS and CDO assets sold on May 3, 2005, was \$586.4 million at December 31, 2004, and this value was included in Grade 2 assets. See *Commercial Real Estate Finance* above.

Grade 1 portfolio assets decreased from \$1.6 billion at December 31, 2005, to \$1.3 billion at March 31, 2006, primarily as a result of the sale of Advantage Sales & Marketing, Inc. (Advantage) on March 29, 2006. Advantage had a value of \$660.4 million, including \$402.7 million of unrealized appreciation, at December 31, 2005. Our investment in Advantage after the sale transaction was \$164.3 million at value, including \$13.0 million of unrealized appreciation, at March 31, 2006, and was included in Grade 1 assets. See *Portfolio and Investment Activity* above for further discussion. Grade 2 portfolio assets increased from \$1.7 billion at December 31, 2005, to \$2.2 billion at March 31, 2006, primarily as a result of the level of new investments made during the first quarter of 2006, as new investments generally enter the portfolio as Grade 2 assets.

Grade 1 portfolio assets increased from \$952.5 million at December 31, 2004, to \$1.6 billion at December 31, 2005, primarily as a result of the appreciation in value of our investment in Advantage Sales & Marketing, Inc. (Advantage) as well as certain other companies. Advantage had a value of \$660.4 million, including \$402.7 million of unrealized appreciation, at December 31, 2005, as compared to a value of \$283.0 million, including \$24.3 million of unrealized appreciation, at December 31, 2004. See further discussion of the valuation of Advantage below. As noted above, in March 2006, we sold our majority interest in Advantage.

Total Grade 3, 4 and 5 portfolio assets were \$219.9 million, \$232.6 million, and \$210.4 million, respectively, or were 5.9%, 6.4%, and 7.0%, respectively, of the total portfolio at value at March 31, 2006, and December 31, 2005 and 2004.

Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio

companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with such companies in order to recover the maximum amount of our investment.

Loans and Debt Securities on Non-Accrual Status. At March 31, 2006, and December 31, 2005 and 2004, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

	2006	2005	2004
(\$ in millions)			
Loans and debt securities in workout status (classified as Grade 4 or 5) ⁽¹⁾			
Private finance			
Companies more than 25% owned	\$ 29.0	\$ 15.6	\$ 34.4
Companies 5% to 25% owned	5.6		
Companies less than 5% owned	51.8	11.4	16.5
Commercial real estate finance	12.6	12.9	5.6
Loans and debt securities not in workout status			
Private finance			
Companies more than 25% owned	40.6	58.0	29.4
Companies 5% to 25% owned	5.1	0.5	0.7
Companies less than 5% owned	4.4	49.5	15.8
Commercial real estate finance	8.6	7.9	12.5
Total	\$ 157.7	\$ 155.8	\$ 114.9
Percentage of total portfolio	4.3%	4.3%	3.8%

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

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent at value at March 31, 2006, and December 31, 2005 and 2004, were as follows:

	2006	2005	2004
(\$ in millions)			
Private finance	\$ 82.6	\$ 74.6	\$ 73.5
Commercial real estate finance			
CMBS bonds			49.0
Commercial mortgage loans	6.0	6.1	10.1
Total	\$ 88.6	\$ 80.7	\$ 132.6
Percentage of total portfolio	2.4%	2.2%	4.4%

In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. In addition, interest may not accrue on loans to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. To the extent interest payments are received on a loan that is not accruing interest, we may use such payments to reduce our cost basis in the investment in lieu of recognizing interest income.

Our loans and debt securities on non-accrual status increased by \$40.9 million during 2005. This net increase during the year resulted primarily from the move of two loans to non-accrual status totaling \$46.7 million at value at December 31, 2005, offset by a net decrease in the value of loans that were on non-accrual status at both

December 31, 2005 and 2004.

As a result of these and other factors, the amount of the private finance portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$88.6 million, \$60.7 million and \$43.9 million at March 31, 2006, and December 31, 2005 and 2004, respectively.

RESULTS OF OPERATIONS**Comparison of Three Months Ended March 31, 2006 and 2005**

The following table summarizes the Company's operating results for the three months ended March 31, 2006 and 2005.

	For the Three Months Ended March 31,		Change	Percentage Change
	2006	2005		
(\$ in thousands, except per share amounts)				
(unaudited)				
Interest and Related Portfolio Income				
Interest and dividends	\$ 88,881	\$ 84,945	\$ 3,936	5%
Loan prepayment premiums	5,286	1,677	3,609	215%
Fees and other income	16,844	8,297	8,547	103%
Total interest and related portfolio income	111,011	94,919	16,092	17%
Expenses				
Interest	24,300	20,225	4,075	20%
Employee	21,428	15,456	5,972	39%
Stock options	3,606		3,606	100%
Administrative	11,519	20,754	(9,235)	(44)%
Total operating expenses	60,853	56,435	4,418	8%
Net investment income before income taxes	50,158	38,484	11,674	30%
Income tax expense (benefit), including excise tax	8,858	(268)	9,126	**
Net investment income	41,300	38,752	2,548	7%
Net Realized and Unrealized Gains (Losses)				
Net realized gains	432,835	10,285	422,550	*
Net change in unrealized appreciation or depreciation	(374,548)	70,584	(445,132)	*
Total net gains	58,287	80,869	(22,582)	*
Net income	\$ 99,587	\$ 119,621	\$ (20,034)	(17)%
Diluted earnings per common share	\$ 0.70	\$ 0.88	\$ (0.18)	(20)%
Weighted average common shares outstanding diluted	141,738	135,579	6,159	5%

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

** Percentage change is not meaningful.

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

Interest and Dividends. Interest and dividend income for the three months ended March 31, 2006 and 2005, was composed of the following:

	2006	2005
(\$ in millions)		
Interest		
Private finance loans and debt securities	\$82.6	\$56.8
CMBS and CDO portfolio		22.1
Commercial mortgage loans	2.8	1.5
Cash and cash equivalents and other	2.9	0.4
Total interest	88.3	80.8
Dividends	0.6	4.1
Total interest and dividends	\$88.9	\$84.9

Our interest income from our private finance loans and debt securities has increased period over period as a result of the growth in this portfolio since March 31, 2005, as shown below. In addition, during the first quarter of 2006, we resumed accruing interest for certain private finance portfolio companies. Such additional interest income totaled \$3.8 million for the three months ended March 31, 2006.

There was no interest income from the CMBS and CDO portfolio in the first quarter of 2006 as we sold this portfolio on May 3, 2005. The CMBS and CDO portfolio sold had a cost basis of \$718.1 million and a weighted average yield on the cost basis of the portfolio of approximately 13.8%. We generally reinvested the principal proceeds from the CMBS and CDO portfolio into our private finance portfolio.

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at March 31, 2006 and 2005, were as follows:

	2006		2005	
	Value	Weighted Average Yield ⁽¹⁾	Value	Weighted Average Yield ⁽¹⁾
(\$ in millions)				
Private finance loans and debt securities	\$2,530.0	12.5%	\$1,556.4	13.8%
CMBS and CDO portfolio			693.2	13.9%
Commercial mortgage loans	102.7	7.6%	89.7	6.4%
Total	\$2,632.7	12.3%	\$2,339.3	13.6%

⁽¹⁾ The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and

debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

The private finance portfolio yield at March 31, 2006, of 12.5% as compared to the private finance portfolio yield of 13.8% at March 31, 2005, reflects the mix of debt investments in the private finance portfolio. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption Private Finance.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests. Dividend income for the three months ended March 31, 2006 and 2005, included \$0 and \$2.0 million, respectively, of dividends from BLX on the Class B equity interests held by us, which were paid in cash.

Loan Prepayment Premiums. Loan prepayment premiums were \$5.3 million and \$1.7 million for the three months ended March 31, 2006 and 2005, respectively. Loan prepayment premiums for the three months ended March 31, 2006, included \$5.0 million related to the repayment of our subordinated debt in connection with the sale of our majority equity interest in Advantage. See Portfolio and Investment Activity above for further discussion. While the scheduled maturities of private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

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

Fees and other income for the three months ended March 31, 2006 and 2005, included fees relating to the following:

	2006	2005
(\$ in millions)		
Structuring and diligence	\$11.0	\$1.3
Transaction and other services provided to portfolio companies	0.1	1.2
Management, consulting and other services provided to portfolio companies and guaranty fees	5.7	4.8
Other income		1.0
Total fees and other income	\$16.8	\$8.3

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level of investment activity and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Structuring and diligence fees for the three months ended March 31, 2006, included structuring fees from Advantage Sales and Marketing, CR Brands, Hot Stuff Foods, and 3SI Security Systems totaling \$8.1 million. Structuring and diligence fees may vary substantially from period to period based on the level of new investment originations and the market rates for these types of fees. Private finance investments funded were \$795.9 million for the three months ended March 31, 2006, as compared to \$168.2 million for the three months ended March 31, 2005.

Management fees for the three months ended March 31, 2006, included \$1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See Portfolio and Investment Activity above for further discussion.

Fees and other income related to the CMBS and CDO portfolio for the three months ended March 31, 2005, were \$1.7 million. As noted above, we sold our CMBS and CDO portfolio on May 3, 2005.

BLX and Advantage. BLX was our largest investment at value at March 31, 2006, and represented 7.9% of our total assets. Advantage and BLX were our largest investments at March 31, 2005, and together represented 19.5% of our total assets.

Total interest and related portfolio income from these investments for the three months ended March 31, 2005 and 2006, was as follows:

(\$ in millions)	2006	2005
Advantage ⁽¹⁾	\$ 14.1	\$ 9.2
BLX	\$ 6.1	\$ 7.8

⁽¹⁾ Includes income from the period we held a majority equity interest only. See Portfolio and Investment Activity above for further discussion.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses.

Interest Expense. The fluctuations in interest expense during the three months ended March 31, 2006 and 2005, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and closing costs, at and for the three months ended March 31, 2006 and 2005, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,	
	2006	2005
Total outstanding debt	\$1,274.2	\$1,296.4
Average outstanding debt	\$1,491.5	\$1,125.0
Weighted average cost ⁽¹⁾	6.5%	6.4%

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

In addition, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$0.2 million and \$0.5 million for the three months ended March 31, 2006 and 2005, respectively.

Employee Expense. Employee expenses for the three months ended March 31, 2006 and 2005, were as follows:

	2006	2005
(\$ in millions)		
Salaries and employee benefits ⁽¹⁾	\$ 17.3	\$ 12.0
Individual performance award (IPA)	1.7	1.9
IPA mark to market expense (benefit)	1.0	0.1
Individual performance bonus (IPB)	1.4	1.5
Total employee expense	\$ 21.4	\$ 15.5
Number of employees at end of period	155	158

⁽¹⁾ Salaries and employee benefits included accrued bonuses of \$7.9 million and \$3.7 million for the three months ended March 31, 2006 and 2005, respectively.

The change in salaries and employee benefits reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Salaries and employee benefits expense has generally increased due to changes in the composition of our employee resources and compensation increases.

The Individual Performance Award (IPA) is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.

As a result of changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting talent in the private equity industry, the Compensation Committee and the Board of Directors determined that for 2005 and 2006 a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB is distributed in cash to award recipients in equal bi-weekly installments (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2006. We currently estimate the IPA and IPB to be approximately \$8.1 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

In connection with our 2006 Annual Meeting of Stockholders, the stockholders approved the issuance of up to 2,500,000 shares of our common stock in exchange for the cancellation of vested in-the-money stock options granted to certain officers and directors under the Amended Stock Option Plan. Under the initiative, which has been reviewed and approved by our Board of Directors, all optionees who hold vested stock options with exercise prices below the market value of the stock (or in-the-money options), would be offered the opportunity to receive cash and common stock in exchange for their voluntary cancellation of their vested stock options. The sum of the cash and common stock to be received by each optionee would equal the in-the-money value of the stock option

cancelled. As part of this initiative, the Board of Directors is also considering the adoption of a target ownership structure that would establish minimum ownership levels for our senior officers and continue to further align the interests of our officers with those of our stockholders. Unlike the accounting treatment typically associated with a stock option exercise, the option cancellation payment (OCP) would be recorded as an expense for financial reporting purposes, and the expense may be significant. Based on the 13 million vested options outstanding and the market price of \$30.50 of our stock on March 10, 2006, the expense related to the OCP would be approximately \$106 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. For income tax purposes, our tax expense resulting from the OCP would be similar to the tax expense that would result from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market would be limited by Section 162(m) of the Code for persons subject to Section 162(m).

Employee Stock Options Expense. In December 2004, the FASB issued Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement), which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement was effective January 1, 2006, and it applies to our stock option plan. Our stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the service period. With respect to options granted prior to January 1, 2006, we have used the modified prospective method for adoption of the Statement. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the service period in the statement of operations beginning in 2006. With respect to options granted on or after January 1, 2006, compensation cost is recognized in the statement of operations over the service period. The effect of this adoption for the three months ended March 31, 2006, was employee-related stock option expense of \$3.6 million, which included \$3.4 million related to previously awarded options that were unvested as of January 1, 2006, and \$0.2 million related to options granted during the three months ended March 31, 2006.

We estimate that the stock option expense that will be recorded in our statement of operations under the Statement, will be approximately \$14.3 million, \$9.3 million, and \$2.8 million for the years ended December 31, 2006, 2007, and 2008, respectively, which includes stock option expense related to options granted in the first quarter of 2006 of approximately \$0.8 million, \$0.5 million, and \$0.2 million, respectively. This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant.

Administrative Expense. Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, stock record expenses, directors' fees, and various other expenses. Administrative expenses for the three months ended March 31, 2006 and 2005, were as follows:

	2006	2005
(\$ in millions)		
Administrative expenses, excluding investigation related costs	\$ 8.6	\$ 8.5
Investigation related costs	2.9	12.3
Total administrative expenses	\$ 11.5	\$ 20.8

Investigation related costs include costs associated with requests for information in connection with two government investigations. These expenses remain difficult to predict. See Legal Proceedings.

Income Tax Expense (Benefit), Including Excise Tax. Income tax expense (benefit) for the three months ended March 31, 2006 and 2005, were as follows:

	2006	2005
(\$ in millions)		
Income tax expense (benefit)	\$0.5	\$(0.3)
Excise tax expense	8.4	
Income tax expense (benefit), including excise tax	\$8.9	\$(0.3)

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period. In addition, our estimated annual taxable income for 2006 currently exceeds our estimated dividend distributions to shareholders from such taxable income in 2006, and such estimated excess taxable income will be distributed in 2007. Therefore, we will be required to pay a 4% excise tax on the excess of 98% of our taxable income over the amount of actual distributions from such taxable income. Accordingly, we have accrued an estimated excise tax of \$8.4 million for the three months ended March 31, 2006, based upon our estimated excess taxable income earned for that period. See Financial Condition, Liquidity and Capital Resources.

Realized Gains and Losses. Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the three months ended March 31, 2006 and 2005, were as follows:

	For the Three Months Ended March 31,	
	2006	2005
(\$ in millions)		
Realized gains	\$436.5	\$14.7
Realized losses	(3.7)	(4.4)
Net realized gains	\$432.8	\$10.3

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

months ended March 31, 2006 and 2005, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

(\$ in millions)	For the Three Months Ended March 31,	
	2006	2005
Reversal of previously recorded unrealized appreciation associated with realized gains	\$(393.6)	\$(9.9)
Reversal of previously recorded unrealized depreciation associated with realized losses	2.7	4.8
Total reversal	\$(390.9)	\$(5.1)

Realized gains for the three months ended March 31, 2006 and 2005, were as follows:
(\$ in millions)

2006		
Portfolio Company		Amount
Private Finance:		
Advantage Sales & Marketing, Inc.		\$433.1
Nobel Learning Communities, Inc.		1.5
The Debt Exchange Inc.		1.1
Other		0.2
Total private finance		435.9
Commercial Real Estate:		
Other		0.6
Total commercial real estate		0.6
Total gross realized gains		\$436.5

2005		
Portfolio Company		Amount
Private Finance:		
Polaris Pool Systems, Inc.		\$ 7.4
U.S. Security Holdings, Inc.		3.3
Oriental Trading Company, Inc.		1.0

Woodstream Corporation	0.9
DCS Business Services, Inc.	0.7
Other	0.9
Total private finance	14.2
Commercial Real Estate:	
Other	0.5
Total commercial real estate	0.5
Total gross realized gains	\$14.7

Realized losses for the three months ended March 31, 2006 and 2005, were as follows:
(\$ in millions)

2006

Portfolio Company	Amount
Private Finance:	
Aspen Pet Products, Inc.	\$1.5
Nobel Learning Communities, Inc.	1.4
Other	0.5
Total private finance	3.4
Commercial Real Estate:	
Other	0.3
Total commercial real estate	0.3
Total gross realized losses	\$3.7

2005

Portfolio Company	Amount
Private Finance:	
Alderwoods Group, Inc.	\$0.8
Other	0.3
Total private finance	1.1
Commercial Real Estate:	
Other	3.3
Total commercial real estate	3.3

Total gross realized losses \$4.4

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of

Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At March 31, 2006, and December 31, 2005, portfolio investments recorded at fair value were approximately 90% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and quarterly unaudited financial

statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by U.S. generally accepted accounting principles and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by U.S. generally accepted accounting principles. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

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

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

As a participant in the private equity business, we invest primarily in private middle market companies for which there is generally no publicly available information. Because of the private nature of these businesses, there is a need to maintain the confidentiality of the financial and other information that we have for the private companies in our portfolio. We believe that maintaining this confidence is important, as disclosure of such information could disadvantage our portfolio companies and could put us at a disadvantage in attracting new investments. Therefore, we do not intend to disclose financial or other information about our portfolio companies, unless required, because we believe doing so may put them at an economic or competitive disadvantage, regardless of our level of ownership or control.

