

ALLIED CAPITAL CORP  
Form N-2/A  
June 10, 2008

*As filed with the Securities and Exchange Commission on June 10, 2008*

**Registration No. 333-141847**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM N-2**

**REGISTRATION STATEMENT  
UNDER  
THE SECURITIES ACT OF 1933**

- Pre-Effective Amendment No.**  
 **Post-Effective Amendment No. 2**

**ALLIED CAPITAL CORPORATION**  
*(Exact Name of Registrant as Specified in Charter)*

**1919 Pennsylvania Avenue, N.W.  
Washington, D.C. 20006-3434  
(202) 721-6100**

*(Address and Telephone Number, including Area Code, of Principal Executive Offices)*

**William L. Walton, Chairman and Chief Executive Officer  
Allied Capital Corporation  
1919 Pennsylvania Avenue, N.W.  
Washington, D.C. 20006-3434**

*(Name and Address of Agent for Service)*

*Copies of information to:*

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

*Approximate Date of Proposed Public Offering:*  
From time to time after the effective date of the Registration Statement.

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

It is proposed that this filing will become effective (Check appropriate box)

when declared effective pursuant to Section 8(c)

**CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933**

<b>Title of Securities Being Registered</b>	<b>Amount Being Registered<sup>(1)</sup></b>	<b>Proposed Maximum Aggregate Principal Amount<sup>(2)</sup></b>	<b>Amount of Registration Fee<sup>(3)</sup></b>
Debt Securities	\$1,380,000,000	\$1,500,000,000	\$42,366

- (1) In reliance upon Rule 429 under the Securities Act of 1933, this amount is in addition to the amount previously registered by the Registrant under a registration statement on Form N-2 (File No. 333-133755). All amounts unsold under the prospectus contained in such prior Registration Statement (a total of \$120,000,000) are carried forward into this Registration Statement, and the prospectus contained as a part of this Registration Statement shall be deemed to be combined with the prospectus contained in the above-referenced registration statement, which has previously been filed.
- (2) Estimated solely for the purpose of computing the registration fee pursuant to Rule 457(o) of the Securities Act of 1933, as amended.
- (3) Previously paid.
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The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

**PROSPECTUS (SUBJECT TO COMPLETION)**

**ISSUED           , 2008**

\$1,500,000,000

**Debt Securities**

We may offer, from time to time, up to an aggregate principal amount of \$1,500,000,000 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. See Plan of Distribution.

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 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, N.W., Washington, DC, 20006 or by telephone at (202) 721-6100 or on our website at [www.alliedcapital.com](http://www.alliedcapital.com). The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains such information.

Our 6.875% Notes due 2047 are traded on the New York Stock Exchange under the symbol AFC.

**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.**

, 2008

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**We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained in this prospectus or any prospectus supplement, if any, 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
Prospectus Summary	1
Selected Condensed Consolidated Financial Data	6
Where You Can Find Additional Information	8
Risk Factors	9
Ratios of Earnings to Fixed Charges	17
Use of Proceeds	18
Price Range of Common Stock and Distributions	19
Management's Discussion and Analysis of Financial Condition and Results of Operations	20
Senior Securities	75
Business	79
Portfolio Companies	93
Determination of Net Asset Value	101
Management	103
Portfolio Management	110
Compensation of Directors and Executive Officers	112
Control Persons and Principal Holders of Securities	131
Certain Relationships and Related Party Transactions	133
Tax Status	134
Certain Government Regulations	136
Stock Trading Plans	139
Dividend Reinvestment Plan	139
Description of Capital Stock	141
Description of Public Notes	147
Plan of Distribution	157
Legal Matters	158
Custodians, Transfer and Dividend Paying Agent and Registrar	158
Brokerage Allocation and Other Practices	158
Independent Registered Public Accounting Firm	158
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 \$1,500,000,000 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.

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## PROSPECTUS SUMMARY

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

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

### BUSINESS (Page 79)

We are a business development company in the private equity business and we are internally managed. Specifically, 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. Since then through March 31, 2008, we have invested more than \$13 billion in thousands of companies nationwide. Our investment objective is to achieve current income and capital gains.

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

We primarily invest in the American entrepreneurial economy. At March 31, 2008, our private finance portfolio included investments in 124 companies that generate aggregate annual revenues of over \$13 billion and employ more than 98,000 people.

We generally target companies in less cyclical industries with, among other things, management teams with meaningful equity ownership, high returns on invested capital, the ability to generate free cash flow, and well-capitalized balance sheets. 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 (an investment that combines both senior and subordinated financing, generally in a first lien position), 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 generally 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 earn income from management, consulting, diligence, structuring, or other fees. We may also enhance our total return with capital gains realized from investments in equity instruments or from equity features, such as nominal cost warrants.

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



We have also participated in commercial real estate finance over our history. Over the past few years, we have not actively participated in commercial real estate finance as we believed that the market for commercial real estate had become too aggressive and that investment opportunities were not priced appropriately. As a result, our commercial real estate finance portfolio totaled \$115.8 million at value, or 2.3% of our total assets, at March 31, 2008. As the capital markets evolve and should commercial real estate investment opportunities improve, we may become more active investors in commercial real estate finance for our own portfolio or through a future managed fund.

In addition to managing our own assets, we manage certain funds that also invest in the debt and equity securities of primarily middle market companies in a variety of industries, which we refer to as Managed Funds. We may invest in the equity of these funds, along with other third parties, from which we may earn a current return and/or future incentive allocation. We may also manage the assets held by these funds, for which we may earn management or other fees for our services.

We are internally managed, led by an experienced management team with our senior officers and managing directors possessing, on average, 22 years of experience. At March 31, 2008, we had 186 employees, who are focused on transaction sourcing, origination and execution, portfolio monitoring, accounting, valuation and other operational and administrative activities. We are headquartered in Washington, DC, with offices in New York, NY, Chicago, IL, and Los Angeles, CA and have centralized investment approval and portfolio management processes.

We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986, otherwise referred to as the Code. Assuming that we qualify as a regulated investment company, we generally will not be subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. See Tax Status. We pay regular quarterly dividends based upon an estimate of annual taxable income available for distribution to shareholders and the amount of taxable income carried over from the prior year for distribution in the current year. Since 1963, our portfolio has provided sufficient ordinary taxable income and realized net capital gains to sustain or grow our dividends over time.

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

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

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

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

Our 6.875% Notes due 2047 are traded on the New York Stock Exchange under the symbol AFC.

**DETERMINATION OF  
NET ASSET VALUE** *(Page 101)*

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 in accordance with our valuation policy and the provisions of the 1940 Act and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157). In the first quarter of 2008, we adopted SFAS 157. The adoption of SFAS 157 did not change our requirement to record our investments at fair value.

There is no single approach 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. 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. Additionally, changes in the market environment and other events that may occur over the life of our investments may cause the gains or losses ultimately realized on our investments to be different than the values determined at the measurement date.

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 157)*

We may offer, from time to time, up to \$1,500,000,000 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 offer our debt securities if our BDC asset coverage ratio would be less than 200% after giving effect to such offering. 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 18)*

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.

Any supplement to this prospectus relating to any offering of debt securities will more fully identify the use of the 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.

Substantially all of our portfolio of investments, which are generally illiquid, are recorded at fair value, as determined in good faith by our Board of Directors. 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 repay our loans or engage in a liquidity event, such as a sale, recapitalization or initial public offering. These conditions could lead to financial losses in our portfolio and a decrease in our revenues, net income and assets. Numerous other factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry or negative economic conditions.

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

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

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

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

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

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

Although funds managed by us may have a different primary investment objective than we do, the managed funds may invest in the same or similar asset classes that we target. There may be conflicts in the allocation of the investment opportunities between us and the managed funds. We have sold assets to certain managed funds and, as

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

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

The trading market or the market value of our publicly issued debt securities may be volatile.

**CERTAIN ANTI-TAKEOVER PROVISIONS** *(Page 143)*

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

**RATIOS OF EARNINGS TO FIXED CHARGES** *(Page 17)*

Our ratio of earnings to fixed charges for the five years ended December 31, 2007, was 2.2, 3.6, 12.3, 4.3, and 3.4, respectively. For the quarter ended March 31, 2008, we had a loss before taxes of \$38.7 million, which included unrealized depreciation (a non-cash item) of \$113.4 million, which resulted in a deficit to cover fixed charges of \$0.8 million. 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 3.0 for the quarter ended March 31, 2008, and 4.2, 8.2, 6.4, 5.2, and 4.4, for the five years ended December 31, 2007, respectively. For more information, see the section entitled "Ratios of Earnings to Fixed Charges" in this prospectus.

**SENIOR SECURITIES** *(Page 75)*

At March 31, 2008, we had \$2.2 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.2%. 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 2.7% as of March 31, 2008, 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, 2007, 2006, 2005, 2004, and 2003, has been derived from our financial statements that were audited by KPMG LLP. Quarterly financial information is derived from unaudited financial data, but in the opinion of management, reflects all adjustments (consisting only of normal recurring adjustments) which are necessary to present fairly the results for such interim periods. Interim results at and for the three months ended March 31, 2008, are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. See **Management's Discussion and Analysis of Financial Condition and Results of Operations and Senior Securities** below for more information.