We will continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter. In addition, we may receive third-party assessments of a particular private finance portfolio company's value in

the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these third-party valuation resources, when applicable, is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

For the three months ended March 31, 2006 and 2005, we received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey) for our private finance portfolio as follows:

	2006	2005
Number of private finance portfolio companies reviewed:		
Duff & Phelps ⁽¹⁾	76	35
Houlihan Lokey	2	1
Total number of private finance portfolio companies reviewed	78	36
Percentage of private finance portfolio reviewed at value:		
Duff & Phelps ⁽¹⁾	82.2%	59.6%
Houlihan Lokey	4.8%	14.9%
Percentage of private finance portfolio reviewed at value	87.0%	74.5%

⁽¹⁾ During the third quarter of 2005, S&P Corporate Value Consulting merged with Duff & Phelps, LLC, a financial advisory and investment banking firm. The merged company operates under the name of Duff & Phelps, LLC.

Professional fees for third-party valuation assistance were \$1.4 million for the year ended December 31, 2005, and are estimated to be approximately \$1.5 million for 2006.

Valuation Methodology CMBS Bonds and CDO and CLO Bonds and Preferred Shares/Income Notes (CMBS/CDO/CLO Assets). CMBS/CDO/CLO Assets 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 bonds and preferred shares/income notes, when available. We recognize unrealized appreciation or depreciation on our CMBS/CDO/CLO Assets as comparable yields in the market change and/ or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We determine the fair value of our CMBS/CDO/CLO Assets on an individual security-by-security basis. When we sold a group of these real estate related assets in a pool in one or more transactions, the total value received for that pool was generally different than the sum of the fair values of the individual bonds or preferred shares/income notes.

Net Change in Unrealized Appreciation or Depreciation. Net change in unrealized appreciation or depreciation for the three months ended March 31, 2006 and 2005, consisted of the following:

(\$ in millions)	2006 ⁽¹⁾	2005 ⁽¹⁾
Net unrealized appreciation or depreciation	\$ 16.4	\$75.7
Reversal of previously recorded unrealized appreciation associated with realized gains	(393.6)	(9.9)
Reversal of previously recorded unrealized depreciation associated with realized losses	2.7	4.8
Net change in unrealized appreciation or depreciation	\$(374.5)	\$70.6

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

At March 31, 2006, our largest investment was in BLX. The following is a summary of the methodology that we used to determine the fair value of this investment.

Business Loan Express, LLC. To determine the value of our investment in BLX at March 31, 2006, we performed four separate valuation analyses to determine a range of values: (1) analysis of comparable public company trading multiples, (2) analysis of BLX's value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. We received valuation assistance from Duff & Phelps for our investment in BLX at March 31, 2006, and December 31, 2005.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at March 31, 2006, was made up of CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at December 31, 2005.

Our investment in BLX at March 31, 2006, was valued at \$326.2 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was \$35.0 million at March 31, 2006. We decreased unrealized appreciation in the first quarter of 2006 by \$22.7 million from December 31, 2005. This decrease resulted from a reduction in enterprise value at March 31, 2006, of approximately 4% as compared to the enterprise value at December 31, 2005. BLX has experienced higher loan prepayments in recent months, which BLX management believes is due to a robust economy and increased competition from banks, and as a result, BLX management has scaled back their projected loan originations as a result of this more competitive lending environment.

Per Share Amounts. All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 141.7 million and 135.6 million for the three months ended March 31, 2006 and 2005, respectively.

Comparison of the Years Ended December 31, 2005, 2004, and 2003

The following table summarizes our operating results for the years ended December 31, 2005, 2004, and 2003.

(in thousands, except per share amounts)	2005	2004	Change	Percent Change	2004	2003	Change	Percent Change
Interest and Related Portfolio Income								
Interest and dividends	\$317,153	\$319,642	\$ (2,489)	(1)%	\$319,642	\$290,719	\$28,923	10%
Loan prepayment premiums	6,250	5,502	748	14%	5,502	8,172	(2,670)	(33)%
Fees and other income	50,749	41,946	8,803	21%	41,946	30,338	11,608	38%
Total interest and related portfolio income	374,152	367,090	7,062	2%	367,090	329,229	37,861	11%
Expenses								
Interest	76,798	75,650	1,148	2%	75,650	77,233	(1,583)	(2)%
Employee	78,300	53,739	24,561	46%	53,739	36,945	16,794	45%
Administrative	70,267	34,686	35,581	103%	34,686	22,387	12,299	55%
Total operating expenses	225,365	164,075	61,290	37%	164,075	136,565	27,510	20%
Net investment income before income taxes	148,787	203,015	(54,228)	(27)%	203,015	192,664	10,351	5%
Income tax expense (benefit), including excise tax	11,561	2,057	9,504	**	2,057	(2,466)	4,523	**
Net investment income	137,226	200,958	(63,732)	(32)%	200,958	195,130	5,828	3%
Net Realized and Unrealized Gains (Losses)								
Net realized gains	273,496	117,240	156,256	133%	117,240	75,347	41,893	56%
Net change in unrealized appreciation or depreciation	462,092	(68,712)	530,804	*	(68,712)	(78,466)	9,754	*

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Total net gains (losses)	735,588	48,528	687,060	*	48,528	(3,119)	51,647	*
Net income	\$872,814	\$249,486	\$623,328	250%	\$249,486	\$192,011	\$57,475	30%
Diluted earnings per common share	\$ 6.36	\$ 1.88	\$ 4.48	238%	\$ 1.88	\$ 1.62	\$ 0.26	16%
Weighted average common shares outstanding	137,274	132,458	4,816	4%	132,458	118,351	14,107	12%
diluted								

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

** Percentage change is not meaningful.

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

Interest and dividend income for the years ended December 31, 2005, 2004, and 2003, was composed of the following:

	2005	2004	2003
(\$ in millions)			
Interest			
Private finance loans and debt securities	\$251.0	\$195.2	\$177.3
CMBS and CDO portfolio	29.4	93.3	86.2
Commercial mortgage loans	7.6	9.4	9.0
Cash and cash equivalents and other	9.4	3.1	2.8
Total interest	297.4	301.0	275.3
Dividends	19.8	18.6	15.4
Total interest and dividends	\$317.2	\$319.6	\$290.7

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. The interest-bearing investments in the portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at December 31, 2005, 2004, and 2003, were as follows:

	2005	2004	2003
(\$ in millions)			
Interest-bearing portfolio at value	\$2,211.4	\$2,301.2	\$1,891.9
Portfolio yield	12.8%	14.0%	14.7%

We sold our CMBS and CDO portfolio on May 3, 2005. As a result of this transaction, our interest income for the year ended December 31, 2005, was reduced due to the loss of interest from the portfolio sold (net of interest income earned on short-term excess cash investments). The CMBS and CDO portfolio sold on May 3, 2005, had a cost basis of \$718.1 million and a weighted average yield on the cost basis of the portfolio of approximately 13.8%. Excess cash proceeds from the sale that were not used for the repayment of debt or other general corporate purposes were held in cash and money market securities until the cash was reinvested in the portfolio.

The portfolio yield at December 31, 2005, of 12.8% as compared to the portfolio yield of 14.0% and 14.7% at December 31, 2004 and 2003, respectively, reflects the sale of the CMBS and CDO portfolio on May 3, 2005, as well as the mix of debt investments in the private finance portfolio. See the discussion of the private finance portfolio yield above under the caption Private Finance.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests. Dividend income included dividends from BLX on the Class B equity interests held by us of \$14.0 million, \$14.8 million, and \$7.8 million for the years ended December 31, 2005, 2004, and 2003, respectively. For the year ended December 31, 2005, \$12.0 million of these dividends were paid in cash and \$2.0 million of these dividends were paid through the issuance of additional Class B equity interests. For the

years ended December 31, 2004 and 2003, these dividends were paid through the issuance of additional Class B equity interests.

Loan prepayment premiums were \$6.3 million, \$5.5 million, and \$8.2 million for the years ended December 31, 2005, 2004, and 2003, respectively. While the scheduled maturities of private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

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

Fees and other income for the years ended December 31, 2005, 2004, and 2003, included fees relating to the following:

	2005	2004	2003
(\$ in millions)			
Structuring and diligence	\$24.6	\$18.4	\$ 6.1
Transaction and other services provided to portfolio companies	2.9	3.2	4.5
Management, consulting and other services provided to portfolio companies and guaranty fees	20.8	17.4	18.7
Other income	2.4	2.9	1.0
Total fees and other income	\$50.7	\$41.9	\$30.3

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level of investment activity and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Fees and other income for the year ended December 31, 2005, included structuring fees from Norwesco, Inc., Callidus Capital Corporation, Triax Holdings, LLC, and Meineke Car Care Centers, Inc. totaling \$9.4 million. Fees and other income for the year ended December 31, 2004, included structuring fees from Advantage, Financial Pacific Company, Mercury Air Centers, Inc. and Insight Pharmaceutical Corporation totaling \$10.0 million.

Fees and other income related to the CMBS and CDO portfolio were \$4.1 million, \$6.2 million, and \$2.8 million for the years ended December 31, 2005, 2004, and 2003, respectively.

Advantage and BLX were our largest investments at value at December 31, 2005 and 2004, and together represented 25.3% and 19.0%, of our total assets, respectively. BLX and

Hillman were our largest portfolio investments at December 31, 2003, and together represented 19.1% of our total assets at December 31, 2003.

Total interest and related portfolio income from these investments for the years ended December 31, 2005, 2004, and 2003, was as follows:

	2005	2004	2003
(\$ in millions)			
Advantage ⁽¹⁾⁽²⁾	\$37.4	\$21.3	\$
BLX	\$37.5	\$50.0	\$46.7
Hillman ⁽¹⁾	\$	\$ 2.5	\$ 9.7

⁽¹⁾ Includes income from our controlled investments only.

⁽²⁾ In March 2006, we sold our majority interest in Advantage. See Management Discussion and Analysis above. **Operating Expenses.** Operating expenses include interest, employee, and administrative expenses.

Interest Expense. The fluctuations in interest expense during the years ended December 31, 2005, 2004, and 2003, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and closing costs, at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

	2005	2004	2003
(\$ in millions)			
Total outstanding debt	\$1,284.8	\$1,176.6	\$954.2
Average outstanding debt	\$1,087.1	\$ 985.6	\$943.5
Weighted average cost ⁽¹⁾	6.5%	6.6%	7.5%

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

In addition, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$1.4 million, \$5.2 million, and \$5.9 million for the years ended December 31, 2005, 2004, and 2003, respectively.

Employee Expense. Employee expenses for the years ended December 31, 2005, 2004, and 2003, were as follows:

	2005	2004	2003
(\$ in millions)			
Salaries and employee benefits	\$57.3	\$40.7	\$28.3
Individual performance award (IPA)	7.0	13.4	
IPA mark to market expense (benefit)	2.0	(0.4)	
Individual performance bonus (IPB)	6.9		
Transition compensation, net	5.1		
Retention award			8.6
Total employee expense	\$78.3	\$53.7	\$36.9
Number of employees at end of period	131	162	125

The change in salaries and employee benefits reflects the effect of wage increases, the change in mix of employees given their area of responsibility and relevant experience level, and the termination of certain employees in our commercial real estate group as discussed

below. Salaries and employee benefits expense has generally increased due to changes in the composition of our employee resources and compensation increases.

Transition compensation costs were \$5.1 million for the year ended December 31, 2005, including \$3.1 million of costs under retention agreements and \$3.1 million of transition services bonuses awarded to certain employees in the commercial real estate group as a result of the sale of the CMBS and CDO portfolio. Transition compensation costs of \$5.1 million for the year ended December 31, 2005, reflect a reduction for salary reimbursements from CWCapital under the transition services agreement of \$1.1 million. See the caption Commercial Real Estate Finance above for additional information.

Employee expense, excluding transition compensation, related to the 31 employees in our commercial real estate group who terminated employment in the third quarter of 2005 as a result of the sale of our CMBS and CDO portfolio, was \$4.5 million, \$6.8 million, and \$3.4 million for the years ended December 31, 2005, 2004, and 2003, respectively.

The Individual Performance Award (IPA) is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.

As a result of changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting talent in the private equity industry, the Compensation Committee and the Board of Directors have determined for 2005 and 2006 that a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB is distributed in cash to award recipients in equal bi-weekly installments (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2006 and they are currently estimated to be approximately \$8.1 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

Administrative Expense. Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, stock record expenses, directors' fees, and various other expenses.

Administrative expenses for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)	2005	2004	2003
Administrative expenses, excluding investigation related costs	\$33.9	\$30.1	\$22.4
Investigation related costs	36.4	4.6	
Total administrative expenses	\$70.3	\$34.7	\$22.4

The increase in administrative expenses, excluding investigation related costs, for the year ended December 31, 2005, over the year ended December 31, 2004, was primarily due to increased expenses related to evaluating potential new investments of \$2.0 million, accounting fees of \$0.8 million, recruiting and employee training costs of \$0.6 million, and valuation assistance fees of \$0.5 million, offset by a decrease in expenses related to a decline in portfolio workout expenses of \$0.6 million.

Administrative expenses, excluding investigation related costs, were \$30.1 million for the year ended December 31, 2004, a \$7.7 million increase over administrative expenses of \$22.4 million for the year ended December 31, 2003. The increase in expenses primarily resulted from:

a net increase in accounting, consulting, and other fees of \$1.7 million. This increase is primarily attributable to fees associated with the implementation of the requirements under the Sarbanes-Oxley Act of 2002 (including Section 404) and valuation assistance,

an increase in deal costs related to evaluating potential new investments of \$1.6 million. Costs related to mezzanine lending are generally paid by the borrower, however, costs related to buyout investments are generally funded by us. Accordingly, if a prospective deal does not close, we incur expenses that are not recoverable,

an increase in expenses related to portfolio development and workout activities of \$1.5 million,

an increase in rent of \$1.4 million associated with the opening of an office in Los Angeles, CA and expanding our office space in Chicago, IL and New York, NY, and

an increase in other expenses, including stock record expense, insurance premiums and directors' fees of \$1.1 million, and travel expenses of \$0.8 million.

In addition, administrative expenses for the years ended December 31, 2005 and 2004, included costs associated with requests for information in connection with two government investigations. These expenses remain difficult to predict. See Legal Proceedings.

Income Tax Expense (Benefit), Including Excise Tax. Income tax expense (benefit) for the years ended December 31, 2005, 2004, and 2003, were as follows:

	2005	2004	2003
(\$ in millions)			
Income tax expense (benefit)	\$ 5.4	\$ 1.1	\$(2.5)
Excise tax expense	6.2	1.0	
Income tax expense (benefit), including excise tax	\$ 11.6	\$ 2.1	\$(2.5)

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period. In addition, our estimated annual taxable income for 2005 exceeded our dividend distributions to shareholders for 2005 from such taxable income, and such estimated excess taxable income will be distributed in 2006. Therefore, we will be required to pay a 4% excise tax on the excess of 98% of our taxable income for 2005 over the amount of actual distributions for 2005. Accordingly, we accrued an estimated excise tax of \$6.2 million for the year ended December 31, 2005, based upon our year-end estimate of annual taxable income for 2005. See Financial Condition, Liquidity and Capital Resources.

Realized Gains and Losses. Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the years ended December 31, 2005, 2004, and 2003, were as follows:

	2005	2004	2003
(\$ in millions)			
Realized gains	\$ 343.1	\$ 267.7	\$ 94.3
Realized losses	(69.6)	(150.5)	(19.0)
Net realized gains	\$ 273.5	\$ 117.2	\$ 75.3

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the years ended December 31, 2005, 2004, and 2003, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

	2005 ⁽¹⁾	2004	2003
(\$ in millions)			
Reversal of previously recorded net unrealized appreciation associated with realized gains	\$(108.0)	\$(210.5)	\$(78.5)
Reversal of previously recorded net unrealized depreciation associated with realized losses	68.0	151.8	20.3
Total reversal	\$ (40.0)	\$ (58.7)	\$(58.2)

- (1) Includes the reversal of net unrealized appreciation of \$6.5 million on the CMBS and CDO assets sold and the related hedges. The net unrealized appreciation recorded on these assets prior to their sale was determined on an individual security-by-security basis. The net gain realized upon the sale of \$227.7 million reflects the total value received for the portfolio as a whole.

Realized gains for the years ended December 31, 2005, 2004, and 2003, were as follows:
(\$ in millions)

2005

Portfolio Company	Amount
Private Finance:	
Housecall Medical Resources, Inc.	\$ 53.7
Fairchild Industrial Products Company	16.2
Apogen Technologies Inc.	9.0
Polaris Pool Systems, Inc.	7.4
MasterPlan, Inc.	3.7
U.S. Security Holdings, Inc.	3.3
Ginsey Industries, Inc.	2.8
E-Talk Corporation	1.6
Professional Paint, Inc.	1.6
Oriental Trading Company, Inc.	1.0
Woodstream Corporation	0.9
Impact Innovations Group, LLC	0.8
DCS Business Services, Inc.	0.7
Other	3.4
Total private finance	106.1
Commercial Real Estate:	
CMBS/CDO assets, net ⁽¹⁾	227.7
Other	9.3
Total commercial real estate	237.0
Total gross realized gains	\$343.1

2004

Portfolio Company	Amount
Private Finance:	
The Hillman Companies, Inc.	\$150.3
CorrFlex Graphics, LLC	25.7
Professional Paint, Inc.	13.7
Impact Innovations Group, LLC	11.1
The Hartz Mountain Corporation	8.3
Housecall Medical Resources, Inc.	7.2
International Fiber Corporation	5.2
CBA-Mezzanine Capital Finance, LLC	4.1
United Pet Group, Inc.	3.8

Oahu Waste Services, Inc.	2.8
Grant Broadcasting Systems II	2.7
Matrics, Inc.	2.1
SmartMail, LLC	2.1
Other	7.6
Total private finance	246.7
Commercial Real Estate:	
CMBS/CDO assets, net ⁽¹⁾	17.4
Other	3.6
Total commercial real estate	21.0
Total gross realized gains	\$267.7

2003

Portfolio Company	Amount
Private Finance:	
Blue Rhino Corporation	\$12.6
CyberRep	9.6
Morton Grove Pharmaceuticals, Inc.	8.5
Warn Industries, Inc.	8.0
Woodstream Corporation	6.6
Kirkland's Inc.	3.0
Julius Koch USA, Inc.	2.8
GC-Sun Holdings II, LP	2.5
Interline Brands, Inc.	1.7
WyoTech Acquisition Corporation	1.3
Advantage Mayer, Inc.	1.2
Other	3.2
Total private finance	61.0
Commercial Real Estate:	
CMBS/CDO assets, net ⁽¹⁾	31.6
Other	1.7
Total commercial real estate	33.3
Total gross realized gains	\$94.3

⁽¹⁾ Net of net realized losses from related hedges of \$0.7 million, \$3.8 million, and \$2.9 million for the years ended December 31, 2005, 2004, and 2003, respectively.

Realized losses for the years ended December 31, 2005, 2004, and 2003, were as follows:
(\$ in millions)

2005

Portfolio Company	Amount
Private Finance:	
Norstan Apparel Shops, Inc.	\$18.5
Acme Paging, L.P.	13.8
E-Talk Corporation	9.0
Garden Ridge Corporation	7.1
HealthASPex, Inc.	3.5
MortgageRamp, Inc.	3.5
Maui Body Works, Inc.	2.7
Packaging Advantage Corporation	2.2
Other	3.7
Total private finance	64.0
Commercial Real Estate:	
Other	5.6
Total commercial real estate	5.6
Total gross realized losses	\$69.6

2004

Portfolio Company	Amount
Private Finance:	
American Healthcare Services, Inc.	\$ 32.9
The Color Factory, Inc.	24.5
Executive Greetings, Inc.	19.3
Sydran Food Services II, L.P.	18.2
Ace Products, Inc.	17.6
Prosperco Finanz Holding AG	7.5
Logic Bay Corporation	5.0
Sun States Refrigerated Services, Inc.	4.7
Chickasaw Sales & Marketing, Inc.	3.8
Sure-Tel, Inc.	2.3
Liberty-Pittsburgh Systems, Inc.	2.0
EDM Consulting, LLC	1.9
Pico Products, Inc.	1.7
Impact Innovations Group, LLC	1.7
Interline Brands, Inc.	1.3
Startec Global Communications Corporation	1.1
Other	2.7

Total private finance	148.2
Commercial Real Estate:	
Other	2.3
Total commercial real estate	2.3
Total gross realized losses	\$ 150.5

2003

Portfolio Company	Amount
Private Finance:	
Allied Office Products, Inc.	\$ 7.7
Candlewood Hotel Company	2.7
North American Archery, LLC	2.1
Other	0.5
Total private finance	13.0
Commercial Real Estate:	
Other	6.0
Total commercial real estate	6.0
Total gross realized losses	\$ 19.0

Change in Unrealized Appreciation or Depreciation. For a discussion of our fair value methodology, see *Change in Unrealized Appreciation or Depreciation* included in the *Comparison of Three Months Ended March 31, 2006 and 2005*.

Private Finance. For the years ended December 31, 2005 and 2004, we received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey) for our private finance portfolio as follows:

	2005				2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Number of private finance portfolio companies reviewed:								
Duff & Phelps ⁽¹⁾	35	72	88	78	22	33	28	22
Houlihan Lokey ⁽²⁾	1	1	3	3				
Total number of private finance portfolio companies reviewed ⁽³⁾	36	72	89	80	22	33	28	22
Percentage of private finance portfolio reviewed at value:								
Duff & Phelps ⁽¹⁾	59.6%	83.0%	86.6%	87.9%	19.9%	21.6%	26.6%	42.2%
Houlihan Lokey ⁽²⁾	14.9%	14.9%	18.9%	23.5%				
Percentage of private finance portfolio reviewed at value ⁽³⁾	74.5%	83.0%	89.3%	92.4%	19.9%	21.6%	26.6%	42.2%

⁽¹⁾ During the third quarter of 2005, S&P Corporate Value Consulting merged with Duff & Phelps, LLC, a financial advisory and investment banking firm. The merged company operates under the name of Duff & Phelps, LLC.

⁽²⁾ Houlihan Lokey was initially engaged in the first quarter of 2005.

⁽³⁾ Duff & Phelps and Houlihan Lokey both reviewed Advantage Sales & Marketing, Inc. in Q2, Q3 and Q4 2005. In addition, Duff & Phelps and Houlihan Lokey both reviewed one other portfolio company in Q3 2005.

Professional fees for third-party valuation assistance for the years ended December 31, 2005 and 2004, were \$1.4 million and \$0.9 million, respectively.

Net Change in Unrealized Appreciation or Depreciation. For the portfolio, net change in unrealized appreciation or depreciation for the years ended December 31, 2005, 2004, and 2003, consisted of the following:

	2005 ⁽¹⁾	2004 ⁽¹⁾	2003 ⁽¹⁾
(\$ in millions)			
Net unrealized appreciation or depreciation	\$ 502.1	\$ (10.0)	\$(20.3)
Reversal of previously recorded unrealized appreciation associated with realized gains	(108.0)	(210.5)	(78.5)
Reversal of previously recorded unrealized depreciation associated with realized losses	68.0	151.8	20.3
Net change in unrealized appreciation or depreciation	\$ 462.1	\$ (68.7)	\$(78.5)

⁽¹⁾ The net change in unrealized appreciation or depreciation can fluctuate significantly from year to year. As a result, annual comparisons may not be meaningful.

At December 31, 2005, our two largest investments were in Advantage and BLX. The following is a summary of the methodology that we used to determine the fair value of these investments.

Advantage Sales & Marketing, Inc. On March 2, 2006, a definitive agreement was signed to sell our majority equity interest in Advantage that indicated an enterprise value of approximately \$1.05 billion. See Portfolio and Investment Activity above. At December 31, 2005, we estimated the enterprise value of Advantage to be \$1.02 billion given that the closing of the transaction was subject to certain closing conditions and the sales price was subject to pre- and post-closing adjustments and certain holdback provisions. Using the enterprise value at December 31, 2005, we determined the value of our investments in Advantage to be \$660.4 million, which resulted in unrealized appreciation on our investment of \$402.7 million at December 31, 2005. This was an increase in unrealized appreciation in the fourth quarter of 2005 of \$224.9 million and an increase of \$378.4 million for the year ended December 31, 2005. Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on our investment in Advantage of \$24.3 million for the year ended December 31, 2004. Both Houlihan Lokey and Duff & Phelps assisted us by reviewing our valuation of our investment in Advantage at December 31, 2005. Duff & Phelps also assisted us by reviewing our valuation of our investment in Advantage at December 31, 2004.

Business Loan Express, LLC. To determine the value of our investment in BLX at December 31, 2005, we performed four separate valuation analyses to determine a range of values: (1) analysis of comparable public company trading multiples, (2) analysis of BLX's value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. We received valuation assistance from Duff & Phelps for our investment in BLX at December 31, 2005 and 2004.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at December 31, 2005, was made up of CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation. The December 31, 2004, comparable group included CapitalSource, Inc., however, it has been excluded from the December 31, 2005,

comparable group as it elected REIT status and no longer trades as a commercial finance company. The remaining comparable group for December 31, 2005, is consistent with the comparable group at December 31, 2004.

Our investment in BLX at December 31, 2005, was valued at \$357.1 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was \$57.7 million at December 31, 2005. Net change in unrealized appreciation or depreciation included a net increase in net unrealized appreciation of \$2.9 million for the year ended December 31, 2005, a net decrease in unrealized appreciation of \$32.3 million for the year ended December 31, 2004, and a net increase in unrealized appreciation of \$51.7 million for the year ended December 31, 2003.

Per Share Amounts. All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 137.3 million, 132.5 million, and 118.4 million for the years ended December 31, 2005, 2004, and 2003, respectively.

OTHER MATTERS

Regulated Investment Company Status. We have elected to be taxed as a regulated investment company under Subchapter M of the Code. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis.

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

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

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

(3) meet asset diversification requirements as defined in the Code; and (4) timely distribute to shareholders at least 90% of our annual investment company taxable income as defined in the Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Our portfolio has historically generated cash flow from which we pay dividends to shareholders and fund new investment activity. Cash generated from the portfolio includes cash flow from net investment income and net realized gains and principal collections related to investment repayments or sales. Cash flow provided by our operating activities before new investment activity for the years ended December 31, 2005, 2004, and 2003, was as follows:

	2005	2004	2003
(\$ in millions)			
Net cash provided by (used in) operating activities	\$ 116.0	\$ (179.3)	\$ 80.3
Add: portfolio investments funded	1,668.1	1,472.4	930.6
Total cash provided by operating activities before new investments	\$1,784.1	\$1,293.1	\$1,010.9

From the cash provided by operating activities before new investments, we make new portfolio investments, fund our operating activities, and pay dividends to shareholders. We also raise new debt and equity capital from time to time in order to fund our investments and operations.

Dividends to common shareholders for the three months ended March 31, 2006, and for the years ended December 31, 2005, 2004, and 2003, were \$82.5 million, \$314.5 million, \$299.3 million, and \$267.8 million, respectively. Total regular quarterly dividends were \$0.59 per common share for the first quarter of 2006, and \$2.30, \$2.28, and \$2.28 per common share for the years ended December 31, 2005, 2004, and 2003, respectively. An extra cash dividend of \$0.03 and \$0.02 per common share was declared during 2005 and 2004, respectively, and was paid to shareholders on January 27, 2006, and January 28, 2005, respectively.

The Board of Directors has declared a dividend of \$0.60 per common share for the second quarter of 2006.

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

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared based upon our estimate of annual taxable income available for distribution to shareholders and the amount of taxable income carried over from the prior year for distribution in the current year. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Code. Excess taxable income carried over and paid out in the next year may be subject to a 4% excise tax. See "Other Matters - Regulated Investment Company Status" above. We believe that carrying over excess taxable income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend. We currently estimate that the taxable income carried over from 2005 for distribution to shareholders in 2006 is \$163.8 million. However, our taxable income for 2005 is an estimate and will not be finally determined until we file our 2005 tax return in September 2006, and therefore, the amount of excess taxable income carried over from 2005 into 2006 may be different from this estimate.

We currently expect that our estimated annual taxable income for 2006 will be in excess of our estimated dividend distributions to shareholders in 2006 from such taxable income, and, therefore, we expect to carry over excess taxable income for distribution to shareholders in 2007. We expect that we will generally be required to pay a 4% excise tax on the excess of 98% of our taxable income for 2006 over the amount of actual distributions from such taxable income in 2006. Accordingly, for the three months ended March 31, 2006, we have accrued an excise tax of \$8.4 million. Excise taxes are accrued based upon estimated excess taxable income as estimated taxable income is earned, therefore, the excise tax accrued to date in 2006 may be adjusted as appropriate in the remainder of 2006 to reflect changes in our estimate of the carry over amount and additional excise tax may be accrued during the remainder of 2006 as additional excess taxable income is earned, if any. Our ability to earn the estimated annual taxable income for 2006 depends on many factors, including our ability to make new investments at attractive yields, the level of repayments in the portfolio, the realization of gains or losses from portfolio exits, and the level of operating expenses incurred. See "Management's Discussion and Analysis of Financial Condition and Results of Operations", "Risk Factors" and Note 10, "Dividends and Distributions and Excise Taxes" of our Notes to Consolidated Financial Statements.

Because we are a regulated investment company, we distribute our taxable income and, therefore, from time to time we will raise new debt or equity capital in order to fund our investments and operations.

Liquidity and Capital Resources

At March 31, 2006, and December 31, 2005 and 2004, our liquidity portfolio (see below), cash and investments in money market securities, total assets, total debt outstanding, total shareholders equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

(\$ in millions)	2006	2005	2004
Liquidity portfolio (including money market securities: 2006-\$101.1; 2005-\$100.0; 2004-\$0)	\$ 202.4	\$ 200.3	\$
Cash and investments in money market securities (including money market securities: 2006-\$38.7; 2005-\$22.0; 2004-\$0)	\$ 43.5	\$ 53.3	\$ 57.2
Total assets	\$4,121.2	\$4,025.9	\$3,261.0
Total debt outstanding	\$1,274.2	\$1,284.8	\$1,176.6
Total shareholders equity	\$2,729.8	\$2,620.5	\$1,979.8
Debt to equity ratio	0.47	0.49	0.59
Asset coverage ratio ⁽¹⁾	317%	309%	280%

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

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

During the fourth quarter of 2005, we established a liquidity portfolio that is composed of money market securities and U.S. Treasury bills. At March 31, 2006, the value and yield of the money market securities were \$101.1 million and 4.6%, respectively, and were held in money market funds. The value and yield of the Treasury bills were \$101.3 million and 4.2%, respectively, at March 31, 2006. The Treasury bills are due in June 2006. The liquidity portfolio was established to provide a pool of liquid assets within our balance sheet. Our investment portfolio is primarily composed of private, illiquid assets for which there is no readily available market. Our liquidity was reduced when we sold our portfolio of CMBS assets in May 2005, particularly BB rated bonds, which were generally more liquid than assets in our private finance portfolio. Given the level of taxable income that we estimate has been carried over from 2005 for distribution in 2006, we established the liquidity portfolio to provide a liquid resource from which to distribute this excess taxable income. We will assess the amount held in and the composition of the liquidity portfolio throughout the year.

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

During the three months ended March 31, 2006, we sold equity of \$83.0 million. We did not sell new equity in a public offering during the year ended December 31, 2005. For the years ended December 31, 2004 and 2003, we sold equity of \$73.5 million and \$422.9 million, respectively. In addition, shareholders equity increased by \$7.7 million,

\$77.5 million, \$51.3 million, and \$21.2 million through the exercise of employee options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the three months ended March 31, 2006, and for the years ended December 31, 2005, 2004, and 2003, respectively.

We employ an asset-liability management approach that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$641.8 million on March 31, 2006. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate investment portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

At March 31, 2006, and December 31, 2005, we had outstanding debt as follows:

	2006				2005			
	Facility Amount	Amount Outstanding	Annual Interest Cost ⁽¹⁾	Annual Return to Cover Interest Payments ⁽²⁾	Facility Amount	Amount Outstanding	Annual Interest Cost ⁽¹⁾	Annual Return to Cover Interest Payments ⁽²⁾
(\$ in millions)								
Notes payable and debentures:								
Unsecured notes payable	\$1,164.7	\$1,164.7	6.2%	1.8%	\$1,164.5	\$1,164.5	6.2%	1.8%
SBA debentures	16.5	16.5	7.4%	0.0%	28.5	28.5	7.5%	0.1%
Total notes payable and debentures	1,181.2	1,181.2	6.2%	1.8%	1,193.0	1,193.0	6.3%	1.9%
Revolving line of credit	772.5	93.0	6.2% ⁽²⁾	0.2%	772.5	91.8	5.6% ⁽³⁾	0.2%
Total debt	\$1,953.7	\$1,274.2	6.5% ⁽³⁾	2.0%	\$1,965.5	\$1,284.8	6.5% ⁽⁴⁾	2.1%

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

(2) The annual portfolio return to cover interest payments is calculated as the March 31, 2006, and December 31, 2005, annualized cost of debt per class of financing outstanding divided by total assets at March 31, 2006, and December 31, 2005.