(in thousands, except per share data)	At and for the Three Months Ended March 31, 2008      2007 (unaudited)		At and for the Year Ended December 31, 2007      2006      2005      2004      2003					
	<b>Operating Data:</b>							
Interest and related portfolio income:								
Interest and dividends	\$ 134,660	\$ 101,983	\$ 417,576	\$ 386,427	\$ 317,153	\$ 319,642	\$ 290,719	
Fees and other income	10,284	5,969	44,129	66,131	56,999	47,448	38,510	
Total interest and related portfolio income	144,944	107,952	461,705	452,558	374,152	367,090	329,229	
Expenses:								
Interest	37,560	30,288	132,080	100,600	77,352	75,650	77,233	
Employee	22,652	21,928	89,155	92,902	78,300	53,739	36,945	
Employee stock options <sup>(1)</sup>	4,195	3,661	35,233	15,599				
Administrative	9,019	13,224	50,580	39,005	69,713	34,686	22,387	
Total operating expenses	73,426	69,101	307,048	248,106	225,365	164,075	136,565	
Net investment income before income taxes	71,518	38,851	154,657	204,452	148,787	203,015	192,664	
Income tax expense (benefit), including excise tax	1,969	(649)	13,624	15,221	11,561	2,057	(2,466)	
Net investment income	69,549	39,500	141,033	189,231	137,226	200,958	195,130	
Net realized and unrealized gains (losses):								
Net realized gains	3,143	27,666	268,513	533,301	273,496	117,240	75,347	
Net change in unrealized appreciation or	(113,404)	65,920	(256,243)	(477,409)	462,092	(68,712)	(78,466)	

depreciation

Total net gains (losses)	(110,261)	93,586	12,270	55,892	735,588	48,528	(3,119)
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Net increase (decrease) in net assets resulting from operations	\$ (40,712)	\$ 133,086	\$ 153,303	\$ 245,123	\$ 872,814	\$ 249,486	\$ 192,011
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**Per Share:**

Diluted earnings (loss) per common share	\$ (0.25)	\$ 0.87	\$ 0.99	\$ 1.68	\$ 6.36	\$ 1.88	\$ 1.62
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Net investment income plus net realized gains per share <sup>(2)</sup>	\$ 0.45	\$ 0.44	\$ 2.65	\$ 4.96	\$ 2.99	\$ 2.40	\$ 2.28
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Dividends per common share <sup>(2)</sup>	\$ 0.65	\$ 0.63	\$ 2.64	\$ 2.47	\$ 2.33	\$ 2.30	\$ 2.28
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Weighted average common shares outstanding diluted	161,507	152,827	154,687	145,599	137,274	132,458	118,351
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(in thousands, except per share data)	At and for the Three Months Ended March 31, 2008 (unaudited)	2007	At and for the Year Ended December 31,				2003
			2006	2005	2004		
<b>Balance Sheet Data:</b>							
Portfolio at value	\$ 4,635,633	\$ 4,780,521	\$ 4,496,084	\$ 3,606,355	\$ 3,013,411	\$ 2,584,599	
Total assets	5,082,242	5,214,576	4,887,505	4,025,880	3,260,998	3,019,870	
Total debt outstanding <sup>(3)</sup>	2,191,563	2,289,470	1,899,144	1,284,790	1,176,568	954,200	
Undistributed (distributions in excess of) earnings	500,464	535,853	502,163	112,252	12,084	(13,401)	
Shareholders equity	2,828,418	2,771,847	2,841,244	2,620,546	1,979,778	1,914,577	
Shareholders equity per common share (net asset value) <sup>(4)</sup>	\$ 16.99	\$ 17.54	\$ 19.12	\$ 19.17	\$ 14.87	\$ 14.94	
Common shares outstanding at end of period	166,472	158,002	148,575	136,697	133,099	128,118	
Asset coverage ratio <sup>(5)</sup>	229%	221%	250%	309%	280%	322%	
Debt to equity ratio	0.77	0.83	0.67	0.49	0.59	0.50	
<b>Other Data:</b>							
Investments funded	\$ 275,130	\$ 1,845,973	\$ 2,437,828	\$ 1,675,773	\$ 1,524,523	\$ 931,450	
Principal collections related to investment repayments or sales	264,777	1,211,550	1,055,347	1,503,388	909,189	788,328	
Realized gains	32,740	400,510	557,470	343,061	267,702	94,305	
Realized losses	(29,597)	(131,997)	(24,169)	(69,565)	(150,462)	(18,958)	

(in thousands, except per share data)	2008		2007			2006		
	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2
<b>Income Data:</b>								
Investment and related income	\$144,944	\$117,709	\$118,368	\$117,676	\$107,952	\$117,708	\$113,383	\$110,456
Interest income	69,549	58,040	18,318	25,175	39,500	49,078	48,658	50,195
Net income (decrease) from operations resulting from investments	(40,712)	27,527	(96,468)	89,158	133,086	33,921	77,886	33,729
Net earnings (loss) per common share	\$(0.25)	\$0.18	\$(0.63)	\$0.57	\$0.87	\$0.23	\$0.53	\$0.24

declared per share <sup>(6)</sup>	0.65	0.72	0.65	0.64	0.63	0.67	0.61	0.60
value per share <sup>(4)</sup>	16.99	17.54	17.90	19.59	19.58	19.12	19.38	19.17

- (1) Effective January 1, 2006, we adopted the provisions of Statement No. 123 (Revised 2004), *Share-Based Payment*. See Management's Discussion and Analysis of Financial Condition and Results of Operations below.
- (2) Dividends are based on taxable income, which differs from income for financial reporting purposes. Net investment income and net realized gains are the most significant components of our annual taxable income from which dividends are paid. See Management's Discussion and Analysis of Financial Condition and Results of Operations and Dividends and Distributions below.
- (3) See Senior Securities and Management's Discussion and Analysis of Financial Condition and Results of Operations for more information regarding our level of indebtedness.
- (4) We determine net asset value per common share as of the last day of the period presented. The net asset values shown are based on outstanding shares at the end of each period presented.
- (5) As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.
- (6) Dividends declared per common share for the fourth quarter of 2007 included the regular quarterly dividend of \$0.65 per common share and an extra dividend of \$0.07 per common share. Dividends declared per common share for the fourth quarter of 2006 included the regular quarterly dividend of \$0.62 per common share and an extra dividend of \$0.05 per common share.

**WHERE YOU CAN FIND  
ADDITIONAL INFORMATION**

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

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

## RISK FACTORS

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

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

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

**Substantially all of our portfolio investments, which are generally illiquid, are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments.** At March 31, 2008, portfolio investments recorded at fair value were 91% 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 market quotation in an active market 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 approach for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. In determining fair value in good faith, we generally obtain financial and other information from portfolio companies, which may represent unaudited, projected or proforma financial information. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and unrealized appreciation when we determine that the fair value of a security is greater than its cost basis. Without a market quotation in an active market 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.

Beginning in the quarter ended March 31, 2008, we adopted the provisions of Statement No. 157, *Fair Value Measurements*, on a prospective basis. Adoption of this statement did not have a material effect on our consolidated financial statements for the first quarter of 2008. However, the impact on our consolidated financial statements in the periods subsequent to the period of adoption cannot be determined at this time as it will be influenced by the estimates of fair value for those periods, the number and amount of investments we originate, acquire or exit and the effect of any additional guidance or any changes in the interpretation of this statement. See Note 2, Summary of Significant Accounting Policies from our Notes to the Consolidated Financial Statements.

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

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

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

**Our private finance investments may not produce current returns or capital gains.** Our private finance portfolio includes loans and debt securities that require the payment of interest currently and equity securities such as conversion rights, warrants, or options, minority equity co-investments, or more significant equity investments in the case of buyout transactions. Our private finance debt investments are generally structured to generate interest income from the time they are made and our equity investments may also produce a realized gain. 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, 2008, our investment in Ciena Capital LLC (Ciena) totaled \$327.8 million at cost and \$29.3 million at value, after the effect of unrealized depreciation of \$298.5 million. In addition, we have an unconditional guarantee of 100% of the total obligations under Ciena's revolving credit facility that totaled

\$384.8 million at March 31, 2008. The guarantee can be called by the lenders in event of default. In addition, we have issued performance guarantees in connection with two non-recourse warehouse facilities. Ciena focuses on loan products that provide financing to commercial real estate owners and operators. Ciena relies on the asset-backed securitization market to finance its loan origination activity. That financing source continues to be unreliable in the current capital markets, and as a result, Ciena has substantially curtailed loan origination activity. Ciena continues to reposition its business; however, there is an inherent risk in repositioning the business and we continue to work with Ciena on restructuring. Our financial results could be negatively affected if Ciena defaults on its revolving line of credit or is not able to reposition its business.

Ciena is a participant in the SBA's 7(a) Guaranteed Loan Program and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA-guaranteed loans issued by Ciena. As an SBA lender, Ciena is also subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of Ciena's lending practices under the Business and Industry Loan program. The OIG and the U.S. Department of Justice are also conducting a civil investigation of Ciena's lending practices in various jurisdictions. These investigations, audits, and reviews are ongoing. These investigations, audits, and reviews have had and may continue to have a material adverse impact on Ciena and, as a result, could negatively affect our financial results. See Management's Discussion and Analysis of Financial Condition and Results of Operations—Private Finance, Ciena Capital LLC, and Valuation of Ciena Capital LLC.

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

At March 31, 2008, we had \$2.2 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.2% and a debt to equity ratio of 0.77 to 1.00. We may incur additional debt in the future. If our portfolio of investments fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due. In order for us to cover annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.7% as of March 31, 2008, which returns were achieved.



*Illustration.* The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) \$5,082.2 million in total assets, (ii) an average cost of funds of 6.2%, (iii) \$2,191.6 million in debt outstanding and (iv) \$2,828.4 million of shareholders' equity.

**Assumed Return on Our Portfolio  
(net of expenses)**

	<b>20%</b>	<b>10%</b>	<b>5%</b>	<b>0%</b>	<b>5%</b>	<b>10%</b>	<b>20%</b>
Corresponding return to shareholder	40.74%	22.77%	13.79%	4.80%	4.18%	13.16%	31.13%

**We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders.** Under the 1940 Act and the covenants applicable to our public debt, we must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders or investors on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of March 31, 2008, our asset coverage for senior indebtedness was 229%.

**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, 2008, were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected net income by approximately 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

**We will continue to need additional capital to grow because we must distribute our income.** We will continue to need capital to fund growth in our investments. Historically, we have borrowed from financial institutions or other investors and have issued debt and equity securities to grow our portfolio. A reduction in the availability of new debt or equity capital could limit our ability to grow. We must distribute at least 90% of our investment company taxable ordinary income (as defined in the Code), which excludes realized net long-term capital gains, to our shareholders to

maintain our eligibility for the tax benefits available to regulated investment companies. As a result, such earnings will not be available to fund investment originations. In addition, as a business development company, we (i) 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 and (ii) may only issue new equity capital at a price, net of discounts and commissions, above our net asset value unless we have received shareholder approval. We intend to continue to borrow from financial institutions or other investors and issue additional debt and equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it

could limit our ability to grow, which could have a material adverse effect on the value of our debt securities or common stock.

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

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

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

**There are potential conflicts of interest between us and the funds managed by us.** Certain of our officers serve or may serve in an investment management capacity to funds managed by us. As a result, investment professionals may allocate such time and attention as is deemed appropriate and necessary to carry out the operations of the managed funds. In this respect, they may experience diversions of their attention from us and potential conflicts of interest between their work for us and their work for the managed funds in the event that the interests of the managed funds run counter to our interests.

Although managed funds may have a different primary investment objective than we do, the managed funds may, from time to time, invest in the same or similar asset classes that we target. These investments may be made at the direction of the same individuals acting in their capacity on behalf of us and the managed funds. As a result, there may be conflicts in the allocation of investment opportunities between us and the managed funds. In the future,

we may not be given the opportunity to participate in investments made by investment funds managed by us or one of our affiliates. See Management's Discussion and Analysis and Results of Operations Managed Funds.

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

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

**Changes in the law or regulations that govern us could have a material impact on us or our operations.** We are regulated by the SEC. In addition, changes in the laws or regulations that govern business development companies, regulated investment companies, asset managers, and real estate investment trusts may significantly affect our business. There are proposals being considered by the current administration to change the regulation of financial institutions that may affect, possibly adversely, investment managers or investment funds. Any change in the law or regulations that govern our business could have a material impact on us or our operations. Laws and regulations may be changed from time to time, and the interpretations of the relevant laws and regulations also are subject to change, which may have a material effect on our operations.