(3) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees and other facility fees of

\$3.3 million at both March 31, 2006, and December 31, 2005.

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

Unsecured Notes Payable. We have issued unsecured long-term notes to institutional investors, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2006 and generally have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity.

On October 13, 2005, we issued \$261.0 million of five-year and \$89.0 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 6.2% and 6.3%, respectively, and have substantially the same terms as our existing unsecured long-term notes. We used a portion of the proceeds from the new long-term note issuance to repay \$125.0 million of our existing unsecured long-term notes that matured on October 15, 2005, and had an annual weighted average interest cost of 8.3%. During the second quarter of 2005, we repaid \$40.0 million of the unsecured notes payable.

On May 1, 2006, we issued \$50 million of seven-year, unsecured notes with a fixed interest rate of 6.75%. This debt matures in May 2013. The proceeds from the issuance of the notes were used to repay \$25 million of 7.49% unsecured long-term notes that matured on May 1, 2006, with the remainder being used to fund new portfolio investments and for general corporate purposes.

Small Business Administration Debentures. Through our small business investment company subsidiary, we have debentures payable to the Small Business Administration (SBA) with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. During the years ended December 31, 2005 and 2004, we repaid \$49.0 million and \$17.0 million, respectively, of this outstanding debt and we repaid \$12.0 million during the first quarter of 2006. Under the small business investment company program, we may borrow up to \$124.4 million from the SBA. We currently do not have plans to borrow additional amounts from the SBA.

Revolving Line of Credit. At March 31, 2006, we had an unsecured revolving line of credit with a committed amount of \$772.5 million. Effective May 22, 2006, we expanded the committed amount under the facility by \$150.0 million, which brought the total committed amount to \$922.5 million. The facility is now fully committed. The revolving line of credit expires on September 30, 2008.

On May 11, 2006, we amended the terms of the revolving credit facility related to interest rates and certain reporting requirements. The interest rate spread was reduced from 1.30% to 1.05%. The revolving line of credit now generally bears interest at a rate equal to (i) LIBOR (for the period we select) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit continues to require the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans, and monthly payments of interest on other loans. All principal is due upon maturity.

At March 31, 2006, there was \$93.0 million outstanding on our unsecured revolving line of credit. The amount available under the line at March 31, 2006, was \$641.8 million, net of amounts committed for standby letters of credit of \$37.7 million. Net borrowings under the revolving line of credit for the three months ended March 31, 2006, were \$1.3 million.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. Our credit facilities also limit our ability to declare dividends if we default under certain provisions. As of March 31, 2006, and December 31, 2005, we were in compliance with these covenants.

The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of March 31, 2006.

(\$ in millions)	Payments Due By Year						
	Total	2006	2007	2008	2009	2010	After 2010
Notes payable and debentures:							
Unsecured long-term notes payable	\$1,164.7	\$175.0	\$	\$153.0	\$267.2	\$408.0	\$161.5
SBA debentures	16.5						16.5
Revolving line of credit ⁽¹⁾	93.0			93.0			
Operating leases	27.9	3.3	4.4	4.5	4.7	4.4	6.6
Total contractual obligations	\$1,302.1	\$178.3	\$4.4	\$250.5	\$271.9	\$412.4	\$184.6

⁽¹⁾ At March 31, 2006, \$641.8 million remained unused and available, net of amounts committed for standby letters of credit of \$37.7 million issued under the credit facility.

Off-Balance Sheet Arrangements

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of March 31, 2006.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2006	2007	2008	2009	2010	After 2010
Guarantees	\$154.0	\$1.3	\$0.6	\$ 3.0	\$143.6	\$	\$5.5
Standby letters of credit ⁽¹⁾	37.7	0.1		37.6			
Total commitments	\$191.7	\$1.4	\$0.6	\$40.6	\$143.6	\$	\$5.5

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

In addition, we had outstanding commitments to fund investments totaling \$329.9 million at March 31, 2006. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

CRITICAL ACCOUNTING POLICIES

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

most difficult, complex, or subjective judgments. Our critical accounting policies are those applicable to the valuation of investments and certain revenue recognition matters as discussed below.

Valuation of Portfolio Investments. As a business development company, we invest in illiquid securities including debt and equity securities of companies and CDO and CLO bonds and preferred shares/income notes. Our investments may be subject to certain restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the Board of Directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a

reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investments. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and/ or our equity security has 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. The value of loan and debt securities may be greater than our cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than our cost basis.

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

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

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

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

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

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

We recognize income from the amortization of original issue discount using the effective interest method using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CDO/ CLO Assets from the date the estimated yield was 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, the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

Fee Income. Fee income includes fees for guarantees and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Guaranty fees are generally 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, consulting and other services fees are generally recognized as income as the services are rendered.

SENIOR SECURITIES

Information about our senior securities is shown in the following tables as of December 31 for the years indicated in the table, unless otherwise noted. The report of our independent registered public accounting firm on the senior securities table as of December 31, 2005, is attached as an exhibit to the registration statement of which this prospectus is a part. The indicates information which the SEC expressly does not require to be disclosed for certain types of senior securities.

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities⁽¹⁾	Asset Coverage Per Unit⁽²⁾	Involuntary Liquidating Preference Per Unit⁽³⁾	Average Market Value Per Unit⁽⁴⁾
Unsecured Long-term Notes Payable				
1996	\$ 0	\$ 0	\$	N/A
1997	0	0		N/A
1998	180,000,000	2,734		N/A
1999	419,000,000	2,283		N/A
2000	544,000,000	2,445		N/A
2001	694,000,000	2,453		N/A
2002	694,000,000	2,704		N/A
2003	854,000,000	3,219		N/A
2004	981,368,000	2,801		N/A
2005	1,164,540,000	3,086		N/A
2006 (as of March 31, unaudited)	1,164,745,000	3,170		N/A
Small Business Administration Debentures ⁽⁵⁾				
1996	\$ 61,300,000	\$2,485	\$	N/A
1997	54,300,000	2,215		N/A
1998	47,650,000	2,734		N/A
1999	62,650,000	2,283		N/A
2000	78,350,000	2,445		N/A
2001	94,500,000	2,453		N/A
2002	94,500,000	2,704		N/A
2003	94,500,000	3,219		N/A
2004	77,500,000	2,801		N/A
2005	28,500,000	3,086		N/A
2006 (as of March 31, unaudited)	16,500,000	3,170		N/A
Overseas Private Investment Corporation Loan				
1996	\$ 8,700,000	\$2,485	\$	N/A
1997	8,700,000	2,215		N/A
1998	5,700,000	2,734		N/A
1999	5,700,000	2,283		N/A
2000	5,700,000	2,445		N/A
2001	5,700,000	2,453		N/A

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2002	5,700,000	2,704	N/A
2003	5,700,000	3,219	N/A
2004	5,700,000	2,801	N/A
2005	0	0	N/A
2006 (as of March 31, unaudited)	0	0	N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities⁽¹⁾	Asset Coverage Per Unit⁽²⁾	Involuntary Liquidating Preference Per Unit⁽³⁾	Average Market Value Per Unit⁽⁴⁾
Revolving Lines of Credit				
1996	\$ 45,099,000	\$2,485	\$	N/A
1997	38,842,000	2,215		N/A
1998	95,000,000	2,734		N/A
1999	82,000,000	2,283		N/A
2000	82,000,000	2,445		N/A
2001	144,750,000	2,453		N/A
2002	204,250,000	2,704		N/A
2003	0	0		N/A
2004	112,000,000	2,801		N/A
2005	91,750,000	3,086		N/A
2006 (as of March 31, unaudited)	93,000,000	3,170		N/A
Auction Rate Reset Note				
1996	\$ 0	\$ 0	\$	N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	76,598,000	2,445		N/A
2001	81,856,000	2,453		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
2005	0	0		N/A
2006 (as of March 31, unaudited)	0	0		N/A
Master Repurchase Agreement and Master Loan and Security Agreement				
1996	\$ 85,775,000	\$2,485	\$	N/A
1997	225,821,000	2,215		N/A
1998	6,000,000	2,734		N/A
1999	23,500,000	2,283		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
2005	0	0		N/A
2006 (as of March 31, unaudited)	0	0		N/A

Senior Note Payable⁽⁶⁾				
1996	\$ 20,000,000	\$2,485	\$	N/A
1997	20,000,000	2,215		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
2005	0	0		N/A
2006 (as of March 31, unaudited)	0	0		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities⁽¹⁾	Asset Coverage Per Unit⁽²⁾	Involuntary Liquidating Preference Per Unit⁽³⁾	Average Market Value Per Unit⁽⁴⁾
Bonds Payable				
1996	\$ 54,123,000	\$ 2,485	\$	N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
2005	0	0		N/A
2006 (as of March 31, unaudited)	0	0		N/A
Redeemable Cumulative Preferred Stock⁽⁵⁾⁽⁷⁾				
1996	\$ 1,000,000	\$ 242	\$ 100	N/A
1997	1,000,000	217	100	N/A
1998	1,000,000	267	100	N/A
1999	1,000,000	225	100	N/A
2000	1,000,000	242	100	N/A
2001	1,000,000	244	100	N/A
2002	1,000,000	268	100	N/A
2003	1,000,000	319	100	N/A
2004	0	0		N/A
2005	0	0		N/A
2006 (as of March 31, unaudited)	0	0		N/A
Non-Redeemable Cumulative Preferred Stock⁽⁵⁾				
1996	\$ 6,000,000	\$ 242	\$ 100	N/A
1997	6,000,000	217	100	N/A
1998	6,000,000	267	100	N/A
1999	6,000,000	225	100	N/A
2000	6,000,000	242	100	N/A
2001	6,000,000	244	100	N/A
2002	6,000,000	268	100	N/A
2003	6,000,000	319	100	N/A
2004	0	0		N/A
2005	0	0		N/A
2006 (as of March 31, unaudited)	0	0		N/A

- (1) Total amount of each class of senior securities outstanding at the end of the period presented.
- (2) The asset coverage ratio for a class of senior securities representing indebtedness is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness. This asset coverage ratio is multiplied by \$1,000 to determine the Asset Coverage Per Unit. The asset coverage ratio for a class of senior securities that is preferred stock is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness, plus the involuntary liquidation preference of the preferred stock (see footnote 3). The Asset Coverage Per Unit for preferred stock is expressed in terms of dollar amounts per share.
- (3) The amount to which such class of senior security would be entitled upon the involuntary liquidation of the issuer in preference to any security junior to it.
- (4) Not applicable, as senior securities are not registered for public trading.

- (5) Issued by our small business investment company subsidiary to the Small Business Administration. These categories of senior securities are not subject to the asset coverage requirements of the 1940 Act. See Certain Government Regulations Small Business Administration Regulations.
- (6) We were the obligor on \$15 million of the senior notes. Our small business investment company subsidiary was the obligor on the remaining \$5 million, which is not subject to the asset coverage requirements of the 1940 Act.
- (7) The Redeemable Cumulative Preferred Stock was reclassified to Other Liabilities on the accompanying financial statements during 2003 in accordance with SFAS No. 150.

BUSINESS

General

We are a business development company, or BDC, and we are in the private equity business. Specifically, we provide long-term debt and equity capital to primarily private middle market companies in a variety of industries. We believe the private equity capital markets are important to the growth of small and middle market companies because such companies often have difficulty accessing the public debt and equity capital markets. We believe that we are well positioned to be a source of capital for such companies. We provide our investors the opportunity to participate in the U.S. private equity industry through an investment in our publicly traded stock.

We have participated in the private equity business since we were founded in 1958. Since then, we have invested more than \$9 billion in thousands of companies nationwide. We primarily invest in the American entrepreneurial economy, helping to build middle market businesses and support American jobs. We generally invest in established companies with adequate cash flow for debt service. We are not venture capitalists, and we generally do not provide seed, or early stage, capital. At March 31, 2006, our private finance portfolio included investments in over 100 companies that generate aggregate annual revenues of over \$12 billion and employ more than 90,000 people.

Our investment objective is to achieve current income and capital gains. In order to achieve this objective, we invest in companies in a variety of industries.

Private Equity Investing

As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, developing, valuing, and ultimately exiting our investments. We generally target companies in less cyclical industries with, among other things, high returns on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and the ability to generate free cash flow. Each investment is subject to an extensive due diligence process. It is not uncommon for a single investment to take from two months to a full year to complete, depending on the complexity of the transaction.

Our investment activity is primarily focused on making long-term investments in the debt and equity of primarily private middle market companies. We have chosen these investments because they can be structured to provide recurring cash flow to us as the investor. In addition to earning interest income, we may earn income from management, consulting, diligence, structuring or other fees. We may also enhance our total return with capital gains realized from equity features, such as nominal cost warrants, or by investing in equity instruments. For the years 1998 through 2005, we have realized \$575.1 million in cumulative net realized gains from our investment portfolio. Net realized gains for this period as a percentage of total assets are shown in the chart below.

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

We believe illiquid investments generally provide better investment returns on average over time than do more liquid investments, such as public equities and public debt instruments, because of the increased liquidity risk in holding such investments. Investors in illiquid investments cannot manage risk through investment trading techniques. In order to manage our risk, we focus on careful investment selection, thorough due diligence, portfolio monitoring and portfolio diversification. Our investment management processes have been designed to incorporate these disciplines. We are led by an experienced management team with our senior officers possessing, on average, 20 years of experience in the private equity industry.

One measure of the performance of a private equity investor is the internal rate of return generated by the investor's portfolio. Since our merger on December 31, 1997, through December 31, 2005, our combined aggregate cash flow Internal Rate of Return (IRR) has been approximately 20% for private finance and CMBS/ CDO investments exited during this period. The IRR is calculated using the aggregate portfolio cash flow for all investments exited over this period. For investments exited during this period, we invested capital totaling \$3.2 billion, earned \$1.6 billion on this invested capital, and

therefore, received \$4.8 billion in total investment proceeds from the exits of these investments. The weighted average holding period of these investments was 34 months. Investments are considered to be exited when the original investment objective has been achieved through the receipt of cash and/or non-cash consideration upon the repayment of our debt investment or sale of an equity investment, or through the determination that no further consideration was collectible and, thus, a loss may have been realized. The aggregate cash flow IRR for private finance investments was approximately 18% and for CMBS/ CDO investments was approximately 24% for the same period. These IRR results represent historical results. Historical results are not necessarily indicative of future results.

We believe our business model is well suited for long-term illiquid investing. Our balance sheet is capitalized with significant equity capital and we use only a modest level of debt capital, which allows us the ability to be patient and to manage through difficult market conditions with less risk of liquidity issues. Under the Investment Company Act of 1940, we are restricted to a debt to equity ratio of approximately one-to-one. Thus, our capital structure, which includes a modest level of long-term leverage, is well suited for long-term illiquid investments.

In general, we compete for investments with a large number of private equity funds and mezzanine funds, other business development companies, hedge funds, investment banks, other equity and non-equity based investment funds, and other sources of financing, including specialty finance companies and traditional financial services companies such as commercial banks. However, we primarily compete with other providers of long-term debt and equity capital to middle market companies, including private equity funds and other business development companies.

Private Finance Portfolio. Our private finance portfolio is primarily composed of debt and equity securities. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. These investments are also generally illiquid.

Our capital is generally used to fund:

Buyouts	Recapitalizations
Acquisitions	Note purchases
Growth	Other types of financings

When assessing a prospective private finance investment, we generally look for companies in less cyclical industries in the middle market (i.e., generally \$50 million to \$500 million in revenues) with certain target characteristics, which may or may not be present in the companies in which we invest. Our target investments generally are in companies with the following characteristics:

Management team with meaningful equity ownership

Dominant or defensible market position

High return on invested capital

Stable operating margins

Ability to generate free cash flow

Well-constructed balance sheet

We generally target investments in the following industries as they tend to be less cyclical, cash flow intensive and generate a high return on invested capital:

Business Services
Financial Services
Consumer Products

Healthcare Services
Energy Services

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. It is our preference to structure our investments with a focus on current recurring interest and other income, which may include management, consulting or other fees. We generally target debt investments of \$10 million to \$100 million and buyout investments of up to \$250 million of invested capital.

Debt investments may include senior loans, unitranche debt (a single debt investment that is a blend of senior and subordinated debt), or subordinated debt (with or without equity features). The junior debt that we invest in that is lower in repayment priority than senior debt is also known as subordinated or mezzanine debt. We may make equity investments for a minority equity stake in portfolio companies in conjunction with our debt investments. We generally target a minimum weighted average portfolio yield of 10% on the debt component of our private finance portfolio. The weighted average yield on our private finance loans and debt securities was 12.5% at March 31, 2006.

Senior loans generally carry a floating rate of interest, usually set as a spread over LIBOR, and generally require payments of both principal and interest throughout the life of the loan. Interest is generally paid to us monthly or quarterly. Senior loans generally have maturities of three to five years. Unitranche debt and subordinated debt generally carry a fixed rate of interest generally with maturities of five to ten years and generally have interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest is generally paid to us quarterly. At March 31, 2006, 80% of our private finance loans and debt securities carried a fixed rate of interest and 20% carried a floating rate of interest.

Through our wholly owned subsidiary, AC Finance LLC, (AC Finance) we may underwrite senior loans related to our portfolio investments or for other companies that are not in our portfolio. When AC Finance underwrites senior loans, we may earn a fee for such loan underwriting activities. Senior loans originated and underwritten by AC Finance may or may not be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus) or funds managed by Callidus, a portfolio company controlled by us. After completion of the sale process, we may or may not retain a position in these senior loans. We may also invest in the bonds or preferred shares/income notes of collateralized loan obligations (CLOs) or collateralized debt obligations (CDOs), where the underlying collateral pool consists of senior loans. Certain of the CLOs and CDOs in which we invest may be managed by Callidus Capital Management, a subsidiary of Callidus.

In a buyout transaction, we generally invest in senior debt, subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership

represents a significant portion of the equity, but may or may not represent a controlling interest. If we invest in non-voting equity in a buyout investment, we generally have an option to acquire a controlling stake in the voting securities of the portfolio company at fair market value. We generally structure our buyout investments such that we seek to earn a blended current return on our total capital invested of approximately 10% through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common equity, and management, consulting, or transaction services fees to compensate us for the managerial assistance that we may provide to the portfolio company. We believe that the transaction fees charged for the services we provide to portfolio companies are generally comparable with transaction fees charged by others in the private equity industry for performing similar services. As a result of our significant equity investment in a buyout investment there is potential to realize larger capital gains through buyout investing as compared to debt or mezzanine investing.

The structure of each debt and equity security is specifically negotiated to enable us to protect our investment, with a focus on preservation of capital, and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our senior loans and unintranche debt are generally secured, however in a liquidation scenario, the collateral may not be sufficient to support our outstanding investment. Our junior or mezzanine loans are generally unsecured. Our investments may be subject to certain restrictions on resale and generally have no established trading market.

At March 31, 2006, 71.0% of the private finance portfolio at value consisted of loans and debt securities and 29.0% consisted of equity securities (equity securities included 26.3% in investment cost basis and 2.7% in net unrealized appreciation). At March 31, 2006, 39.0% of the private finance investments at value were in companies more than 25% owned, 9.6% were in companies 5% to 25% owned, and 51.4% were in companies less than 5% owned.

Our ten largest investments at value at March 31, 2006, were as follows:

At March 31, 2006				
(\$ in millions)				
Portfolio Company	Company Information	Cost	Value	Percentage of Total Assets
Business Loan Express, LLC ⁽¹⁾	Originates, sells, and services primarily real estate secured small business loans specifically for businesses with financing needs of up to \$4.0 million. Provides SBA 7(a) loans, conventional small business loans and small investment real estate loans. Nationwide non-bank preferred lender in the SBA s 7(a) guaranteed loan program.	\$291.3	\$326.2	7.9%
Mercury Air Centers, Inc.	Owens and operates fixed base operations under long-term leases from local airport authorities, which generally consist of terminal and hangar complexes that service the needs of the general aviation community.	\$121.5	\$180.0	4.4%
Advantage Sales & Marketing, Inc. ⁽¹⁾⁽²⁾	Sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry.	\$151.3	\$164.3	4.0%
Hot Stuff Foods, LLC	Provider of food service programs predominately to convenient stores. Manufactures and distributes a broad line of branded food products for on-site preparation and sales through in-store Hot Stuff branded kitchens and grab and go service points.	\$155.3	\$155.3	3.8%
Financial Pacific Company	Specialized commercial finance company that leases business-essential equipment to small businesses nationwide.	\$ 95.4	\$127.7	3.1%
Norwesco, Inc.	Designs, manufactures and markets a broad assortment of polyethylene tanks primarily to the agricultural and septic tank markets.	\$120.1	\$126.5	3.1%
Meineke Car Care Centers, Inc.	Business format franchisor in the car care sector of the automotive aftermarket industry with approximately 900 locations worldwide.	\$126.5	\$125.7	3.0%
CR Brands, Inc.	Manufactures and markets consumer branded and private label household cleaning and laundry products.	\$109.1	\$113.2	2.7%

At March 31, 2006

(\$ in millions) Portfolio Company	Company Information	Cost	Value	Percentage of Total Assets
STS Operating, Inc. ⁽³⁾	Distributes systems, components and engineering services for hydraulic, pneumatic, electronic and filtration systems.	\$10.1	\$104.4	2.5%
Healthy Pet Corp.	Veterinary hospitals offering medical and surgical services, specialized treatments, diagnostic services, pharmaceutical products, as well as routine health exams and vaccinations.	\$90.1	\$ 90.8	2.2%

(1) See Management's Discussion and Analysis of Financial Condition and Results of Operations.

(2) In March 2006, we sold our majority interest in Advantage. See Management's Discussion and Analysis of Financial Condition and Results of Operations for further detail.

(3) In May 2006, we announced the completion of the sale of STS Operating, Inc. See Management's Discussion and Analysis of Financial Condition and Results of Operations for further detail.

We monitor the portfolio to maintain diversity within the industries in which we invest. Our portfolio is not concentrated and we currently do not have a policy with respect to concentrating (i.e., investing 25% or more of our total assets) in any particular industry. We may or may not concentrate in any industry or group of industries in the future. The industry composition of the private finance portfolio at value at March 31, 2006, and December 31, 2005, was as follows:

	2006	2005
Industry		
Business services	33%	45%
Consumer products	25	14
Financial services	14	15
Industrial products	11	10
Retail	3	3
Healthcare services	2	2
Energy services	2	2
Broadcasting and cable	1	1
Other ⁽¹⁾	9	8
Total	100%	100%

(1) Includes investments in senior debt CDO and CLO funds. These funds invest in senior debt representing a variety of industries.

Commercial Real Estate Finance Portfolio. Since 1998, our commercial real estate investments have generally been in the non-investment grade tranches of commercial mortgage-backed securities, also known as CMBS, and in the bonds and preferred shares of collateralized debt obligations, also known as CDOs. With regard to CMBS, non-investment grade means that nationally recognized statistical rating organizations rate these securities below the top four investment-grade rating categories (i.e., AAA

through BBB), and are sometimes referred to as junk bonds. On May 3, 2005, we completed the sale of our portfolio of CMBS and CDO investments to affiliates of Caisse de dépôt et placement du Québec (the Caisse). See

Management's Discussion and Analysis of Financial Condition and Results of Operations. After the completion of this sale, our commercial real estate finance portfolio consists of commercial mortgage loans, real estate owned and equity interests, which totaled \$129.4 million at value on March 31, 2006.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWCapital Investments LLC, an affiliate of the Caisse (CWCapital), pursuant to which we sold certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. Under this agreement, we have agreed not to invest in CMBS and real estate related CDOs and refrain from certain other real estate related investing or servicing activities for a period of three years, subject to certain limitations and excluding our existing portfolio and related activities.

Business Processes

Business Development and New Deal Origination. Over the years, we believe we have developed and maintained a strong industry reputation and an extensive network of relationships with numerous private equity investors, investment banks, business brokers, merger and acquisition advisors, financial services companies, banks, law firms and accountants through whom we source investment opportunities. Through these relationships, we believe we have been able to strengthen our position as a private equity investor. We are well known in the private equity industry, and we believe that our experience and reputation provide a competitive advantage in originating new investments.

From time to time, we may receive referrals for new prospective investments from our portfolio companies as well as other participants in the capital markets. We generally pay referral fees to those who refer transactions to us that we consummate.

New Deal Underwriting and Investment Execution. In a typical transaction, we review, analyze, and substantiate through due diligence, the business plan and operations of the potential portfolio company. We perform financial due diligence, perform operational due diligence, study the industry and competitive landscape, and conduct reference checks with company management or other employees, customers, suppliers, and competitors, as necessary. We may work with external consultants, including accounting firms and industry or operational consultants, in performing due diligence and in monitoring our portfolio investments.

Once we have determined that a prospective portfolio company is suitable for investment, we work with the management and the other capital providers, including senior, junior, and equity capital providers, to structure a deal. We negotiate among these parties to agree on the rights and terms of our investment relative to the other capital in the portfolio company's capital structure. The typical debt transaction requires approximately two to six months of diligence and structuring before funding occurs. The typical buyout transaction may take up to one year to complete because the due diligence and structuring process is significantly longer when investing in a substantial equity stake in the company.

Our investments are tailored to the facts and circumstances of each deal. The specific structure is designed to protect our rights and manage our risk in the transaction. We generally structure the debt instrument to require restrictive affirmative and negative covenants, default penalties, lien protection, or other protective provisions. In addition, each debt investment is individually priced to achieve a return that reflects our rights and priorities in the portfolio company's capital structure, the structure of the debt instrument, and our perceived risk of the investment. Our loans and debt securities have an annual stated interest rate; however, that interest rate is only one factor in pricing the investment. The annual stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity or upon prepayment. In addition to the interest earned on loans and debt securities, our debt investments may include equity features, such as warrants or options to buy a minority interest in the portfolio company. The warrants we receive with our debt securities generally require only a nominal cost to exercise, and thus, if the portfolio company appreciates in value, we achieve additional investment return from this equity interest. We may structure the warrants to provide minority rights provisions and event-driven puts. In many cases, we will also obtain registration rights in connection with these equity interests, which may include demand and piggyback registration rights.

We have a centralized, credit-based approval process. The key steps in our investment process are:

Initial investment screening;

Initial investment committee approval;

Due diligence, structuring and negotiation;

Internal review of diligence results;

Final investment committee approval;

Approval by the Executive Committee of the Board of Directors (for all debt investments that represent a commitment equal to or greater than \$20 million and every buyout transaction); and

Funding of the investment (due diligence must be completed with final investment committee approval and Executive Committee approval, as needed, before funds are disbursed).

The investment process benefits from the significant professional experience of the members of our investment committee, which is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer, and certain of our Managing Directors.

Portfolio Monitoring and Development. Middle market companies often lack the management expertise and experience found in larger companies. As a BDC, we are required by the 1940 Act to make available significant managerial assistance to our portfolio companies. Our senior level professionals work with portfolio company management teams to assist them in building their businesses. Managerial assistance includes, but is not limited to, management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters. Our corporate finance assistance includes supporting our portfolio companies' efforts to structure and

attract additional capital. We believe our extensive network of industry relationships and our internal resources help make us a collaborative partner in the development of our portfolio companies.

Our team of investment professionals regularly monitors the status and performance of each investment. This portfolio company monitoring process generally includes review of the portfolio company's financial performance against its business plan, review of current financial statements and compliance with financial covenants, evaluation of significant current developments and assessment of future exit strategies. For debt investments we may have board observation rights that allow us to attend portfolio company board meetings. For buyout investments, we generally hold a majority of the seats on the board of directors where we own a controlling interest in the portfolio company and we have board observation rights where we do not own a controlling interest in the portfolio company.

Our portfolio management committee oversees the overall performance of the portfolio, including reviewing the performance of selected portfolio companies, overseeing portfolio companies in workout status, reviewing and approving certain amendments or modifications to existing investments, reviewing and approving certain portfolio exits, and reviewing and approving certain actions by portfolio companies whose voting securities are more than 50% owned by us. Our portfolio management committee is chaired by our Chief Executive Officer and includes our Chief Operating Officer, Chief Financial Officer, Chief Valuation Officer (non-voting member), and three Managing Directors. From time to time we will identify investments that require closer monitoring or become workout assets. We develop a workout strategy for workout assets and the portfolio management committee gauges our progress against the strategy.

We seek to price our investments to provide an investment return considering the fact that certain investments in the portfolio may underperform or result in loss of investment return or investment principal. As a private equity investor, we will incur losses from our investing activities, however we have a history of working with troubled portfolio companies in order to recover as much of our investments as is practicable.

Portfolio Grading

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

Portfolio Valuation

We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our

portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

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

Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by U.S. generally accepted accounting principles and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by U.S. generally accepted accounting principles. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

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

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

As a participant in the private equity business, we invest primarily in private middle market companies for which there is generally no publicly available information. Because of the private nature of these businesses, there is a need to maintain the confidentiality of the financial and other information that we have for the private companies in our portfolio. We believe that maintaining this confidence is important, as disclosure of such information could disadvantage our portfolio companies and could put us at a disadvantage in attracting new investments. Therefore, we do not intend to disclose financial or other information about our portfolio companies, unless required, because we believe doing so may put them at an economic or competitive disadvantage, regardless of our level of ownership or control. We will continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter as discussed below.

Valuation Process. The portfolio valuation process is managed by our Chief Valuation Officer (CVO). The CVO works with the investment professionals responsible

for each investment. The following is a description of the steps we take each quarter to determine the value of our portfolio.

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

The CVO reviews the preliminary valuation as determined by the deal team.

The CVO, members of the valuation team, and third-party consultants, as applicable (see below), meet with each Managing Director or responsible senior officer to discuss the preliminary valuation determined and documented by the deal team for each of their respective investments.

The CEO, COO, CFO and the managing directors meet with the CVO to discuss the preliminary valuation results.

Valuation documentation is distributed to the members of the Board of Directors.

The Audit Committee of the Board of Directors meets with the third-party consultants (see below) to discuss the assistance provided and results.

The Board of Directors and the CVO meet to discuss and review valuations.

To the extent there are changes or if additional information is deemed necessary, a follow-up Board meeting may take place.

The Board of Directors determines the fair value of the portfolio in good faith.

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

We have received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey). We currently intend to continue to obtain valuation assistance from third parties. We currently anticipate that we will generally obtain valuation assistance for all companies in the portfolio where we own more than 50% of the outstanding voting equity securities on a quarterly basis and that we will generally obtain assistance for companies where we own equal to or less than 50% of the outstanding voting equity securities at least once during the course of the calendar year. Valuation assistance may or may not be obtained for new companies that enter the portfolio after June 30 of any calendar year during that year or for investments with a cost and value less than \$250,000. For the quarter ended March 31, 2006, Duff & Phelps and Houlihan Lokey assisted us by reviewing our valuation of 78 portfolio companies, which represented 87.0% of the private finance portfolio at value. See Management's Discussion and Analysis of Financial Condition and Results of Operations.

Disposition of Investments

We manage our portfolio of investments in an effort to maximize our expected returns. Our portfolio is large and we frequently are repaid by our borrowers and exit our debt and equity investments as portfolio companies are sold, recapitalized or complete an initial public offering. In our debt investments where we have equity features, we frequently are in a minority ownership position in a portfolio company, and as a result, generally exit the investment when the majority equity stakeholder decides to sell or recapitalize the company. Where we have a control position in an investment, as we may have in buyout investments, we have more flexibility and can determine whether or not we should exit our investment. Our most common exit strategy for a buyout investment is the sale of a portfolio company to a strategic or financial buyer. If an investment has appreciated in value, we may realize a gain when we exit the investment. If an investment has depreciated in value, we may realize a loss when we exit the investment.

We are in the investment business, which includes acquiring and exiting investments. It is our policy not to comment on potential transactions in the portfolio prior to reaching a definitive agreement or, in many cases, prior to consummating a transaction. To the extent we enter into any material transactions, we would provide disclosure as required.

Dividends

We have elected to be taxed as a regulated investment company under Subchapter M of the Code. As such, we are not subject to corporate-level income taxation on income we timely distribute to our stockholders as dividends. We determine our regular quarterly dividends based upon an estimate of annual taxable income, which includes our taxable interest, dividend, and fee income, as well as taxable net capital gains. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends, which includes contractual payment-in-kind interest, and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

As a regulated investment company, we distribute substantially all of our annual taxable income to shareholders through the payment of cash dividends. Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared considering our estimate of annual taxable income available for distribution to shareholders. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Code. The amount of excess taxable income that may be carried over for distribution in the next year under the Code is approximately three quarters of dividend payments. Excess taxable income carried over and paid out in the next year may be subject to a 4% excise tax (see Other Matters Regulated Investment Company Status). We believe that carrying over excess taxable

income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend.

We began paying quarterly dividends in 1963, and our portfolio has provided sufficient ordinary taxable income and realized net capital gains to sustain or grow our dividends over time. Since inception, our average annual total return to shareholders (assuming all dividends were reinvested) was 18.0%. Over the past one, three, five and ten years, our total return to shareholders (assuming all dividends were reinvested) has been 23.5%, 20.6%, 17.1% and 19.8%, respectively, with the dividend providing a meaningful portion of this return.

The percentage of our dividend generated by ordinary taxable income versus capital gain income will vary from year to year. The percentage of ordinary taxable income versus net capital gain income supporting the dividend since 1986 is shown below.