**Failure to invest a sufficient portion of our assets in qualifying assets could preclude us from investing in accordance with our current business strategy.** As a business development company, we may not acquire any assets other than qualifying assets unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets. Therefore, we may be precluded from investing in what we believe are attractive investments if such investments are not qualifying assets for purposes of the 1940 Act. If we do not invest a sufficient portion of our assets in qualifying assets, we could lose our status as a business development company, which would have a material adverse effect on our business, financial condition and results of operations. Similarly, these rules could prevent us from making additional investments in existing portfolio companies, which could result in the dilution of our position, or could require us to dispose of investments at inopportune times in order to comply with the 1940 Act. If we were forced to sell nonqualifying investments in the portfolio for compliance purposes, the proceeds from such sale could be significantly less than the current value of such investments.

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

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

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

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

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

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

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

the time remaining to the maturity of these debt securities;

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

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

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

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

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

There also may be a limited number of buyers for our debt securities. This too may materially adversely affect the market value of the debt securities or the trading market for the debt securities.

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

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

### **Disclosure Regarding Forward-Looking Statements**

Information contained or incorporated by reference in this prospectus, and any prospectus supplement 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, including economic downturns or recessions;

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

future changes in laws or regulations or changes in accounting principles; 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 with respect to such supplements. The forward-looking statements contained in this prospectus and any accompanying prospectus supplement are excluded from the safe harbor protection provided by Section 27A of the Securities Act of 1933.



**RATIOS OF EARNINGS TO FIXED CHARGES**

For the five years ended December 31, 2007, the ratios of earnings to fixed charges of the Company, computed as set forth below, were as follows:

	<b>Year Ended December 31,</b>				
	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Earnings to Fixed Charges*	2.2	3.6	12.3	4.3	3.4

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), including 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. For the quarter ended March 31, 2008, we had a loss before taxes of \$38.7 million, which included unrealized depreciation (a non-cash item) of \$113.4 million, which resulted in a deficit to cover fixed charges of \$0.8 million.

\* 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 3.0 for the quarter ended March 31, 2008, and 4.2, 8.2, 6.4, 5.2, and 4.4, for the five years ended December 31, 2007, respectively.

### **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 capital as we deem appropriate to fund such new investments. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

We anticipate that substantially all of the net proceeds of any offering of debt securities will be used as described above or in any prospectus supplement and pricing supplement, if any, accompanying this prospectus, within six months, but in no event longer than two years. Pending investment, we intend to invest the net proceeds of any offering of 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 and the Nasdaq Global Select Market 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 9, 2008, the last reported closing sale price of our common stock was \$18.59 per share.

	NAV <sup>(1)</sup>	Closing Sales Price		Premium of High Sales Price to NAV <sup>(2)</sup>	Premium of Low Sales Price to NAV <sup>(2)</sup>	Declared Dividends
		High	Low			
<b><i>Year ended December 31, 2006</i></b>						
First Quarter	\$ 19.50	\$ 30.68	\$ 28.51	157%	146%	\$ 0.59
Second Quarter	\$ 19.17	\$ 31.32	\$ 28.77	163%	150%	\$ 0.60
Third Quarter	\$ 19.38	\$ 30.88	\$ 27.30	159%	141%	\$ 0.61
Fourth Quarter	\$ 19.12	\$ 32.70	\$ 29.99	171%	157%	\$ 0.62
Extra Dividend						\$ 0.05
<b><i>Year ended December 31, 2007</i></b>						
First Quarter	\$ 19.58	\$ 32.98	\$ 28.05	168%	143%	\$ 0.63
Second Quarter	\$ 19.59	\$ 32.96	\$ 28.90	168%	148%	\$ 0.64
Third Quarter	\$ 17.90	\$ 32.87	\$ 27.10	184%	151%	\$ 0.65
Fourth Quarter	\$ 17.54	\$ 30.90	\$ 21.15	176%	121%	\$ 0.65
Extra Dividend						\$ 0.07
<b><i>Year ended December 31, 2008</i></b>						
First Quarter	\$ 16.99	\$ 23.26	\$ 18.38	137%	108%	\$ 0.65
Second Quarter (through June 9, 2008)	*	\$ 21.52	\$ 18.59	*	*	\$ 0.65

(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.

Shares of business development companies may trade at a market price that is less than the value of the net assets attributable to those shares. Our common stock currently continues to trade in excess of net asset value. The possibility that our shares of common stock will trade at a discount from net asset value or at premiums that are unsustainable over the long term is separate and distinct from the risk that our net asset value will decrease. There can be no assurance, however, that our shares will continue to trade at a premium to our net asset value.

We are not generally able to issue and sell our common stock at a price below net asset value per share. We may, however, sell our common stock, or sell warrants, options or rights to acquire such common stock, at a price below the current net asset value of the common stock if our board of directors determines that such sale is in our best interests and the best interests of our stockholders, and our stockholders approve our policy and practice of making such sales. In any such case, the price at which our securities are to be issued and sold may not be less than a price which, in the determination of our board of directors, closely approximates the market value of such securities (less any distributing

commission or discount).

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

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

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

*The information contained in this section should be read in conjunction with our Consolidated Financial Statements and the Notes thereto.*

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

**OVERVIEW**

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

Our portfolio composition at March 31, 2008 and 2007, and at December 31, 2007, 2006, and 2005, was as follows:

	<b>March 31,</b>		<b>December 31,</b>		
	<b>2008</b>	<b>2007</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Private finance	98%	97%	97%	97%	96%
Commercial real estate finance	2%	3%	3%	3%	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 primarily results from the stated interest rate earned on a loan or debt security and the amortization of loan origination fees and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory, and competitive factors that influence new investment activity, interest rates on the types of loans we make, the level of repayments in the portfolio, the amount of loans and debt securities for which interest is not accruing and our ability to secure debt and equity capital for our investment activities. The level of fee income is primarily related to the level of new investment activity and the level of fees earned from portfolio companies and managed funds. The level of investment activity can vary substantially from period to period depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make.

Because we are a regulated investment company for tax purposes, we intend to distribute substantially all of our annual taxable income available for distribution 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, 2008 and 2007, and at and for the years ended December 31, 2007, 2006, and 2005, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,		At and for the Years Ended December 31,		
	2008	2007	2007	2006	2005
Portfolio at value	\$ 4,635.6	\$ 4,498.8	\$ 4,780.5	\$ 4,496.1	\$ 3,606.4
Investments funded <sup>(1)</sup>	\$ 275.1	\$ 170.2	\$ 1,846.0	\$ 2,437.8	\$ 1,675.8
Payment-in-kind interest and dividends, net of cash collections	\$ 13.4	\$ 8.1	\$ 12.0	\$ 7.3	\$ 25.7
Principal collections related to investment repayments or sales <sup>(2)</sup>	\$ 264.8	\$ 235.5	\$ 1,211.6	\$ 1,055.3	\$ 1,503.4
Yield on interest-bearing investments <sup>(3)</sup>	12.3%	11.6%	12.1%	11.9%	12.8%

(1) Investments funded included investments acquired through the issuance of our common stock as consideration totaling \$7.2 million for the year ended December 31, 2005. See also Private Finance below.

(2) Principal collections related to investment repayments or sales for the three months ended March 31, 2008, and for the year ended December 31, 2007, included collections of \$30.0 million and \$224.2 million, respectively, related to the sale of loans to the Allied Capital Senior Debt Fund, L.P. See discussion below.

(3) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, plus the effective interest yield on the preferred shares/income notes of CLOs, plus the annual stated interest (LIBOR plus 7.5%) on the subordinated certificates in the Unitranche Fund LLC 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, 2008 and 2007, and at and for the years ended December 31, 2007, 2006, and 2005, were as follows:

	At and for the Three Months Ended March 31,				At and for the Years Ended December 31,					
	2008		2007		2007		2006		2005	
(in millions)	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Portfolio at value:										
Loans and debt securities:										
Loans	\$ 325.7	7.0%	\$ 365.0	8.4%	\$ 344.3	7.7%	\$ 405.2	8.4%	\$ 239.8	
Unitranche debt	655.7	11.8%	780.2	11.4%	653.9	11.5%	799.2	11.2%	294.2	
Subordinated debt	2,430.4	13.0%	1,946.1	12.5%	2,416.4	12.8%	1,980.8	12.9%	1,560.9	
Loans and debt securities:										
Preferred securities:										
Income notes of CLOs	197.4	15.8%	96.1	13.5%	203.0	14.6%	97.2	15.5%	72.3	
Subordinated certificates in the Unitranche Fund	31.5	12.4%			0.7	12.4%				
Equity securities:										
Equity securities	879.1		1,188.9		1,041.0		1,095.5		1,312.1	
Equity securities	1,108.0		1,285.0		1,244.7		1,192.7		1,384.4	
Portfolio	\$ 4,519.8		\$ 4,376.3		\$ 4,659.3		\$ 4,377.9		\$ 3,479.3	
Investments funded <sup>(3)</sup>	\$ 274.6		\$ 170.2		\$ 1,828.0		\$ 2,423.4		\$ 1,462.3	
Investment in-kind										
Interest and dividends, cash collections, and other income	\$ 13.2		\$ 5.3		\$ 12.7		\$ 3.4		\$ 25.7	
Net change in investment portfolio	\$ 256.4		\$ 235.1		\$ 1,188.2		\$ 1,015.4		\$ 703.9	

<sup>(1)</sup> The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value. The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest (LIBOR plus 7.5%) divided by (b) total



investment at value. The weighted average yields are computed as of the balance sheet date.

- (2) Investments in the preferred shares/income notes of CLOs and subordinated certificates in the Unitranche Fund LLC earn a current return that is included in interest income in the consolidated statement of operations.
- (3) Investments funded for the year ended December 31, 2006, included debt investments in certain portfolio companies received in conjunction with the sale of such companies. See Private Finance - Investments Funded below.
- (4) Includes collections from the sale or repayment of senior loans totaling \$48.6 million, \$94.7 million, \$393.4 million, \$322.7 million, and \$301.8 million for the three months ended March 31, 2008 and 2007, and for the years ended December 31, 2007, 2006, and 2005, respectively.

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 (an investment that combines both senior and subordinated financing, generally in a first lien position), or subordinated

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

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

During the first six months of 2007, we found it difficult to find investments with attractive prices and structures. As a result, new investment activity was lower than in prior quarters. During the second half of 2007 and into the first quarter of 2008, our investment pace increased as pricing and structures improved. In the first quarter of 2008, we invested \$274.6 million in private finance as compared to \$170.2 million in the first quarter of 2007.