Corporate Structure and Offices

We are a Maryland corporation and a closed-end, non-diversified management investment company that has elected to be regulated as a business development company under the 1940 Act. Our predecessor corporation was incorporated under the laws of the District of Columbia in 1958 and we reorganized as a Maryland corporation in 1993. We have a wholly owned subsidiary, Allied Investments L.P. (Allied Investments), that is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company. We own all of the partnership interests in Allied Investments. The assets held by Allied Investments represented 1.9% of our total assets at March 31, 2006. See **Certain Government Regulations** below for further information about small business investment company regulation.

In addition, we have a real estate investment trust subsidiary, Allied Capital REIT, Inc., and several subsidiaries that are single-member limited liability companies established for specific purposes, including holding real estate property. We also have a subsidiary, A.C. Corporation, that generally provides diligence and structuring services on our transactions, as well as structuring, transaction, management, and other services to Allied

Capital and our portfolio companies. A.C. Corporation has a wholly owned subsidiary, AC Finance LLC, that generally underwrites and arranges senior loans for our portfolio companies and other third parties.

Our executive offices are located at 1919 Pennsylvania Avenue, 3rd Floor, NW, Washington, DC 20006-3434 and our telephone number is (202) 721-6100. In addition, we have regional offices in Chicago, Los Angeles, and New York.

Employees

At March 31, 2006, we employed 155 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of our employees are located in our Washington, DC office. We believe that our relations with our employees are excellent.

Legal Proceedings

On June 23, 2004, we were notified by the SEC that they are conducting an informal investigation of us. On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to us at this time, the inquiries appear to primarily pertain to matters related to portfolio valuation and our portfolio company, Business Loan Express, LLC. To date, we have produced materials in response to requests from both the SEC and the U.S. Attorney's office, and certain current and former employees have provided testimony and have been interviewed by the staff of the SEC and the U.S. Attorney's Office. We are voluntarily cooperating with these investigations.

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

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

PORTFOLIO COMPANIES

The following is a listing of each portfolio company or its affiliate, together referred to as portfolio companies, in which we had an equity investment at March 31, 2006. Percentages shown for class of securities held by us represent percentage of the class owned and do not necessarily represent voting ownership or economic ownership. Percentages shown for equity securities other than warrants or options represent the actual percentage of the class of security held before dilution. Percentages shown for warrants and options held represent the percentage of class of security we may own assuming we exercise our warrants or options before dilution.

The portfolio companies are presented in three categories: companies more than 25% owned which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by us under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company's board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company. We make available significant managerial assistance to our portfolio companies. We generally receive rights to observe the meetings of our portfolio companies' board of directors, and may have one or more voting seats on their boards.

For information relating to the amount and nature of our investments in portfolio companies, see our consolidated statement of investments at March 31, 2006, at pages F-7 to F-16.

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
PRIVATE FINANCE			
Companies More Than 25% Owned			
Acme Paging, L.P. ⁽¹⁾ 6080 SW 40th Street, Suite 3 Miami, FL 33155	Paging Services	Common Stock in Affiliate	80.0%
Alaris Consulting, LLC ⁽¹⁾⁽²⁾ 360 W. Butterfield Road Suite 400 Elmhurst, IL 60126	Consulting Firm	Equity Interests	100.0%
Avborne, Inc. ⁽¹⁾⁽⁶⁾ c/o Trivest, Inc. 7500 NW 26th Street Miami, FL 33122	Aviation Services	Series B Preferred Stock Common Stock	23.8% 27.2%
Avborne Heavy Maintenance, Inc. ⁽¹⁾⁽⁶⁾ c/o Trivest, Inc. 7500 26th Street N.W. Miami, FL 33122	Aviation Services	Series A Preferred Stock Common Stock	27.5% 27.5%
Business Loan Express, LLC ⁽¹⁾ 1633 Broadway New York, NY 10019	Small Business Lender	Class A Equity Interests Class B Equity Interests Class C Equity Interests Equity Interest in BLX Subsidiary ⁽³⁾	100.0% 100.0% 94.9% 20.0%
Callidus Capital Corporation ⁽¹⁾⁽⁴⁾ 520 Madison Avenue	Asset Manager and Finance Company	Common stock	100.0%

New York, NY 10022

CR Brands, Inc.⁽¹⁾
141 Venture Boulevard
Spartanburg, SC 29306

Household Cleaning
Products

Common Stock

78.2%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Diversified Group Administrators, Inc. 201 Johnson Rd Building #1 Houston, PA 15342	Third Party Administrator for Self-funded Health Benefit Plan	Series B Preferred Stock Series A Preferred Stock Common Stock	64.7% 69.9% 45.8%
Financial Pacific Company ⁽¹⁾ 3455 South 344th Way, Suite 300 Federal Way, WA 98001	Commercial Finance Leasing	Series A Preferred Stock Common Stock	99.4% 99.4%
ForeSite Towers, LLC ⁽¹⁾ 22 Iverness Center Parkway Suite 50 Birmingham, AL 35242	Tower Leasing	Series A Preferred Equity Interest Series B Preferred Equity Interest Series E Preferred Equity Interest Common Equity Interest	100.0% 100.0% 100.0% 77.3%
Global Communications, LLC ⁽¹⁾ 1000 North Dixie Highway West Palm Beach, FL 33401	Muzak Franchisee	Preferred Equity Interest Options for Common Equity Interest	77.8% 59.3%
Gordian Group, Inc. ⁽¹⁾ 499 Park Avenue New York, NY 10022	Financial Advisory Services	Common Stock	100.0%
Healthy Pet Corp. ⁽¹⁾ 1720 Post Road Fairfield, CT 06430	Comprehensive Veterinary Services	Common Stock	98.7%
HMT, Inc. 4422 FM 1960 West Suite 350 Houston, TX 77068	Storage Tank Maintenance & Repair	Class B Preferred Stock Common Stock Warrants to Purchase Common Stock	33.5% 25.0% 9.7%
Impact Innovations Group, LLC 12 Piedmont Center, Suite 210 Atlanta, GA 30305	Information Technology Services Provider	Equity Interest in Affiliate ⁽⁵⁾	50.0%
Insight Pharmaceuticals Corporation ⁽¹⁾ 550 Township Line Road, Suite 300 Blue Bell, PA 19422	Marketer of Over-The- Counter Pharmaceuticals	Preferred Stock Common Stock	91.2% 91.2%
Jakel, Inc. ⁽¹⁾ 400 Broadway Highlands, IL 62249	Manufacturer of Electric Motors and Blowers	Series A-1 Preferred Stock Class B Common Stock	32.3% 100.0%
Legacy Partners Group, LLC ⁽¹⁾ 520 Madison Avenue, 27th Floor New York, NY 10022	Merger and Acquisition Advisor	Equity Interests	100.0%
Litterer Beteiligungs-GmbH Uhlandstrasse 1 69493 Hirschberg Germany	Scaffolding Company	Equity Interest	25.0%

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Mercury Air Centers, Inc. ⁽¹⁾ 1951 Airport Road Atlanta, GA 30341	Fixed Base Operations	Series A Common Stock Common Stock	100.0% 95.0%
MVL Group, Inc. ⁽¹⁾ 1061 E. Indiantown Road Suite 300 Jupiter, FL 33477	Market Research Services	Common Stock	64.9%
Powell Plant Farms, Inc. ⁽¹⁾ Route 3, Box 1058 Troup, TX 75789	Plant Producer & Wholesaler	Preferred Stock Warrants to Purchase Common Stock	100.0% 83.5%
Service Champ, Inc. ⁽¹⁾ 180 New Britain Boulevard Chalfont, PA 18914	Wholesale Distributor of Auto Parts	Common Stock	63.9%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Staffing Partners Holding Company, Inc. ⁽¹⁾ 104 Church Lane, #100 Baltimore, MD 21208	Temporary Employee Services	Series B Preferred Stock	71.4%
		Redeemable Preferred Stock	48.3%
		Class A-1 Common Stock	50.0%
		Class A-2 Common Stock	24.4%
		Class B Common Stock	48.8%
		Warrants to purchase Class B Common Stock	30.3%
Startec Global Communications Corporation ⁽¹⁾ 7631 Calhoun Drive Rockville, MD 20850	Telecommunications Services	Common Stock	68.5%
STS Operating, Inc. (d/b/a SunSource Technology Services, Inc.) ⁽¹⁾⁽¹¹⁾ 2301 Windsor Court Addison, IL 60101	Industrial Distribution	Common Stock	77.1%
		Options to Purchase	
		Common Stock	1.0%
Triview Investments, Inc. ⁽¹⁾⁽¹⁰⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Multi-system Cable Operator and Pharmaceutical Marketer	Common Stock	99.5%
Companies 5% to 25% Owned			
Advantage Sales & Marketing, Inc. ⁽¹⁾ 19100 Von Karman Avenue Suite 600 Irvine, CA 92612	Sales and Marketing Agency	Class A Equity Units	4.0%
Air Evac Lifeteam LLC 1448 W. Eighth Street West Plains, MO 65775	Air Ambulance Service	Series A Preferred Equity Interest	6.6%
		Series B Preferred Equity Interest	6.2%
BB&T Capital Partners/ Windsor Mezzanine Fund, LLC 200 West Second Street, 4th Floor Winston-Salem, NC 27101	Private Equity Fund	Class A Equity Interests	7.5%
		Class A-1 Equity Interests	100.0%
Becker Underwood, Inc. 801 Dayton Avenue Ames, IA 50010	Speciality Chemical Manufacturer	Common Stock	6.1%
BI Incorporated 1 North Franklin Street Chicago, IL 60606	Electronic Monitoring Equipment	Common Stock	7.1%
MedBridge Healthcare, LLC ⁽¹⁾ 110 West North Street, Suite 100 Greenville, SC 29601	Sleep Diagnostic Facilities	Debt Convertible into Equity Interests	75.0%
		Class C Equity Interests	100.0%
Nexcel Synthetics, LLC 6076 Southern Industrial Drive	Manufacturer of Carpet Backing	Class A Equity Interest	6.8%
		Class B Equity Interest	6.8%

Birmingham, AL 35235			
Pres Air Trol LLC 1009 W. Boston Post Road Mamaroneck, NY 10543	Pressure Switch Manufacturer	Class A Equity Interests	32.8%
Progressive International Corporation 6111 S. 228th Street Kent, WA 98064	Retail Kitchenware	Series A Redeemable Preferred Stock Class A Common Stock Warrants to Purchase Class A Common Stock	12.5% 1.0% 42.0%
Soteria Imaging Services, LLC 6009 Brownsboro Park Blvd., Suite H Louisville, KY 40207	Diagnostic Imaging Facilities Operator	Class A Preferred Equity Interest	10.8%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Universal Environmental Services, LLC 411 Dividend Drive Peachtree City, GA 30269	Used Oil Recycling	Class A Preferred Equity Interests Class B Preferred Equity Interests	15.0% 15.0%
Companies Less Than 5% Owned			
Advanced Circuits, Inc. 30 South Wacker Drive, Suite 3700 Chicago, IL 60606	Printed Circuit Boards Manufacturer	Common Stock	3.0%
Amerex Group, LLC 1500 Rahway Avenue Avenal, NJ 07001	Supplier of Outerwear Apparel	Class B Equity Interests	100.0%
Benchmark Medical, Inc. 101 Lindin Drive, Suite 420 Malvern, PA 19355	Outpatient Physical Therapy Services	Warrant to Purchase Common Stock	2.5%
Border Foods, Inc. 1750 Valley View Lane, Suite 350 Farmer s Branch, TX 75234	Mexican Ingredient & Food Product Manufacturer	Series A Preferred Stock Series B-2 Preferred Stock Warrants to Purchase Series B-2 Preferred Stock Common Stock Warrants to Purchase Common Stock	9.4% 100.0% 100.0% 12.4% 73.8%
Callidus Debt Partners CLO Fund III, Ltd. ⁽⁷⁾ 135 Lasalle Street Chicago, IL 60694	Senior Debt Fund	Preferred Shares	68.4%
Camden Partners Strategic Fund II, L.P. One South Street Suite 2150 Baltimore, MD 21202	Private Equity Fund	Limited Partnership Interest	3.9%
Catterton Partners V, L.P. 7 Greenwich Office Park Greenwich, CT 06830	Private Equity Fund	Limited Partnership Interest	0.8%
Centre Capital Investors IV, LP 30 Rockefeller Plaza, 50th Floor New York, NY 10020	Private Equity Fund	Limited Partnership Interest	0.6%
Commercial Credit Group, Inc. 212 South Tyron Street, Suite 1400 Charlotte, NC 28281	Equipment Finance and Leasing	Series C Preferred Stock Warrants to Purchase Common Stock	100.0% 28.5%
Component Hardware Group, Inc. 1890 Swarthmore Ave. Lakewood, NJ 08701	Designer & Developer of Hardware Components	Class A Preferred Stock Class B Common Stock	7.4% 13.5%
Cooper Natural Resources, Inc.	Sodium Sulfate Producer	Series A Convertible	

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P.O. Box 1477 Seagraves, TX 79360		Preferred Stock	100.0%
		Warrants to Purchase Series A Convertible Preferred Stock	36.8%
		Warrants to Purchase Common Stock	6.5%
Coverall North America, Inc. 5201 Congress Avenue, Suite 275 Boca Raton, FL 33487	Contract Cleaning Services	Preferred Stock	100.0%
		Warrant to Purchase Common Stock	21.4%
Distant Lands Trading Co. 11754 State Highway 64 West Tyler, TX 75704	Provider of Premium Coffee and Coffee Beans	Class A Common Stock	4.4%
DVS VideoStream, LLC 2600 West Olive Avenue Burbank, CA 91505	Media Technical Post- Production Service Provider	Debt Convertible into Equity Interests	20.8%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Dynamic India Fund IV 3rd Floor, Les Cascades Edith Cavell Street Port Luis Mauritius	Private Equity Fund	Equity Interests	2.4%
eCentury Capital Partners, L.P. 8270 Greensboro Drive Suite 1025 McLean, VA 22102	Private Equity Fund	Limited Partnership Interest	25.0%
Elexis Beta GmbH Ulmenstraße 22 60325 Frankfurt am Main Germany	Distance Measurement Device Manufacturer	Options to Purchase Shares	9.8%
Frozen Specialties, Inc. 720 Barre Road Archbold, OH 43502	Private Label Frozen Food Manufacturer	Warrants to Purchase Class A Common Stock	2.7%
Geotrace Technologies, Inc. 1011 Highway 6 South, Suite 220 Houston, TX 77077	Oil and Gas Reservoir Analysis	Warrant to Purchase Preferred Stock Warrant to Purchase Common Stock	8.4% 8.4%
Grotech Partners, VI, L.P. c/o Grotech Capital Group 9690 Deereco Road Suite 800 Timonium, MD 21093	Private Equity Fund	Limited Partnership Interest	2.4%
Havco Wood Products LLC P.O. BOX 1342 Cape Girardeau, MO 63702	Hardwood Flooring Products Manufacturer	Equity Interests	4.5%
Homax Holdings, Inc. 468 West Horton Road Bellingham, WA 98226	Supplier of Branded Consumer Products	Preferred Stock Common Stock Warrant to Purchase Preferred Stock Warrant to Purchase Common Stock	0.1% 0.1% 1.1% 1.1%
Hot Stuff Foods, LLC 2930 W Maple Street, Box 85210 Sioux Falls, SD 57118	Food services to Convenience Stores	Class B Common Stock (9) Warrants to Purchase Common Stock	100.0% 51.0%
International Fiber Corporation 50 Bridge Street North Tonawanda, NY 14120	Cellulose and Fiber Producer	Series A Preferred Stock	4.7%

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Kodiak Fund LP 2107 Wilson Boulevard, Suite 410 Arlington, VA 22201	Private Equity Fund	Limited Partnership Interests	4.0%
MedAssets, Inc. 100 Northpoint Center East #150 Alpharetta, GA 30022	Healthcare Outsourcing	Series B Convertible Preferred Stock Warrants to Purchase Common Stock	 7.8% 0.6%
Meineke Car Care Centers, Inc. 128 South Tryon Street Suite 900 Charlotte, NC 28202	Franchisor of Car Care Centers	Class B Common Stock ⁽⁹⁾ Warrant to Purchase Class A Common Stock	 99.6% 51.0%
MHF Logistical Solutions, Inc. 800 Cranberry Woods Drive Suite 450 Cranberry Township, PA 16066	Third-Party Environmental Logistics	Series A Preferred Stock Common Stock	3.6% 3.6%
Mid-Atlantic Venture Fund IV, L.P. 128 Goodman Drive Bethlehem, PA 18015	Private Equity Fund	Limited Partnership Interest	6.7%
Mogas Energy, LLC 13137 Thunderhead Falls Lane Rapid City, SD 57702	Natural Gas Pipeline Operator	Warrants to Purchase Equity Interests	20.0%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Network Hardware Resale, Inc. 26 Castilian Drive, Suite A Santa Barbara, CA 93117	Provider of Pre-Owned Networking Equipment	Debt Convertible into Common Stock	21.8%
Norwesco, Inc. P.O. BOX 439 4365 Steiner St. St. BoniFaciuss, MN 55375	Polyethylene Tanks Manufacturer	Class B Nonvoting Common Stock ⁽⁹⁾ Warrants to Purchase Class A Common Stock	96.3% 50.2%
Novak Biddle Venture Partners III, L.P. 7501 Wisconsin Avenue East Tower, Suite 1380 Bethesda, MD 20814	Private Equity Fund	Limited Partnership Interest	2.5%
Odyssey Investment Partners Fund III LP 280 Park Avenue, 38th Floor West Tower New York, NY 10017	Private Equity Fund	Limited Partnership Interest	0.7%
Opinion Research Corporation P.O. Box 183 Princeton, NJ 08542	Corporate Marketing Research Firm	Warrants to Purchase Common Stock	6.4%
Oriental Trading Company, Inc. 108th Street, 4206 South Omaha, NE 68137	Direct Marketer of Toys	Class A Common Stock	1.7%
Palm Coast Data, LLC 11 Commerce Blvd Palm Coast, FL 32164	Magazines and Subscribers Relationship Management	Class B Common Stock ⁽⁹⁾ Warrants to Purchase Class A Common Stock	100.0% 56.9%
Performant Financial Corporation 333 N. Canyon Pkwy Suite 100 Livermore, CA 94551	Collections and Default Prevention Services	Common Stock	2.9%
Pro Mach, Inc. 1000 Abernathy Road, Suite 1110 Atlanta, GA 30328	Packaging Machinery Manufacturer	Equity Interests	2.3%
S.B. Restaurant Company (d/b/a Elephant Bar) 6326-A Lindmar Drive Goleta, CA 93117	Restaurants	Series B Convertible Preferred Stock Warrant to Purchase Series A Common Stock	2.5% 13.1%
SBBUT, LLC 52 River Road Stowe, VT 05672	Holding Company	Equity Interests in Affiliate Company	10.4%
Soff-Cut Holdings, Inc.	Concrete Sawing		14.3%

1112 Olympic Drive Corona, CA 91719	Equipment Manufacturer	Series A Preferred Stock Common Stock	2.7%
SPP Mezzanine Fund, L.P. 330 Madison Avenue, 28th Floor New York, NY 10017	Private Equity Fund	Limited Partnership Interest	35.7%
Tradesmen International, Inc. 9760 Shepard Road Macedonia, OH 44056	Outsourced Skilled Construction Craftsmen	Warrant to Purchase Common Stock	4.5%
TransAmerican Auto Parts, LLC 801 West Artesia Blvd Compton, CA 90220	Auto Parts and Accessories Retailer and Wholesaler	Preferred Equity Interests Common Equity Interests	1.4% 1.4%
United Site Services, Inc. 200 Friberg Parkway, Suite 4000 Westborough, MA 01582	Portable Rest Room Services	Common Stock	1.3%
Updata Venture Partners II, L.P. 11600 Sunrise Valley Drive Reston, VA 20191	Private Equity Fund	Limited Partnership Interest	15.0%
Venturehouse-Cibernet Investors, LLC 509 Seventh Street, NW Washington, DC 20004	Third-Party Billing	Equity Interest	3.3%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Venturehouse Group, LLC 1780 Tysons Boulevard, Suite 400 McLean, VA 22102	Private Equity Fund	Common Equity Interest	3.1%
VICORP Restaurants, Inc. 400 W. 48th Avenue Denver, CO 80216	Restaurants	Warrant to Purchase Preferred Stock Warrant to Purchase Common Stock	1.0% 3.4%
Walker Investment Fund II, LLLP 3060 Washington Road Suite 200 Glenwood, MD 21738	Private Equity Fund	Limited Partnership Interest	5.1%
Wear Me Apparel Corporation 31 West 34th Street New York, NY 10001	Marketer of Children's Apparel	Warrant to Purchase Common Stock	2.0%
Woodstream Corporation 69 North Locust Street Lititz, PA 17543	Pest Control Manufacturer	Common Stock Warrants to Purchase Common Stock	4.4% 3.7%
COMMERCIAL REAL ESTATE FINANCE⁽⁸⁾			
8830 Macon Highway Holding Company, LLC ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Mobile Home Park	Equity Interests	100.0%
WSALD-CEH, LLC ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Commercial Real Estate Developer	Equity Interest	50.0%
NPH, Inc. ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Commercial Real Estate Developer	Common Stock	100.0%
Stemmons Freeway Hotel, LLC ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Hotel	Equity Interests	100.0%
Timarron Capital, Inc. ⁽¹⁾ 804 Worthington Court Southlake, TX 76092	Commercial Real Estate Loan Origination and Securitization	Common Stock	100.0%
WSA Commons LLC 421 East 4th Street Cincinnati, OH 45202	Residential Real Estate Development	Equity Interests	50.0%
Van Ness Hotel, Inc. ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Hotel	Common Stock	100.0%

- (1) The portfolio company is deemed to be an affiliated person under the 1940 Act because we hold one or more seats on the portfolio company's board of directors, are the general partner, or are the managing member.
- (2) Alaris Consulting, LLC owns 95% of Alaris Consulting, Inc.
- (3) Included in Class C Equity Interests in the Consolidated Statement of Investments.
- (4) Callidus Capital Corporation owns 80% of Callidus Capital Management, LLC.
- (5) The affiliate holds subordinated debt issued by Impact Innovations Group, LLC. We made an investment in and exchanged our existing subordinated debt for equity interests in the affiliate.
- (6) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.
- (7) Callidus Capital Management, LLC is the manager of the fund (see Note 4 above).
- (8) These portfolio companies are included in the Commercial Real Estate Finance Equity Interests in the Consolidated Statement of Investments.
- (9) Common stock is non-voting. In addition to non-voting stock ownership, we have an option to acquire a majority of the voting securities of the portfolio company at fair market value.
- (10) Triview Investments Inc. holds investments in Longview Cable & Data, LLC and Triax Holdings, LLC.
- (11) In May 2006, we announced the completion of the sale of STS Operating, Inc. See Management's Discussion and Analysis of Financial Condition and Results of Operations for further detail.

DETERMINATION OF NET ASSET VALUE

Quarterly Net Asset Value Determination

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

Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At March 31, 2006, portfolio investments recorded at fair value were 90% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

Valuation Methodology Private Finance. Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based on the enterprise value at

which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

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

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

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

Valuation Methodology – CDO and CLO Bonds and Preferred Shares/ Income Notes (CDO/ CLO Assets). CDO/ CLO Assets 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 bonds and preferred

shares/income notes, when available. We recognize unrealized appreciation or depreciation on our CDO/ CLO Assets as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We determine the fair value of our CDO/ CLO Assets on an individual security-by-security basis. If we were to sell a group of these CDO/ CLO Assets in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual bonds or preferred shares/income notes.

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. The value of loan and debt securities may be greater than our cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than our cost basis.

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

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

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

MANAGEMENT

Our Board of Directors oversees our management. The responsibilities of each director include, among other things, the oversight of our investment activity, the quarterly valuation of our assets, and oversight of our financing arrangements. The Board of Directors maintains an Executive Committee, Audit Committee, Compensation Committee, and Corporate Governance/Nominating Committee, and may establish additional committees in the future. All of our directors also serve as directors of our subsidiaries.

The management of our company and our investment portfolio is the responsibility of various corporate committees, including the management committee, the investment committee, and the portfolio management committee. See Portfolio Management.

Structure of Board of Directors

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

Directors

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons of Allied Capital as defined in the 1940 Act. Information regarding our Board of Directors is as follows:

Name	Age	Position	Director Since ⁽¹⁾	Expiration of Term
Interested Directors				
William L. Walton	56	Chairman, Chief Executive Officer and President	1986	2007
Joan M. Sweeney	46	Chief Operating Officer	2004	2007
Robert E. Long	75	Director	1972	2007
Independent Directors				
Ann Torre Bates	48	Director	2003	2009
Brooks H. Browne	56	Director	1990	2007
John D. Firestone	62	Director	1993	2008
Anthony T. Garcia	49	Director	1991	2008
Edwin L. Harper	64	Director	2006	2009
Lawrence I. Hebert	59	Director	1989	2008
John I. Leahy	75	Director	1994	2009
Alex J. Pollock	63	Director	2003	2009
Marc F. Racicot	57	Director	2005	2008
Guy T. Steuart II	74	Director	1984	2009
Laura W. van Roijen	54	Director	1992	2008

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

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

Executive Officers

Information regarding our executive officers is as follows:

Name	Age	Position
William L. Walton	56	Chairman, Chief Executive Officer and President
Joan M. Sweeney	46	Chief Operating Officer
Kelly A. Anderson	52	Executive Vice President and Treasurer
Scott S. Binder	51	Chief Valuation Officer
Michael J. Grisius	42	Managing Director
Jeri J. Harman	48	Managing Director
Thomas C. Lauer	39	Managing Director
Robert D. Long	49	Managing Director
Justin S. Maccarone	47	Managing Director
Diane E. Murphy	52	Executive Vice President and Director of Human Resources
Penni F. Roll	40	Chief Financial Officer
Daniel L. Russell	41	Managing Director
John M. Scheurer	53	Managing Director
John D. Shulman	43	Managing Director
Suzanne V. Sparrow	40	Chief Compliance Officer, Executive Vice President and Secretary

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

Biographical Information**Directors**

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

Interested Directors

William L. Walton has been the Chairman, Chief Executive Officer, and President of Allied Capital since 1997. Mr. Walton's previous experience includes serving as a Managing Director of Butler Capital Corporation, a mezzanine buyout firm, the personal investment advisor to William S. Paley, founder of CBS, and a Senior Vice President in Lehman Brothers Kuhn Loeb's Merger and Acquisition Group. He also founded two education service companies Language Odyssey and SuccessLab. Mr. Walton currently serves on the Board of Directors for the National Foundation for Teaching Entrepreneurship and the National Symphony Orchestra. He is a member of the World Economic Forum and an Advisory Board member for the Center for Strategic & International Studies. Mr. Walton also serves on The Kelley School of Business Board of Advisors at Indiana University.

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

Coopers & Lybrand, and the Division of Enforcement of the Securities and Exchange Commission.

Robert E. Long has been the Chief Executive Officer and a director of GLB Group, Inc., an investment management firm, since 1997 and President of Ariba GLB Group, Inc., the parent company of GLB Group, Inc., since 2005. He has been the Chairman of Emerald City Radio Partners, LLC since 1997. Mr. Long was the President of Business News Network, Inc. from 1995 to 1998, the Chairman and Chief Executive Officer of Southern Starr Broadcasting Group, Inc. from 1991 to 1995, and a director and the President of Potomac Asset Management, Inc. from 1983 to 1991. Mr. Long is a director of AmBase Corporation, CSC Scientific, Inc., and Advanced Solutions International, Inc. Mr. Long is the father of Robert D. Long, an executive officer of Allied Capital.

Independent Directors

Ann Torre Bates has been a strategic and financial consultant since 1997. From 1995 to 1997, Ms. Bates served as Executive Vice President, CFO and Treasurer of NHP, Inc., a national real estate services firm. From 1991 to 1995, Ms. Bates was Vice President and Treasurer of US Airways. She serves on the boards and audit committees of Franklin Mutual Series and SLM Corporation (Sallie Mae).

Brooks H. Browne has been a private investor since 2002. Mr. Browne was the President of Environmental Enterprises Assistance Fund from 1993 to 2002 and served as a director from 1991 to 2005. He currently serves as Vice Chairman of the Board for Winrock International, a non-profit organization.

John D. Firestone has been a Partner of Secor Group, a venture capital firm since 1978. Mr. Firestone has also served as a director of Security Storage Company of Washington, DC, since 1978. He is currently a director of Cuisine Solutions, Inc., and four non-profit organizations, including the National Rehabilitation Hospital, The Washington Ballet and the Tudor Place Foundation of which he is the past president. From 1997 to 2001 he was a director of The Bryn Mawr Trust Corporation.

Anthony T. Garcia has been a private investor since 2003. Mr. Garcia was Vice President of Finance of Formity Systems, Inc., a developer of software products for business management of data networks, from January 2002 through 2003. Mr. Garcia was a private investor from 2000 to 2001, the General Manager of Breen Capital Group, an investor in tax liens, from 1997 to 2000, and a Senior Vice President of Lehman Brothers Inc. from 1985 to 1996.

Edwin L. Harper has been an executive for Assurant, Inc., a financial services and insurance provider, since 1998. He currently serves as Senior Vice President, Public Affairs and Government Relations and previously served as Chief Operating Officer and Chief Financial Officer for Assurant's largest subsidiary. From 1992 to 1997, Mr. Harper served as President and Chief Executive Officer of the Association of American Railroads. He also spent five years with Campbell Soup Company, serving as Chief Financial Officer from 1986 to 1991. Earlier in his career, Mr. Harper served on the White House staffs of both President Reagan and President Nixon. Mr. Harper currently serves as Director for the Council for Excellence in Government.

Lawrence I. Hebert is Senior Advisor for PNC Bank, N.A., and was a director and President and Chief Executive Officer of Riggs Bank N.A., a subsidiary of Riggs National

Corporation, from 2001 to 2005. Mr. Hebert also served as Chief Executive Officer of Riggs National Corporation during 2005 and served as a director of Riggs National Corporation from 1988 to 2005. Mr. Hebert served as a director of Riggs Investment Advisors and Riggs Bank Europe Limited (both indirect subsidiaries of Riggs National Corporation). Mr. Hebert previously served as Vice Chairman from 1983 to 1998, President from 1984 to 1998, and Chairman and Chief Executive Officer from 1998 to 2001 of Allbritton Communications Company.

John I. Leahy has been the President of Management and Marketing Associates, a management consulting firm, since 1986. Previously, Mr. Leahy spent 34 years of his career with Black & Decker Corporation, where he served as President and CEO of the United States subsidiary from 1979 to 1981 and President and Group Executive Officer of the Western Hemisphere of Black & Decker Corporation from 1982 to 1985. Mr. Leahy is currently a director of B&L Sales, Inc. and is Trustee Emeritus of the Sellinger School of Business, Loyola College, Maryland.

Alex J. Pollock has been a Resident Fellow at the American Enterprise Institute since 2004. He was President and Chief Executive Officer of the Federal Home Loan Bank of Chicago from 1991 to 2004. He serves as a director of the Chicago Mercantile Exchange, Great Lakes Higher Education Corporation, the Great Books Foundation, the Illinois Council on Economic Education and the International Union for Housing Finance. Allied Capital has contributed \$25 thousand to the American Enterprise Institute.

Marc F. Racicot was named President and Chief Executive Officer of the American Insurance Association in August 2005. Prior to that, he was an attorney at the law firm of Bracewell & Giuliani, LLP from 2001 to 2005. He is a former Governor (1993 to 2001) and Attorney General (1989 to 1993) of the State of Montana. Mr. Racicot was appointed by President Bush to serve as the Chairman of the Republican National Committee (2002 to 2003) and he served as Chairman of the Bush/Cheney Re-election Committee from 2003 to 2004. He presently serves on the Board of Directors for Burlington Northern Santa Fe Corporation, Massachusetts Mutual Life Insurance Company, Jobs for America's Graduates, and the Board of Visitors for the University of Montana School of Law.

Guy T. Steuart II has been a director and President of Steuart Investment Company, which manages, operates, and leases real and personal property and holds stock in operating subsidiaries engaged in various businesses, since 1960 where he served as President until 2003 and currently serves as Chairman. Mr. Steuart has served as Trustee Emeritus of Washington and Lee University since 1992.

Laura W. van Roijen has been a private investor since 1992. Ms. van Roijen was a Vice President at Citicorp from 1982 to 1992.

Executive Officers who are not Directors

Kelly A. Anderson, Executive Vice President and Treasurer, has been employed by Allied Capital since 1987. Ms. Anderson is responsible for Allied Capital's treasury, cash management and infrastructure operations.

Scott S. Binder, Chief Valuation Officer, has been employed by Allied Capital since 1997. He has served as Chief Valuation Officer since 2003. He served as a consultant to the Company from 1991 until 1997. Prior to joining the Company, Mr. Binder formed and was President of Overland Communications Group. He also served as a board member and financial consultant for a public affairs and lobbying firm in Washington, DC. Mr. Binder

founded Lonestar Cablevision in 1986, serving as President until 1991. In the early 1980 s, Mr. Binder worked for two firms specializing in leveraged lease transactions. From 1976 to 1981, he was employed by Coopers & Lybrand.

Michael J. Grisius, Managing Director, has been employed by the Company since 1992. Prior to joining Allied Capital, Mr. Grisius worked in leveraged finance at Chemical Bank from 1989 to 1992 and held senior accountant and consultant positions with KPMG LLP from 1985 to 1988.