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

**Investments Funded.** Investments funded and the weighted average yield on loans and debt securities funded for the three months ended March 31, 2008 and 2007, and for the years ended December 31, 2007, 2006, and 2005, consisted of the following:

(\$ in millions)	For the Three Months Ended March 31, 2008					
	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 26.8	7.4%	\$ 10.4	6.7%	\$ 37.2	7.2%
Unitranche debt <sup>(2)</sup>	4.5	10.3%	0.5	6.6%	5.0	9.9%
Subordinated debt	129.9 <sup>(4)</sup>	12.0%	31.3	14.2%	161.2	12.4%
Total loans and debt securities	161.2	11.2%	42.2	12.3%	203.4	11.4%
Preferred shares/income notes of CLOs <sup>(5)</sup>	3.0	27.6%			3.0	27.6%
Subordinated certificates in Unitranche Fund LLC	30.7	12.4%			30.7	12.4%
Equity	13.6		23.9		37.5	
Total	\$ 208.5		\$ 66.1		\$ 274.6	



## For the Three Months Ended March 31, 2007

(\$ in millions)	Debt Investments		Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 41.2	8.8%	\$ 12.7	10.4%	\$ 53.9	9.2%
Unitranche debt <sup>(2)</sup>	5.3	11.0%			5.3	11.0%
Subordinated debt	14.4	9.3%	62.1	10.5%	76.5	10.3%
Total loans and debt securities	60.9	9.1%	74.8	10.5%	135.7	9.9%
Equity	9.7		24.8		34.5	
Total	\$ 70.6		\$ 99.6		\$ 170.2	

## 2007 Investments Funded

(\$ in millions)	Debt Investments		Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 249.0	9.2%	\$ 63.1	8.8%	\$ 312.1	9.1%
Unitranche debt <sup>(2)</sup>	109.1	10.8%	74.9	13.0%	184.0	11.7%
Subordinated debt	719.4 <sup>(4)</sup>	12.8%	197.6	12.1%	917.0	12.6%
Total loans and debt securities	1,077.5	11.7%	335.6	11.7%	1,413.1	11.7%
Preferred shares/income notes of CLOs <sup>(5)</sup>	116.2	16.4%			116.2	16.4%
Subordinated certificates in Unitranche Fund LLC	0.7	12.4%			0.7	12.4%
Equity	152.0 <sup>(6)</sup>		146.0		298.0	
Total	\$ 1,346.4		\$ 481.6		\$ 1,828.0	

## 2006 Investments Funded

(\$ in millions)	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>

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Loans and debt securities:

Senior loans	\$ 245.4	9.4%	\$ 239.8	8.9%	\$ 485.2	9.2%
Unitranche debt <sup>(2)</sup>	471.7	10.7%	146.5	12.9%	618.2	11.3%
Subordinated debt <sup>(3)</sup>	510.7	13.0%	423.8	14.4%	934.5	13.6%
Total loans and debt securities	1,227.8	11.4%	810.1	12.5%	2,037.9	11.9%
Preferred shares/income notes of CLOs <sup>(5)</sup>	26.1	14.8%			26.1	14.8%
Equity	65.3		294.1		359.4	
Total	\$ 1,319.2		\$ 1,104.2		\$ 2,423.4	

(\$ in millions)	Debt Investments		2005 Investments Funded Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 76.8	10.0%	\$ 250.2	6.4%	\$ 327.0	7.2%
Unitranche debt <sup>(2)</sup>	259.5	10.5%			259.5	10.5%
Subordinated debt	296.9 <sup>(4)</sup>	12.3%	330.9	12.5%	627.8	12.4%
Total loans and debt securities	633.2	11.3%	581.1	9.9%	1,214.3	10.6%
Preferred shares/income notes of CLOs <sup>(5)</sup>	47.9	14.2%			47.9	14.2%
Equity	34.6		165.5		200.1	
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. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs funded. The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest (LIBOR plus 7.5%) divided by (b) total investment at value. The weighted average yield is calculated using yields as of the date an investment is funded.
- (2) Unitranche debt is an investment that combines both senior and subordinated financing, generally in a first lien position. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt.
- (3) Debt investments funded for the year ended December 31, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a \$30 million subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS.
- (4) Subordinated debt investments for the three months ended March 31, 2008, and the years ended December 31, 2007 and 2005, included \$2.0 million, \$45.3 million and \$45.5 million, respectively, in investments in the bonds of collateralized loan obligations (CLOs) and one collateralized debt obligations (CDO). Certain of these CLOs and the CDO are managed by Callidus Capital Corporation (Callidus), a portfolio company controlled by us. These CLOs and the CDO primarily invest in senior corporate loans.
- (5) CLO equity investments included preferred shares/income notes of CLOs that primarily invest in senior corporate loans. Certain of these CLOs are managed by Callidus.
- (6) Equity investments for the year ended December 31, 2007, included \$31.8 million invested in the Allied Capital Senior Debt Fund, L.P. See [Managed Funds](#) below.

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

We may underwrite or arrange senior loans related to our portfolio investments or for other companies that are not in our portfolio. When we underwrite or arrange senior loans, we may earn a fee for such activities. Senior loans

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

We are currently focused on selling or encouraging the recapitalization or refinancing of some of our lower yielding debt investments. We may sell loans or debt securities to Managed Funds or portfolio companies may refinance their debt through a Managed Fund.

**Yield.** The weighted average yield on the private finance loans and debt securities was 12.2% at March 31, 2008, as compared to 11.7%, 12.1%, 11.9% and 13.0% at March 31, 2007, December 31, 2007, 2006 and 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 accruing (see Portfolio Asset Quality Loans and Debt Securities on Non-Accrual Status below) and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period.

The yield on the private finance portfolio declined in 2006 and 2007 partly due to our strategy to pursue investments where our position in the portfolio company capital structure is more senior, such as senior debt and unitranche investments that typically have lower yields than subordinated debt investments. In addition, during the fourth quarter of 2006, the guaranteed dividend yield on our investment in Ciena Capital LLC's 25% Class A equity interests was placed on non-accrual status. The Class A equity interests are included in our loans and debt securities. See Ciena Capital LLC below.

**Outstanding Investment Commitments.** At March 31, 2008, we had outstanding private finance investment commitments as follows:

(\$ in millions)	Companies	Companies	Companies	Total
	More Than 25% Owned <sup>(1)</sup>	5% to 25% Owned	Less Than 5% Owned	
Senior loans	\$ 8.6	\$ 12.0	\$ 98.5	\$ 119.1 <sup>(2)</sup>
Unitranche debt	3.0		44.6	47.6
Subordinated debt	23.0	4.3		27.3
Total loans and debt securities	34.6	16.3	143.1	194.0
Unitranche Fund <sup>(3)</sup>	493.5			493.5
Equity securities	91.7	9.8	56.3	157.8 <sup>(4)</sup>
Total	\$ 619.8	\$ 26.1	\$ 199.4	\$ 845.3

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

(\$ in millions)	Committed Amount	Amount Drawn	Amount Available to be Drawn
------------------	---------------------	-----------------	------------------------------------



Revolving line of credit for working capital	\$	4.0	\$	1.6	\$	2.4
Subordinated debt to support warehouse facilities & warehousing activities <sup>(*)</sup>		18.0		4.0		14.0
Total	\$	22.0	\$	5.6	\$	16.4

(\*) Callidus has a synthetic credit facility with a third party for up to approximately \$55 million. We have agreed to designate our subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support this facility.

(2) Includes \$113.2 million in the form of revolving senior debt facilities to 33 companies.

(3) Represents our commitment to the Unitranche Fund LLC (see discussion below), which we estimate will be funded over a two to three year period as investments are made by the Unitranche Fund.

(4) Includes \$66.1 million to 13 private equity and venture capital funds, including \$3.9 million in co-investment commitments to one private equity fund.

In addition to these outstanding investment commitments at March 31, 2008, 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. See *Financial Condition, Liquidity and Capital Resources* below.

***Investments in Collateralized Loan Obligations and Collateralized Debt Obligations (CLO/CDO Assets).*** At both March 31, 2008, and December 31, 2007, we had investments in ten CLO issuances and one CDO bond, which represented 5.7% and 5.6% of our total assets, respectively, and five CLO issuances and one CDO bond, which represented 2.9% of our total assets, at December 31, 2006. At March 31, 2008, and at December 31, 2007 and 2006, our CLO/CDO Assets were as follows:

(\$ in millions)	2008			2007			2006		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
CLO/CDO bonds	\$ 92.7	\$ 92.1	12.7%	\$ 90.7	\$ 89.9	13.3%	\$ 45.4	\$ 45.6	12.8%
Preferred shares/income notes of CLOs	224.1	197.4	15.8%	218.3	203.0	14.6%	101.1	97.2	15.5%
Total	\$ 316.8	\$ 289.5		\$ 309.0	\$ 292.9		\$ 146.5	\$ 142.8	

<sup>(1)</sup> The weighted average yield is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective interest yield on the preferred shares/income notes, divided by (b) CLO and CDO assets at value.

The market yield used in the valuation of the CLO and CDO assets may be different than the interest yields shown above. See discussion below.

The CLO and CDO issuances in which we have invested are primarily invested in senior corporate loans. See also Note 3, *Portfolio* from our Notes to the Consolidated Financial Statements.

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

The CLOs and CDO in which we invest are invested primarily in first lien loans to corporate borrowers. We are not an investor in CLOs and CDO that hold subprime residential real estate loans. The CLO/CDO Assets in which we have 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 will bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes. At March 31, 2008, and December 31, 2007 and 2006, the face value of the CLO/CDO Assets held by us was subordinate to as much as 94%, 94% and 92%, respectively, of the face value of the securities outstanding in these CLOs and CDO.



At March 31, 2008, and December 31, 2007 and 2006, the underlying collateral assets of these CLO and CDO issuances, consisting primarily of senior corporate loans, were issued by 636 issuers, 671 issuers and 465 issuers, respectively, and had balances as follows:

(\$ in millions)	2008	2007	2006
Bonds	\$ 286.1	\$ 288.5	\$ 245.4
Syndicated loans	4,206.5	4,122.7	1,769.9
Cash <sup>(1)</sup>	101.4	104.4	59.5
Total underlying collateral assets <sup>(2)</sup>	\$ 4,594.0	\$ 4,515.6	\$ 2,074.8

(1) Includes undrawn liability amounts.

(2) At March 31, 2008, and December 31, 2007 and 2006, the total face value of defaulted obligations was \$42.3 million, \$18.4 million and \$9.6 million, respectively, or approximately 0.9%, 0.4% and 0.5%, respectively, of the total underlying collateral assets.

Since the third quarter of 2007, the debt capital markets have been volatile and market yields for CLO securities have increased. We believe the market yields for our investments in CLO preferred shares/income notes have increased, and as a result, the fair value of certain of our investments in these assets has decreased. At March 31, 2008, the market yields used to value our preferred shares/income notes were 22% to 23%, with the exception of the income notes in one CLO with a cost and value of \$23.1 million where we used a market yield of 18% due to the characteristics of the issuance. At December 31, 2007, the market yields used to value our preferred shares/income notes were 20% to 21%, with the exception of the income notes in one CLO with a cost and value of \$18.7 million where we used a market yield of 15.9% and one CLO with a cost and value of \$22.1 million where we used a market yield of 18% due to the characteristics of these issuances. Net change in unrealized appreciation or depreciation for the three months ended March 31, 2008, and for the year ended December 31, 2007, included a net decrease of \$11.2 million and \$12.4 million, respectively, related to our investments in CLO/CDO Assets. We received valuation assistance for our investments in the CLO/CDO Assets in each quarter of 2007 and in the first quarter of 2008. See Results of Operations Valuation Methodology Private Finance below for further discussion of the third-party valuation assistance we received.

**Ciena Capital LLC.** Ciena Capital LLC (f/k/a Business Loan Express, LLC) (Ciena) focuses on loan products that provide financing to commercial real estate owners and operators. Ciena is also a participant in the SBA s 7(a) Guaranteed Loan Program and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). Ciena is headquartered in New York, NY and maintains offices in other U.S. locations. We invested in Ciena in 2000.

At March 31, 2008, our investment in Ciena totaled \$327.8 million at cost and \$29.3 million at value, after the effect or unrealized depreciation of \$298.5 million. See Results of Operations, Valuation of Ciena Capital LLC for a discussion of the determination of the value of Ciena at March 31, 2008. At December 31, 2007, our investment in Ciena totaled \$327.8 million at cost and \$68.6 million at value, after the effect of unrealized depreciation of \$259.2 million. In 2007, we increased our investment in Ciena by \$32.4 million. We acquired \$29.2 million in additional Class A equity interests to fund payments to the SBA discussed below and to provide additional capital to Ciena. In addition, we purchased \$3.2 million in Class A equity interests from Ciena s former Chief Executive Officer. At December 31, 2006, our investment in Ciena totaled \$295.3 million at cost and \$210.7 million at value, after the effect of unrealized depreciation of \$84.6 million.

Net change in unrealized appreciation or depreciation included a net decrease on our investment in Ciena of \$39.3 million, \$174.5 million and \$142.3 million for the three months ended March 31, 2008, and for the years ended December 31, 2007 and 2006, respectively, and a net increase of \$2.9 million for the year ended December 31, 2005. See Results of Operations, Valuation of Ciena Capital LLC below.

Total interest and related portfolio income earned from our investment in Ciena for the three months ended March 31, 2008 and 2007, and for the years ended December 31, 2007, 2006, and 2005, was as follows:

(\$ in millions)	Three Months Ended March 31,		Year Ended December 31,		
	2008	2007	2007	2006	2005
Interest income on subordinated debt and Class A equity interests <sup>(1)</sup>	\$	\$	\$	\$ 11.9	\$ 14.3
Dividend income on Class B equity interests <sup>(1)</sup>					14.0
Fees and other income		1.4	5.4	7.8	9.2
Total interest and related portfolio income	\$	\$ 1.4	\$ 5.4	\$ 19.7	\$ 37.5

<sup>(1)</sup> Interest and dividend income from Ciena for the years ended December 31, 2006 and 2005, included interest and dividend income of \$5.7 million and \$8.9 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to us through the issuance of additional debt or equity interests.

In the fourth quarter of 2006, we placed our investment in Ciena's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from our investment in Ciena for the three months ended March 31, 2008 and 2007, and for the year ended December 31, 2007, and interest income for 2006 was lower as compared to 2005. In consideration for providing a guaranty on Ciena's revolving credit facility and standby letters of credit (discussed below), we earned fees of \$1.4 million, \$5.4 million, \$6.1 million, and \$6.3 million for the three months ended March 31, 2007, and for the years ended December 31, 2007, 2006, and 2005, respectively, which were included in fees and other income. Ciena has not yet paid the \$5.4 million in such fees earned by us in 2007. At both March 31, 2008, and December 31, 2007, such fees were included as a receivable in other assets. We considered this outstanding receivable in our valuation of Ciena at March 31, 2008, and at December 31, 2007. We did not accrue the fees earned from Ciena for providing the guaranty and standby letters of credit for the three months ended March 31, 2008. The remaining fees and other income in 2006 and 2005 relate to management fees from Ciena. We did not charge Ciena management fees in the first quarter of 2008, in 2007 or in the fourth quarter of 2006.

We guarantee Ciena's revolving credit facility that matures in March 2009. On January 30, 2008, Ciena completed an amendment of the terms of its revolving credit facility. The amendment reduced the commitments from the lenders under the facility from \$500 million to \$450 million at the effective date of the amendment, with further periodic reductions in total commitments to \$325 million by December 31, 2008. In addition, certain financial and other covenants were amended. In connection with this amendment, we increased our unconditional guarantee from 60% to 100% of the total obligations under this facility (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) and replaced \$42.5 million in letters of credit issued under the Ciena credit facility with new letters of credit under our revolving line of credit. The guaranty of the Ciena revolving credit facility can be called by the lenders in the event of a default, which includes the occurrence of any event of default under our revolving credit facility, subject to grace periods in certain cases. The amendment also prohibits cash payments from Ciena to us for interest, guarantee fees, management fees, and dividends. At March 31, 2008, the principal amount outstanding on Ciena's revolving credit facility was \$335.0 million and letters of credit issued under the facility were \$46.9 million. The total obligation guaranteed by us at March 31, 2008, was \$384.8 million. At March 31, 2008, we had provided standby letters of credit totaling \$59.5 million in connection with term securitizations completed by Ciena. At December 31, 2007, the total obligation guaranteed by us was \$258.7 million, and we had provided four

standby letters of credit totaling \$18.0 million in connection with four term securitization transactions completed by Ciena.

Ciena relies on the asset-backed securitization market to finance its loan origination activity. That financing source continues to be unreliable in the current capital markets, and as a result, Ciena has substantially curtailed loan origination activity, including loan originations under the SBA's 7(a) Guaranteed Loan Program. Ciena continues to reposition its business. However, there is an inherent risk in this repositioning and we continue to work with Ciena on restructuring. Ciena maintains two non-recourse securitization warehouse facilities, and there is no

assurance that Ciena will be able to refinance these facilities in the loan securitization market. We have issued performance guaranties whereby we have agreed to indemnify the warehouse providers for any damages, losses, liabilities and related costs and expenses that they may incur as a result of Ciena's failure to perform any of its obligations as loan originator, loan seller or loan servicer under the warehouse securitizations.

The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA guaranteed loans issued by Ciena. Specifically, on or about January 9, 2007, Ciena became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleged that a former Ciena employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. We understand that Ciena is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. On October 1, 2007, the former Ciena employee pled guilty to one count of conspiracy to fraudulently originate SBA-guaranteed loans and one count of making a false statement before a grand jury.

On March 6, 2007, Ciena entered into an agreement with the SBA. According to the agreement, Ciena remains a preferred lender in the SBA 7(a) Guaranteed Loan Program and retains the ability to sell loans into the secondary market. As part of this agreement, Ciena agreed to the immediate payment of approximately \$10 million to the SBA to cover amounts paid by the SBA with respect to some of the SBA-guaranteed loans that have been the subject of the charges by the U.S. Attorney's Office for the Eastern District of Michigan against Mr. Harrington. Ciena also entered into an escrow agreement with the SBA and an escrow agent in which Ciena agreed to deposit \$10 million with the escrow agent for any additional payments Ciena may be obligated to pay to the SBA in the future under the agreement. During the term of the agreement, any loans originated by Ciena that will be sold into the secondary market or loans that default after having been sold into the secondary market will be reviewed by an independent third party selected by the SBA prior to the sale of such loans into the secondary market or prior to reimbursement by the SBA. Ciena remains subject to SBA rules and regulations and as a result may be required to make additional payments to the SBA in the ordinary course of business.

As an SBA lender, Ciena is also subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of Ciena's lending practices under the Business and Industry Loan (B&I) program. The OIG and the U.S. Department of Justice are also conducting a civil investigation of Ciena's lending practices in various jurisdictions. These investigations, audits and reviews are ongoing.

On or about January 16, 2007, Ciena and its subsidiary Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC). The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans. On December 18, 2007, the United States District Court for the Northern District of Georgia dismissed all claims in this matter. The plaintiffs are appealing the dismissal.

These investigations, audits, reviews, and litigation have had and may continue to have a material adverse impact on Ciena and, as a result, could continue to negatively affect our financial results. We have considered Ciena's current regulatory issues, ongoing investigations, litigation, and the repositioning of its business in performing the valuation of Ciena at March 31, 2008, and December 31, 2007. See Results of Operations Valuation of Ciena Capital LLC below. We are monitoring the situation.



***Mercury Air Centers, Inc.*** At March 31, 2007, our investment in Mercury Air Centers, Inc. (Mercury) totaled \$84.8 million at cost and \$301.4 million at value, which included unrealized appreciation of \$216.6 million. At December 31, 2006, our investment in Mercury totaled \$84.3 million at cost and \$244.2 million at value, or 5.0% of our total assets, which included unrealized appreciation of \$159.9 million. We completed the purchase of a majority ownership in Mercury in April 2004.

In August 2007, we completed the sale of our majority equity interest in Mercury. For the year ended December 31, 2007, we realized a gain of \$262.4 million, subject to post-closing adjustments. In addition, we were repaid approximately \$51 million of subordinated debt outstanding to Mercury at closing.

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

Total interest and related portfolio income earned from our investment in Mercury for the three months ended March 31, 2007, and for the years ended December 31, 2007, 2006, and 2005, was as follows:

(\$ in millions)	Three Months Ended March 31, 2007	Year Ended December 31,		
		2007	2006	2005
Interest income	\$ 2.0	\$ 5.1	\$ 9.3	\$ 8.8
Fees and other income	0.1	0.2	0.6	0.7
Total interest and related portfolio income	\$ 2.1	\$ 5.3	\$ 9.9	\$ 9.5

Net change in unrealized appreciation or depreciation for the three months ended March 31, 2007, included an increase in unrealized appreciation totaling \$56.7 million related to our investment in Mercury. Net change in unrealized appreciation or depreciation for the year ended December 31, 2007, included an increase in unrealized appreciation totaling \$74.9 million for the first half of 2007 and the reversal of \$234.8 million associated with the sale of our majority equity interest in the third quarter of 2007. Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on our investment in Mercury of \$106.1 million and \$53.8 million for the years ended December 31, 2006 and 2005, respectively.