Jeri J. Harman, Managing Director, has been employed by the Company since 2004. Prior to joining Allied Capital, Ms. Harman served as a Managing Director and Principal for American Capital Strategies, Ltd., a business development company, from 2000 until 2004. She worked as a Managing Director and Head of Private Placements for First Security Van Kasper from 1996 to 2000 and a Managing Director of Coopers & Lybrand from 1993 to 1996. From 1982 to 1993, Ms. Harman held various senior level positions in the private placement arm of The Prudential Insurance Company of America. She has served on the Board of Directors for the Association of Corporate Growth since 2000.

Thomas C. Lauer, Managing Director, has been employed by the Company since 2004. Prior to joining Allied Capital, Mr. Lauer worked in GE Capital s sponsor finance group from 2003 to 2004 and in the merchant banking and leveraged finance groups of Wachovia Securities (previously First Union Securities) from 1997 to 2003. He also held senior analyst positions at Intel Corporation and served as a corporate lender and credit analyst at National City Corporation.

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

Justin S. Maccarone, Managing Director, has been employed by the Company since April 2005. Prior to joining Allied Capital, Mr. Maccarone served as a partner with UBS Capital Americas, LLC, a private equity fund focused on middle market investments from 1993 to 2005. Prior to that, Mr. Maccarone served as a Senior Vice President at GE Capital specializing in merchant banking and leveraged finance from 1989 to 1993 and served as Vice President of the Leveraged Finance Group at HSBC/ Marine Midland Bank from 1981 to 1989.

Diane E. Murphy, Ms. Murphy, Executive Vice President and Director of Human Resources, has been employed by the Company since 2000. Prior to joining the Company, Ms. Murphy was employed by Allfirst Financial from 1982 to 1999 and served in several capacities including head of the retail banking group in the Greater Washington Metro Region from 1994 to 1996 and served as the senior human resources executive from 1996 to 1999.

Penni F. Roll, Chief Financial Officer, has been employed by the Company since 1995. Ms. Roll is responsible for Allied Capital s financial operations. Prior to joining Allied Capital, Ms. Roll was employed by KPMG LLP in the firm s audit practice.

Daniel L. Russell, Managing Director, has been employed by the Company since 1998. Prior to joining Allied Capital, Mr. Russell was employed by KPMG LLP in the firm's financial services group.

John M. Scheurer, Managing Director, has been employed by the Company since 1991. Earlier in his career, Mr. Scheurer managed his own commercial real estate company, served as executive vice president of Hunter Companies, a full service commercial real estate leasing, investment and management company, and spent seven years with First American Bank in Washington DC. Mr. Scheurer is currently a member of the Board of Governors of the Commercial Mortgage Securities Association. He has also served as Chairman and as a Vice Chair of the Capital Markets Committee for the Commercial Real Estate Finance Committee of the Mortgage Bankers Association.

John D. Shulman, Managing Director, has been employed by the Company since 2001. Prior to joining Allied Capital, Mr. Shulman served as the President and CEO of Onyx International, LLC, a venture capital firm, from 1994 to 2001. Prior to his involvement with Onyx, Mr. Shulman served as Director of Development for the Tower Companies, a diversified portfolio of private equity and real estate investments. He currently serves as a director of ChemLink Laboratories LLC and as a member of the investment committees of Taiwan Mezzanine Fund and Greater China Private Equity Fund.

Suzanne V. Sparrow, Executive Vice President, Chief Compliance Officer and Corporate Secretary, has been employed by the Company since 1987. Ms. Sparrow manages Allied Capital's compliance and corporate governance activities.

Committees of the Board of Directors

Our Board of Directors has established an Executive Committee, an Audit Committee, a Compensation Committee, and a Corporate Governance/ Nominating Committee. The Audit Committee, Compensation Committee, and Corporate Governance/ Nominating Committee each operate pursuant to a committee charter. The charter of each Committee is available on our web site at www.alliedcapital.com in the Investor Resources section and is also available in print to any stockholder who requests a copy.

The Executive Committee has and may exercise those rights, powers, and authority that the Board of Directors from time to time grants to it, except where action by the Board is required by statute, an order of the Securities and Exchange Commission (the Commission), or Allied Capital's charter or bylaws. The Executive Committee has been delegated authority from the Board to review and approve certain investments. The Executive Committee met 42 times during 2005. The Executive Committee members currently are Messrs. Walton, Harper, Hebert, Leahy, Long, Pollock and Steuart. Messrs. Harper, Hebert, Leahy, Pollock, and Steuart are independent directors for purposes of the 1940 Act. Messrs. Walton and Long are interested persons of the Company, as defined in the 1940 Act.

The Audit Committee operates pursuant to a charter approved by the Board of Directors. The charter sets forth the responsibilities of the Audit Committee. The primary function of the Audit Committee is to serve as an independent and objective party to assist the Board of Directors in fulfilling its responsibilities for overseeing and monitoring the quality and integrity of our financial statements, the adequacy of our system of internal controls, the review of the independence, qualifications and performance of our

independent registered public accounting firm, and the performance of our internal audit function. The Audit Committee met 18 times during 2005. The Audit Committee is presently composed of four persons, including Messrs. Browne (Chairman) and Garcia and Mmes. Bates and van Roijen, all of whom are considered independent under the rules promulgated by the New York Stock Exchange. Our Board of Directors has determined that Messrs. Browne and Garcia and Ms. Bates are audit committee financial experts as defined under Item 401 of Regulation S-K of the Securities Exchange Act of 1934, as each meets the current independence and experience requirements of Rule 10A-3 of the Exchange Act and, in addition, are not interested persons of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940.

The Compensation Committee approves management's recommendations for the compensation of our executive officers and reviews the amount of salary and bonus for each of the Company's other officers and employees. In addition, the Compensation Committee approves stock option grants for our officers under our Amended Stock Option Plan, determines the Individual Performance Awards (IPA) and Individual Performance Bonuses (IPB) for participants and determines other compensation arrangements for employees. The Compensation Committee met 11 times during 2005. The Compensation Committee members currently are Messrs. Leahy (Chairman), Browne, Firestone, Garcia, and Racicot, each of whom is not an interested person as defined in Section 2(a)(19) of the Investment Company Act of 1940.

The Corporate Governance/ Nominating Committee recommends candidates for election as directors to the Board of Directors and makes recommendations to the Board as to our corporate governance policies. The Corporate Governance/ Nominating Committee met five times during 2005. The Corporate Governance/ Nominating Committee members currently are Messrs. Hebert (Chairman), Firestone, Pollock, and Racicot, each of whom is not an interested person as defined in Section 2(a)(19) of the Investment Company Act of 1940.

PORTFOLIO MANAGEMENT

The management of our company and our investment portfolio is the responsibility of various corporate committees, including the management committee, the investment committee, and the portfolio management committee. In addition, the Executive Committee of the Board of Directors approves certain investment decisions.

Our management committee is responsible for, among other things, business planning and the establishment and review of general investment criteria. The management committee is chaired by William Walton, our Chief Executive Officer (CEO), and includes Joan Sweeney, our Chief Operating Officer (COO), Penni Roll, our Chief Financial Officer (CFO), Scott Binder, our Chief Valuation Officer (CVO), and Michael Grisius, Jeri Harman, Thomas Lauer, Robert D. Long, Justin Maccarone, Daniel Russell, John Scheurer, and John Shulman, all managing directors.

Our investment committee is responsible for approving new investments. Our investment committee is chaired by William Walton, CEO, and includes Joan Sweeney, COO, Penni Roll, CFO, Scott Binder, CVO (non-voting) and James Fisher, John Fruehwirth, Michael Grisius, Jeri Harman, Thomas Lauer, Robert D. Long, Justin Maccarone, Robert Monk, Daniel Russell, John Scheurer and John Shulman, all managing directors.

In addition to approval by the investment committee, each transaction that represents a commitment equal to or greater than \$20 million, every buyout transaction, and any other investment that in our judgment demonstrates unusual risk/reward characteristics also requires the approval of the Executive Committee of the Board of Directors. Our Executive Committee is currently comprised of Messrs. Walton, Harper, Hebert, Leahy, Long, Pollock and Steuart.

Our portfolio management committee oversees the overall performance of the portfolio, including reviewing the performance of selected portfolio companies, overseeing portfolio companies in workout status, reviewing and approving certain amendments or modifications to existing investments, reviewing and approving certain portfolio exits, and reviewing and approving certain actions by portfolio companies whose voting securities are more than 50% owned by us. From time to time we will identify investments that require closer monitoring or become workout assets. We develop a workout strategy for workout assets and the portfolio management committee gauges our progress against the strategy. Our portfolio management committee is chaired by William Walton, CEO, and includes Joan Sweeney, COO, Penni Roll, CFO, Scott Binder, CVO (non-voting), and Christina DelDonna, John Fontana, and John Scheurer, and Paul Tanen, all managing directors.

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

Biographical Information for Non-Executive Officers

Information regarding the business experience of the additional investment professionals who are directors or executive officers is contained under the caption Management Biographical Information.

Christina L. DelDonna, Managing Director, has been employed by the Company since 1992. Ms. DelDonna has previously worked in a number of other managerial roles during her tenure with the Company. Prior to joining Allied Capital, Ms. DelDonna held several accounting, audit, and financial analyst roles within a variety of industries.

James A. Fisher, Managing Director, has been employed by the Company since January 2006 and manages Allied Capital's senior loan origination and underwriting activities. Prior to joining Allied Capital, Mr. Fisher managed the senior loan origination group at Callidus Capital Management, a specialized asset management company, from 2004 to 2006. Previously, Mr. Fisher was a Senior Vice President at JP Morgan Chase in charge of the Middle Market Structured Finance Division from 2000 to 2003, where he also served as a member of the Middle Market Banking Group's senior management team. He began his career in 1981 with the middle market lending group at JP Morgan Chase and served in various credit and management positions.

N. John Fontana, Managing Director, has been employed by the Company since 2004. Prior to joining Allied Capital, Mr. Fontana was a Principal of Tigris, an operations consulting firm in the consumer products and manufacturing industries from 2002 to 2004. From 1999 to 2002, Mr. Fontana was a turnaround manager working for a series of private equity and venture capital firms. He participated in the buyout and served as Chief

Operating Officer of Electrolux, LLC from 1998 to 1999. From 1994 to 1998, he served as a Partner with Deloitte & Touche Consulting Group where he led turnaround and operating improvement engagements for private equity firms.

John M. Fruehwirth, Managing Director, has been employed by the Company since 2003. Previously, he worked at Wachovia (formerly First Union) in several merchant banking groups including Wachovia Capital Partners, Leveraged Capital and Middle Market Capital from 1999 to 2003. Prior to that, Mr. Fruehwirth worked in First Union's Leveraged Finance Group from 1996 to 1998.

Robert M. Monk, Managing Director, has been employed by the Company since 1993. Prior to joining Allied Capital, Mr. Monk worked in the leveraged finance group at First Union National Bank (currently Wachovia Securities).

Paul R. Tanen, Managing Director, has been employed by Allied Capital since May 2006, and was also employed by the Company from 2000 until 2004. From 2004 to 2006, Mr. Tanen served as a consultant to the Company. Prior to working with Allied Capital, Mr. Tanen served as a Managing Director at Ridgefield Partners from 1998 to 2000, and was a Founding Member of the private equity group at Charter Oak Partners from 1992 to 1998.

Compensation

The compensation for the members of our management committee, investment committee, and portfolio management committee includes: (i) base salary; (ii) annual bonus; (iii) individual performance award and/or individual performance bonus; and (iv) stock options. Compensation for the members of our Executive Committee, with the exception of Mr. Walton, consists of: (i) annual retainer; (ii) attendance fee per committee meeting; and (iii) stock options. See Management and Compensation of Executive Officers and Directors.

Beneficial Ownership

Each member of the Executive Committee, excluding Messrs. Harper and Pollock, beneficially owns shares of our common stock with a value of more than \$1,000,000, based on the closing price of \$30.21 on June 6, 2006, on the New York Stock Exchange. Messrs. Harper and Pollock beneficially own shares of our common stock with a value of \$100,000 to \$500,000 and with a value of \$500,000 to \$1,000,000, respectively, based on the closing price of \$30.21 on June 6, 2006, on the New York Stock Exchange. Each member of the management committee, the investment committee and the portfolio management committee beneficially owns shares of our common stock with a value of more than \$1,000,000, based on the closing price of \$30.21 on June 6, 2006, on the New York Stock Exchange.

Conflicts of Interest

Because each of the members of the Executive Committee, the management committee, the investment committee, and the portfolio management committee provide portfolio management services of this type only to us, there are no conflicts of interest with respect to their management of other accounts or investment vehicles.

COMPENSATION OF EXECUTIVE OFFICERS AND DIRECTORS

Under SEC rules applicable to business development companies, we are required to set forth certain information regarding the compensation of certain executive officers and directors. The following table sets forth compensation earned during the year ended December 31, 2005, by all of our directors and our three highest paid executive officers (collectively, the "Compensated Persons") in each capacity in which each Compensated Person served. Certain of the Compensated Persons served as both officers and directors.

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

Compensation Table

Name	Aggregate Compensation from the Company ^(1,2)	Securities Underlying Options/ SARs ⁽³⁾	Pension or Retirement Benefits Accrued as Part of Company Expenses ⁽¹⁾	Directors Fees Paid by the Company ⁽⁴⁾
Interested Directors:				
William L. Walton, <i>Chairman & CEO</i>	\$7,381,605		\$	\$
Joan M. Sweeney, <i>Chief Operating Officer</i>	4,119,587			
Robert E. Long, <i>Director</i>	84,000	5,000		84,000
Independent Directors:				
Ann Torre Bates, <i>Director</i>	88,500	5,000		88,500
Brooks H. Browne, <i>Director</i>	113,500	5,000		113,500
John D. Firestone, <i>Director</i>	66,000	5,000		66,000
Anthony T. Garcia, <i>Director</i>	107,000	5,000		107,000
Lawrence I. Hebert, <i>Director</i>	101,000	5,000		101,000
John I. Leahy, <i>Director</i>	112,500	5,000		112,500
Alex J. Pollock, <i>Director</i>	73,500	5,000		73,500
Marc F. Racicot, <i>Director</i>	50,000	10,000		50,000
Guy T. Steuart II, <i>Director</i>	83,500	5,000		83,500
Laura W. van Roijen, <i>Director</i>	92,000	5,000		92,000
Executive Officers:				
John M. Scheurer, <i>Managing Director</i>	4,167,568	50,000		

(1) The following table provides detail as to aggregate compensation paid for 2005 to our three highest paid executive officers, including the Chief Executive Officer:

	Salary	Bonus ⁽⁵⁾	IPA	IPB	Other Benefits
Mr. Walton	\$1,528,846	\$2,750,000	\$1,475,000	\$1,475,000	\$152,759
Ms. Sweeney	1,019,231	1,500,000	750,000	750,000	100,356

Mr. Scheurer	611,538	2,350,000	550,000	550,000	106,030
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For 2005, the Company established individual performance awards (IPA) and individual performance bonuses (IPB). See also Individual Performance Award and Individual Performance Bonus . Included for each executive officer in Other Benefits is, among other things, an employer contribution to the 401(k) Plan, a contribution to the Deferred Compensation Plan I, amounts attributed to travel of non-employee family members when they have accompanied a Compensated Person on a business trip, and health and dental insurance. See also Employment Agreements.

(2) Messrs. Walton, Pollock and Scheurer and Ms. Sweeney deferred \$1.6 million, \$28 thousand, \$0.6 million, and \$0.8 million, respectively, of the compensation earned during the year ended December 31, 2005.

(3) See Stock Option Awards for terms of options granted in 2005.

(4) Consists only of directors fees paid by Allied Capital for 2005. Such fees are also included in the column titled Aggregate Compensation from the Company .

(5) Mr. Scheurer s 2005 bonus included two one-time lump sum bonuses totaling \$1,500,000. See Retention Agreements for further discussion.

Compensation of Non-Officer Directors

Each non-officer director receives an annual retainer of \$40,000. In addition, committee chairs receive an annual retainer of \$5,000. For each committee meeting attended, Executive Committee members receive \$1,500 per meeting; Audit Committee members receive \$3,000 per meeting; and members of the Compensation and Corporate Governance/Nominating Committees receive \$2,000 per meeting.

Directors may choose to defer such fees through our Deferred Compensation Plan, and may choose to have invested such deferred income in shares of our common stock through a trust.

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

Stock Option Awards

The following table sets forth the details relating to option grants in 2005 to Compensated Persons under our Amended Stock Option Plan, and the potential realizable value of each grant, as prescribed to be calculated by the SEC. See Amended Stock Option Plan.

Options Granted During 2005

Name	Number of Securities Underlying Options Granted	Percent of Total Options Granted in 2005 ⁽¹⁾	Exercise Price Per Share	Market Value	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation Over 10-Year Term ⁽²⁾	
						5%	10%
Interested Directors:							
William L. Walton ⁽³⁾							
Joan M. Sweeney ⁽³⁾							
Robert E. Long ⁽⁴⁾	5,000	0.07%	\$26.80	\$26.80	5/17/2015	\$84,272	\$213,561
Independent Directors:							
Ann Torre Bates ⁽⁴⁾	5,000	0.07	26.80	26.80			