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

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our \$184 million in subordinated debt outstanding at closing. For the year ended December 31, 2006, we realized a gain on the sale of our equity investment of \$434.4 million, subject to post-closing adjustments and excluding any earn-out amounts. We realized additional gains in 2008 and 2007, resulting from post-closing adjustments and an earn-out payment totaling \$1.7 million and \$3.4 million, respectively, subject to additional 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. In addition, a portion of our cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. At March 31, 2008, and December 31, 2007, the amount of the escrow included in other assets on our consolidated balance sheet was approximately \$23 million and \$25 million, respectively. For tax purposes, the receipt of the \$150 million subordinated note as part of our

consideration for the common stock sold and the hold back of certain proceeds in escrow will generally allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note or other amounts are collected.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest was \$14.1 million (which included a prepayment premium of \$5.0 million), and \$37.4 million, for the years ended December 31, 2006, and 2005, respectively. In addition, we earned structuring fees of \$2.3 million on our new \$150 million subordinated debt investment in Advantage upon the closing of the sale transaction in 2006. Net change in unrealized appreciation or depreciation for the year ended December 31, 2006, included the reversal of \$389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale

of our majority equity interest in Advantage and for the year ended December 31, 2005, included an increase in unrealized appreciation of \$378.4 million, related to our majority equity interest investment in Advantage.

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

Our investment in Advantage, which was composed of subordinated debt and a minority equity interest, totaled \$155.7 million at cost and \$167.6 million at value, which included unrealized appreciation of \$11.9 million at March 31, 2008, and \$154.8 million at cost and \$165.8 million at value, which included unrealized appreciation of \$11.0 million at December 31, 2007.

### 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, 2008 and 2007, and at and for the years ended December 31, 2007, 2006, and 2005, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,				At and for the Years Ended December 31,					
	2008		2007		2007		2006		2005	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Portfolio at value:										
Commercial										
mortgage loans	\$ 53.5	7.9%	\$ 72.2	7.5%	65.4	6.8%	71.9	7.5%	102.6	7.6%
Real estate owned	30.2		21.0		21.3		19.6		13.9	
Equity interests	32.1		29.3		34.5		26.7		10.6	
Total portfolio	\$ 115.8		\$ 122.5		\$ 121.2		\$ 118.2		\$ 127.1	
Investments funded	\$ 0.5		\$		\$ 18.0		\$ 14.4		\$ 213.5	
Payment-in-kind interest, net of cash collections	\$ 0.2		\$ 0.2		\$ (0.7)		\$ 0.8		\$	
Principal collections related to investment repayments or sales <sup>(2)</sup>	\$ 8.4		\$ 0.4		\$ 23.4		\$ 39.9		\$ 799.5	

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

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



Our commercial real estate investments funded for the three months ended March 31, 2008, and for the years ended December 31, 2007, 2006, and 2005, were as follows:

(\$ in millions)	Face Amount	Discount	Amount Funded
<b><i>For the Three Months Ended March 31, 2008</i></b>			
Commercial mortgage loans	\$ 0.5	\$	\$ 0.5
Equity interests			
Total	\$ 0.5		\$ 0.5
<b><i>For the Year Ended December 31, 2007</i></b>			
Commercial mortgage loans	\$ 17.0	\$	\$ 17.0
Equity interests	1.0		1.0
Total	\$ 18.0	\$	\$ 18.0
<b><i>For the Year Ended December 31, 2006</i></b>			
Commercial mortgage loans	\$ 8.0		\$ 8.0
Equity interests	6.4		6.4
Total	\$ 14.4	\$	\$ 14.4
<b><i>For the Year Ended December 31, 2005</i></b>			
CMBS bonds <sup>(1)</sup>	\$ 211.5	\$ (90.5)	\$ 121.0
Commercial mortgage loans	88.5	(0.8)	87.7
Equity interests	4.8		4.8
Total	\$ 304.8	\$ (91.3)	\$ 213.5

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

At March 31, 2008, we had outstanding funding commitments related to the commercial real estate portfolio of \$40.0 million, and commitments in the form of standby letters of credit and guarantees related to equity interests of \$8.2 million.

***Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares.*** On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares 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 agreed not to primarily invest in non-investment grade 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.

## Managed Funds

We manage funds that invest in the debt and equity of primarily private middle market companies in a variety of industries (together, the Managed Funds). As of March 31, 2008, and December 31, 2007, the funds that we manage had total assets of approximately \$1.2 billion and \$400 million, respectively. During 2007, we established the Allied Capital Senior Debt Fund, L.P. and the Unitranche Fund LLC, and in the first quarter of 2008, we formed the AGILE Fund I, LLC, and assumed the management of Knightsbridge CLO 2007-1 Ltd., all discussed below. Our responsibilities to the Managed Funds may include deal origination, underwriting, and portfolio monitoring and development services consistent with the activities that we perform for our portfolio. Each of the Managed Funds may separately invest in the debt or equity of a portfolio company. Our portfolio may include debt or equity investments issued by the same portfolio company as investments held by one or more Managed Funds, and these investments may be senior, pari passu or junior to the debt and equity investments held by us. We may or may not participate in investments made by investment funds managed by us or one of our affiliates. We expect to continue to grow our managed capital base and have identified other private equity-related funds that we intend to develop. By growing our privately managed capital base, we are seeking to diversify our sources of capital, leverage our core investment expertise and increase fees and other income from asset management activities. See Risk Factors There are potential conflicts of interest between us and the funds managed by us.

**Allied Capital Senior Debt Fund, L.P.** The Allied Capital Senior Debt Fund, L.P. (ACSDF) is a private fund that generally invests in senior, unitranche and second lien debt. ACSDF has closed on \$125 million in equity capital commitments and had total assets of approximately \$432 million and \$400 million at March 31, 2008, and December 31, 2007, respectively. AC Corp, our wholly-owned subsidiary, is the investment manager and Callidus acts as special manager to ACSDF. One of our affiliates is the general partner of ACSDF, and AC Corp serves as collateral manager to a warehouse financing vehicle associated with ACSDF. AC Corp will earn a management fee of up to 2% per annum of the net asset value of ACSDF and will pay Callidus 25% of that management fee to compensate Callidus for its role as special manager.

We are a special limited partner in ACSDF, which is a portfolio investment, and have committed and funded \$31.8 million to ACSDF. At March 31, 2008, our investment in ACSDF totaled \$31.8 million at cost and \$32.6 million at value, and at December 31, 2007, totaled \$31.8 million at cost and \$32.8 million at value. As a special limited partner, we expect to earn an incentive allocation of 20% of ACSDF's annual net income earned in excess of a specified minimum return, subject to certain performance benchmarks. The value of our investment in ACSDF is based on the net asset value of ACSDF, which reflects the capital invested plus our allocation of the net earnings of ACSDF, including the incentive allocation.

We may offer to sell loans to ACSDF or the warehouse financing vehicle. ACSDF or the warehouse financing vehicle may purchase loans from us. In connection with ACSDF's formation in June 2007 and during the second half of 2007, we sold \$224.2 million of seasoned assets with a weighted average yield of 10.0% to a warehouse financing vehicle associated with ACSDF. In the first quarter of 2008, we sold \$30.0 million of seasoned assets with a weighted average yield of 8.2% to the warehouse financing vehicle. ACSDF also purchases loans from other third parties. In addition, during the second half of 2007, we repurchased one asset for \$12.0 million from ACSDF, which we had sold to ACSDF in June 2007.

**Unitranche Fund LLC.** In December 2007, we formed the Unitranche Fund LLC (Unitranche Fund), which we co-manage with an affiliate of General Electric Capital Corporation (GE). The Unitranche Fund is a private fund that generally focuses on making first lien unitranche loans to middle market companies with EBITDA of at least \$15 million. The Unitranche Fund may invest up to \$270 million in a single borrower. For financing needs greater than \$270 million, we and GE may jointly underwrite additional financing for a total unitranche financing of up to \$500 million. Allied Capital, GE and the Unitranche Fund may co-invest in a single borrower, with the Unitranche



Fund holding at least a majority of the issuance. GE has committed \$3.075 billion to the Unitranche Fund consisting of \$3.0 billion of senior notes and \$0.075 billion of subordinated certificates and we have committed \$525.0 million of subordinated certificates. The Unitranche Fund will be capitalized as transactions are completed. At March 31, 2008 the Unitranche Fund had total assets of approximately \$142 million. At March 31, 2008, and December 31, 2007, our investment in the Unitranche Fund totaled \$31.5 million at cost and at value and \$0.7 million at cost and at value, respectively.

The Unitranche Fund is governed by an investment committee with equal representation from Allied Capital and GE and both Allied Capital and GE provide origination, underwriting and portfolio management services to the Unitranche Fund and its affiliates. We will earn a management and sourcing fee totaling 0.375% per annum of managed assets.

**AGILE Fund I, LLC.** In January 2008, we entered into an investment agreement with the Goldman Sachs Private Equity Group, part of Goldman Sachs Asset Management (Goldman Sachs). As part of the investment agreement, we agreed to sell a pro-rata strip of private equity and debt investments to AGILE Fund I, LLC (AGILE), a private fund in which a fund managed by Goldman Sachs owns substantially all of the interests, for a total transaction value of \$167 million. The sales of the assets closed in the first quarter of 2008.

The sale to AGILE included 13.7% of our equity investments in 23 of our buyout portfolio companies and 36 of our minority equity portfolio companies for a total purchase price of \$104 million, which resulted in a net realized gain of \$8.8 million and dividend income of \$5.4 million. In addition, we sold approximately \$63 million in debt investments, which represented 7.3% of our unitranche, second lien and subordinated debt investments in the buyout investments included in the equity sale. AGILE generally has the right to co-invest in its proportional share of any future follow-on investment opportunities presented by the companies in its portfolio.

We are the managing member of AGILE, and are entitled to an incentive allocation subject to certain performance benchmarks. We own the remaining interests in AGILE not held by Goldman Sachs. At March 31, 2008, AGILE had total assets of approximately \$174 million and our investment in AGILE totaled \$0.9 million at cost and at value.

In addition, pursuant to the investment agreement Goldman Sachs has committed to invest at least \$125 million in future investment vehicles managed by us and will have future opportunities to invest in our affiliates, or vehicles managed by them, and to coinvest alongside us in the future, subject to various terms and conditions.

As part of this transaction, we sold nine venture capital and private equity limited partnership investments for approximately \$28 million to a fund managed by Goldman Sachs, which assumed the \$4.7 million of unfunded commitments related to these limited partnership investments. The sales of these limited partnership investments closed at the end of the first quarter of 2008 and resulted in a net realized loss of \$5.5 million.

**Knightsbridge CLO 2007-1 Ltd.** On March 31, 2008, we assumed the management of Knightsbridge CLO 2007-1 Ltd. We earn a management fee of up to 0.6% per annum of the assets of the fund. Callidus may assist us in the management of the fund and we may pay Callidus a portion of the management fee earned for this assistance. This CLO invests primarily in middle market senior loans. At March 31, 2008, Knightsbridge CLO 2007-1 Ltd. had total assets of approximately \$500 million and our investment in this CLO totaled \$54.4 million at cost and \$53.0 million at value.

In aggregate, including the total assets on our balance sheet and capital committed to our Managed Funds, we have more than \$9 billion in managed capital.

## **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, 2008, and December 31, 2007 and 2006, our portfolio was graded as follows:

Grade (\$ in millions)	2008		2007		2006	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
1	\$ 1,301.7	28.1%	\$ 1,539.6	32.2%	\$ 1,307.3	29.1%
2	3,079.8	66.4	2,915.7	61.0	2,672.3	59.4
3	141.1	3.1	122.5	2.6	308.1	6.9
4	61.6	1.3	157.2	3.3	84.2	1.9
5	51.4	1.1	45.5	0.9	124.2	2.7
	\$ 4,635.6	100.0%	\$ 4,780.5	100.0%	\$ 4,496.1	100.0%

The amount of the portfolio in each grading category may vary substantially from period to period resulting primarily from changes in the composition of the portfolio as a result of new investment, repayment, and exit activity, changes in the grade of investments to reflect our expectation of performance, and changes in investment values. We expect that a number of investments will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number and amount of investments included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with portfolio companies in order to recover the maximum amount of our investment.

Total Grade 4 and 5 portfolio assets were \$113.0 million, \$202.7 million and \$208.4 million, respectively, or were 2.4%, 4.2% and 4.6%, respectively, of the total portfolio value at March 31, 2008, December 31, 2007 and 2006. Grade 4 and 5 assets include loans, debt securities, and equity securities.

At March 31, 2008, and December 31, 2007, our Class A equity interests in Ciena, valued at \$29.3 million and \$68.6 million, respectively, were classified as Grade 5 and Grade 4, respectively, and our Class B and Class C equity interests, which had no value, were classified as Grade 5 at both periods. At December 31, 2006, \$135.9 million of our investment in Ciena at value was classified as Grade 3, which included our Class A equity interests and certain of our Class B equity interests that were not depreciated, and \$74.8 million of our investment in Ciena at value was classified as Grade 5, which included certain of our Class B equity interests and all our Class C equity interests that were depreciated at December 31, 2006. See Private Finance Ciena Capital LLC above.

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

At March 31, 2008, and December 31, 2007 and 2006, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

(\$ in millions)	2008	2007	2006
Loans and debt securities in workout status (classified as Grade 4 or 5) <sup>(1)</sup>			
Private finance			
Companies more than 25% owned	\$ 62.4	\$ 114.1	\$ 51.1
Companies 5% to 25% owned	2.6	11.7	4.0
Companies less than 5% owned	23.3	23.8	31.6
Commercial real estate finance	5.9	12.4	12.2
Loans and debt securities not in workout status			
Private finance			
Companies more than 25% owned	31.0	21.4	87.1
Companies 5% to 25% owned	12.3	13.4	7.2
Companies less than 5% owned	11.7	13.3	38.9
Commercial real estate finance	1.5	1.9	6.7
Total	\$ 150.7	\$ 212.0	\$ 238.8
Percentage of total portfolio	3.3%	4.4%	5.3%

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

At March 31, 2008, and December 31, 2007 and 2006, our Class A equity interests in Ciena of \$29.3 million, which represented 0.6% of the total portfolio at value, \$68.6 million, which represented 1.4% of the total portfolio at value, and \$66.6 million, which represented 1.5% of the total portfolio at value, respectively, were included in non-accruals. At March 31, 2008, these Class A equity interests were classified as Grade 5, at December 31, 2007, these Class A equity interests were classified as Grade 4 and at December 31, 2006, these Class A equity interests were classified as Grade 3. See Private Finance Ciena Capital LLC above.

**Loans and Debt Securities Over 90 Days Delinquent.** Loans and debt securities greater than 90 days delinquent at value at March 31, 2008, and December 31, 2007 and 2006, were as follows:

(\$ in millions)	2008	2007	2006
Private finance	\$ 54.0	\$ 139.9	\$ 46.5
Commercial mortgage loans	15.4	9.2	1.9
Total	\$ 69.4	\$ 149.1	\$ 48.4
Percentage of total portfolio	1.5%	3.1%	1.1%

Loans and debt securities over 90 days delinquent at March 31, 2008, and December 31, 2007, include our investment in the Class A equity interests of Ciena, which became over 90 days delinquent in the first quarter of 2007. The amount of loans and debt securities over 90 days delinquent increased from \$48.4 million at December 31, 2006, to

\$149.1 million at December 31, 2007, primarily due to not receiving payment on our Class A equity interests of Ciena. At March 31, 2008, and December 31, 2007, the Class A equity interests were \$29.3 million or 0.6% of the total portfolio at value and \$68.6 million, or 1.4% of the total portfolio at value, respectively. These equity interests were placed on non-accrual during the fourth quarter of 2006. See Private Finance, Ciena Capital LLC above.

The amount of the portfolio that is on non-accrual status or greater than 90 days delinquent may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$55.5 million, \$149.1 million and \$44.3 million at March 31, 2008, December 31, 2007 and 2006, respectively.

## **OTHER ASSETS AND OTHER LIABILITIES**

Other assets is primarily composed of fixed assets, prepaid expenses, deferred financing and offering costs, and accounts receivable, which includes amounts received in connection with the sale of portfolio companies, including amounts held in escrow, and other receivables from portfolio companies. At March 31, 2008, and December 31, 2007 and 2006, other assets totaled \$171.3 million, \$157.9 million and \$123.0 million, respectively. The increase in other assets since year end 2007 was primarily the result of an increase in accounts receivable due to \$32.4 million in consideration received in connection with the sale of investments, which was received in cash in April 2008, partially offset by the March 2008 distribution of the assets held in deferred compensation trusts, which totaled \$21.1 million at December 31, 2007.

Accounts payable and other liabilities is primarily composed of the liabilities related to accrued interest, bonus and taxes, including excise tax. At March 31, 2008, and December 31, 2007 and 2006, accounts payable and other liabilities totaled \$62.3 million, \$153.3 million and \$147.1 million, respectively. The decrease in accounts payable and other liabilities since year end 2007 was primarily the result of the termination of the deferred compensation plans in March 2008, the liability for which totaled \$52.5 million at December 31, 2007. In addition, accounts payable and other liabilities were reduced by the payment of liabilities at December 31, 2007, related to accrued 2007 bonuses of \$40.1 million and excise tax of \$16.0 million, offset by increases in the first quarter of 2008 related to accrued bonuses and excise tax totaling \$12.6 million and interest payable totaling \$11.5 million. Accrued interest payable fluctuates from period to period depending on the amount of debt outstanding and the contractual payment dates of the interest on such debt.

**RESULTS OF OPERATIONS****Comparison of the Three Months Ended March 31, 2008 and 2007**

The following table summarizes our operating results for the three months ended March 31, 2008 and 2007.

(In thousands, except per share amounts)	For the Three Months Ended March 31, 2008          2007		Change	Percent Change
	(unaudited)			
<b>Interest and Related Portfolio Income</b>				
Interest and dividends	\$ 134,660	\$ 101,983	\$ 32,677	32%
Fees and other income	10,284	5,969	4,315	72%
Total interest and related portfolio income	144,944	107,952	36,992	34%
<b>Expenses</b>				
Interest	37,560	30,288	7,272	24%
Employee	22,652	21,928	724	3%
Employee stock options	4,195	3,661	534	15%
Administrative	9,019	13,224	(4,205)	(32)%
Total operating expenses	73,426	69,101	4,325	6%
Net investment income before income taxes	71,518	38,851	32,667	84%
Income tax expense (benefit), including excise tax	1,969	(649)	2,618	403%
Net investment income	69,549	39,500	30,049	76%
<b>Net Realized and Unrealized Gains (Losses)</b>				
Net realized gains	3,143	27,666	(24,523)	*
Net change in unrealized appreciation or depreciation	(113,404)	65,920	(179,324)	*
Total net gains (losses)	(110,261)	93,586	(203,847)	*
Net income	\$ (40,712)	\$ 133,086	\$ (173,798)	(131)%
Diluted earnings per common share	\$ (0.25)	\$ 0.87	\$ (1.12)	(129)%
Weighted average common shares outstanding    diluted	161,507	152,827	8,686	6%

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



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

*Interest and Dividends.* Interest and dividend income for the three months ended March 31, 2008 and 2007, was composed of the following:

(\$ in millions)	2008	2007
Interest		
Private finance loans and debt securities	\$ 107.0	\$ 92.9
Preferred shares/income notes of CLOs	7.5	3.7
Subordinated certificates in Unitranche Fund LLC	0.3	
Commercial mortgage loans	1.2	1.3
Cash, U.S. Treasury bills, money market and other securities	1.8	2.8
Total interest	117.8	100.7
Dividends	16.9	1.3
Total interest and dividends	\$ 134.7	\$ 102.0

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the yield on the interest-bearing investments in the portfolio at March 31, 2008 and 2007, were as follows:

(\$ in millions)	2008		2007	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Loans and debt securities:				
Private finance	\$ 3,411.8	12.2%	\$ 3,091.3	11.7%
Commercial mortgage loans	53.5	7.9%	72.2	7.5%
Total loans and debt securities	3,465.3	12.1%	\$ 3,163.5	11.6%
Equity securities:				
Preferred shares/income notes of CLOs	197.4	15.8%	96.1	13.5%
Subordinated certificates in Unitranche Fund LLC	31.5	12.4%		
Total	\$ 3,694.2	12.3%	\$ 3,259.6	11.7%

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(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total interest-bearing investments at value. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value.

The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest (LIBOR plus 7.5%) divided by (b) total investment at value. The weighted average yields are computed as of the balance sheet date.

Our interest income from our private finance loans and debt securities has increased period over period primarily as a result of the growth in this portfolio. The private finance loan and debt securities portfolio yield at March 31, 2008, of 12.2% as compared to the private finance portfolio yield of 11.7% at March 31, 2007, reflects the mix of debt investments in the private finance loan and debt securities portfolio. The weighted average yield varies from period to period based on the current stated interest on loans and debt securities and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption Portfolio and Investment Activity Private Finance.

Interest income also includes the effective interest yield on our investments in the preferred shares/income notes of CLOs. Interest income from these investments has increased period over period primarily as a result of the growth in these assets. The weighted average yield on the preferred shares/income notes of the CLOs at March 31, 2008,

was 15.8%, as compared to the weighted average yield on the preferred shares/income notes of the CLOs of 13.5% at March 31, 2007.

The value and weighted average yield of the cash, U.S. Treasury bills, money market and other securities was \$201.6 million and 1.5%, respectively, at March 31, 2008, and \$271.5 million and 5.3%, respectively, at March 31, 2007. See *Financial Condition, Liquidity and Capital Resources* below.

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 for the three months ended March 31, 2008, was \$16.9 million as compared to \$1.3 million for the three months ended March 31, 2007. The increase period over period was primarily a result of a \$7.1 million dividend received in connection with the recapitalization of Norwesco, Inc., a portfolio company, and \$5.5 million of dividends paid in cash in connection with the sale to AGILE Fund I, LLC during the first quarter of 2008. See *Portfolio and Investment Activity Managed Funds* above. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests.

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

Fees and other income for the three months ended March 31, 2008 and 2007, included fees relating to the following:

(\$ in millions)	2008	2007
Structuring and diligence	\$ 5.1	\$ 1.8
Management, consulting and other services provided to portfolio companies	2.9	1.8
Commitment, guaranty and other fees from portfolio companies <sup>(1)</sup>	1.7	2.0
Fund management fees <sup>(2)</sup>	0.6	
Loan prepayment premiums		0.3
Other income		0.1
<b>Total fees and other income</b>	<b>\$ 10.3</b>	<b>\$ 6.0</b>

<sup>(1)</sup> Includes guaranty and other fees from Ciena of \$1.4 million for 2007. See *Private Finance, Ciena Capital, LLC* above.

<sup>(2)</sup> See *Portfolio and Investment Activity Managed Funds* above.

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

Structuring and diligence fees primarily relate to the level of new investment originations. Private finance investments funded were \$274.6 million for the three months ended March 31, 2008, as compared to \$170.2 million for the three months ended March 31, 2007. Structuring and diligence fees for the three months ended March 31, 2008, included \$1.8 million earned by us in connection with investments made by the Unitranche Fund, LLC.

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.

See Portfolio and Investment Activity above for further information regarding our total interest related portfolio income for Ciena and Mercury.

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

**Interest Expense.** The fluctuations in interest expense during the three months ended March 31, 2008 and 2007, were primarily attributable to changes in the level of our borrowings under various notes payable and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and debt financing costs, at and for the three months ended March 31, 2008 and 2007, were as follows:

(\$ in millions)	2008	2007
Total outstanding debt	\$ 2,191.6	\$ 1,891.5
Average outstanding debt	\$ 2,209.5	\$ 1,841.2
Weighted average cost <sup>(1)</sup>	6.2%	6.5%

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 (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 included interest paid to the Internal Revenue Service related to installment sale gains totaling \$1.9 million and \$0.3 million for the three months ended March 31, 2008 and 2007, respectively. Installment interest expense for the year ended December 31, 2008, is estimated to be a total of \$7.7 million. See Dividends and Distributions below.

**Employee Expense.** Employee expenses for the three months ended March 31, 2008 and 2007, were as follows:

(\$ in millions)	2008	2007
Salaries and employee benefits	\$ 22.7	\$ 21.4
Individual performance award (IPA)	2.4	2.5
IPA mark to market expense (benefit)	(4.1)	(4.0)
Individual performance bonus (IPB)	1.7	2.0
Total employee expense <sup>(1)</sup>	\$ 22.7	\$ 21.9
Number of employees at end of period	186	170

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 (1) Excludes stock options expense. See below.

The change in salaries and employee benefits reflects the effect of an increase in the number of employees, compensation increases, and the change in mix of employees given their area of responsibility and relevant experience level. Salaries and employee benefits include an accrual for employee bonuses, which are generally paid annually after the completion of the fiscal year. The quarterly accrual is based upon an estimate of annual bonuses and is subject to

change. The amount of the current year bonuses will be finalized by the Compensation Committee and the Board of Directors at the end of the year. Salaries and employee benefits included accrued bonuses of \$10.3 million and \$10.4 million for the three months ended March 31, 2008 and 2007, respectively.

The IPA is an incentive compensation program for certain officers and is generally determined annually at the beginning of each year but may be adjusted throughout the year. Through December 31, 2007, the IPA was deposited in a deferred compensation trust in four equal installments, generally on a quarterly basis, in the form of cash. The trustee was required to use the cash to purchase shares of our common stock in the open market.

Through December 31, 2007, the IPA amounts were contributed into the trust and invested in our common stock. The accounts of the trust were consolidated with our accounts. The common stock was classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represented the amount owed to the employees, was included in other liabilities. Changes in the

value of our common stock held in the deferred compensation trust were not recognized. However, the liability was marked to market with a corresponding charge or credit to employee compensation expense. On March 18, 2008, prior to the distribution of the assets held in the trust, we were required to record a final mark to market of the liability with a corresponding credit to employee compensation expense.

In December 2007, our Board of Directors made a determination that it was in Allied Capital's best interest to terminate our deferred compensation arrangements. The Board of Directors' decision was primarily in response to increased complexity resulting from recent changes in the regulation of deferred compensation arrangements. The Board of Directors resolved that the accounts under these Plans would be distributed to participants in full on March 18, 2008, the termination and distribution date, or as soon as was reasonably practicable thereafter, in accordance with the provisions of each of these Plans.

The accounts under the deferred compensation arrangements totaled \$52.5 million at December 31, 2007. The balances on the termination date were distributed to participants in March 2008 subsequent to the termination date, in accordance with the transition rule for payment elections under Section 409A of the Code. Distributions from the plans were made in cash or shares of our common stock, net of required withholding taxes. The distribution of the accounts under the deferred compensation arrangements will result in a tax deduction for 2008, subject to the limitations set by Section 162(m) of the Code for persons subject to such section.

The IPB is distributed in cash to award recipients throughout the year (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 2008 and they are currently estimated to be approximately \$9.5 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. For 2008, the Compensation Committee has determined that the IPAs will be paid in cash in two equal installments during the year, as long as the recipient remains employed by us. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

*Stock Options Expense.* Effective January 1, 2006, we adopted FASB Statement No. 123 (Revised 2004), *Share-Based Payment* (SFAS 123R) using the modified prospective method of application, which required us to recognize compensation costs on a prospective basis beginning January 1, 2006. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006, using the fair value amounts determined for proforma disclosure under SFAS 123R. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized in the consolidated statement of operations over the service period. Our employee stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the related service period. On February 1, 2008, the Compensation Committee of our Board of Directors granted 7.1 million options with an exercise price of \$22.96 per share. The options vest ratably over a three-year period beginning on June 30, 2009.

The stock option expense for the three months ended March 31, 2008 and 2007, was as follows:

(\$ in millions)	2008	2007
Employee Stock Option Expense:		
Previously awarded, unvested options as of January 1, 2006	\$ 1.7	\$ 3.2
Options granted on or after January 1, 2006	2.5	0.5

Total employee stock option expense	\$ 4.2	\$ 3.7
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We estimate that the employee-related stock option expense for outstanding unvested options as of March 31, 2008, will be approximately \$13.2 million, \$6.8 million, and \$4.0 million for the years ended December 31, 2008, 2009, and 2010, respectively. This estimate may change if our assumptions related to future option forfeitures change. This estimate does not include any expense related to stock option grants after March 31, 2008, as the fair value of those stock options will be determined at the time of grant.



*Administrative Expense.* Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, travel costs, stock record expenses, directors' fees and stock option expense, and various other expenses.

Administrative expenses for the three months ended March 31, 2008 and 2007, were \$9.0 million and \$13.2 million, respectively. Administrative expenses declined due to a reduction in investigation and litigation costs, net of insurance reimbursements, of \$3.8 million. Administrative expenses for the three months ended March 31, 2007, included costs of \$1.4 million incurred to engage a third party to conduct a review of Ciena's internal control systems. See Private Finance, Ciena Capital LLC above.

*Income Tax Expense (Benefit), Including Excise Tax.* Income tax expense (benefit) for the three months ended March 31, 2008 and 2007, was as follows:

(\$ in millions)	2008	2007
Income tax expense (benefit)	\$ (0.3)	\$ (4.2)
Excise tax expense <sup>(1)</sup>	2.3	3.6
Income tax expense (benefit), including excise tax	\$ 2.0	\$ (0.6)

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<sup>(1)</sup> While excise tax expense is presented in the Consolidated Statement of Operations as a reduction to net investment income, excise tax relates to both net investment income and net realized gains.

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

Our excess taxable income carried over from 2007 plus our estimated annual taxable income for 2008 currently exceeds our estimated dividend distributions to shareholders in 2008, therefore, we expect to carry over excess taxable income earned in 2008 for distribution in 2009. Therefore, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions for the year. We have recorded an estimated excise tax of \$2.3 million for the three months ended March 31, 2008. See Dividends and Distributions.

*Realized Gains and Losses.* Net realized gains primarily result from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the three months ended March 31, 2008 and 2007, were as follows:

(\$ in millions)	2008	2007
Realized gains	\$ 32.7	\$ 33.2
Realized losses	(29.6)	(5.5)
Net realized gains	\$ 3.1	\$ 27.7

The realized gains and losses for the three months ended March 31, 2008, were primarily a result of the sale to AGILE Fund I, LLC. The net realized gain from this transaction totaled \$8.8 million. In addition, realized losses for the quarter included \$5.5 million related to the sale of the venture capital and private equity limited partnership investments to a fund managed by Goldman Sachs. See [Managed Funds](#) above.

When we exit an investment and realize a gain or loss or receive a dividend on an equity security from a portfolio company, 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, 2008 and 2007, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized or when dividends were received as follows:

(\$ in millions)	2008	2007
Reversal of previously recorded net unrealized appreciation associated with realized gains	\$ (32.5)	\$ (32.1)
Reversal of previously recorded net unrealized appreciation associated with dividends received	(13.5)	
Reversal of previously recorded net unrealized depreciation associated with realized losses	28.5	5.8
Total reversal	\$ (17.5)	\$ (26.3)

Realized gains for the three months ended March 31, 2008 and 2007, were as follows:

(\$ in millions)	2008	Amount
<b>Portfolio Company</b>		
<b>Private Finance:</b>		
Norwesco, Inc.	\$	10.7
BenefitMall, Inc.		4.9
Financial Pacific Company		3.1
Penn Detroit Diesel Allison, LLC		1.7
Service Champ, Inc.		1.7
Advantage Sales & Marketing, Inc. <sup>(1)</sup>		3.2
Coverall North America, Inc.		1.4
CR Holding, Inc.		1.0
Other		4.9
Total private finance		32.6
<b>Commercial Real Estate:</b>		
Other		0.1
Total commercial real estate		0.1
Total realized gains	\$	32.7

Portfolio Company	2007	Amount
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**Private Finance:**

Palm Coast Data, LLC	\$	20.0
Mogas Energy, LLC		4.5
Tradesmen International, Inc		3.8
ForeSite Towers, LLC		3.8
Other		1.1
Total realized gains	\$	33.2

(1) Includes an additional realized gain of \$1.7 million related to the release of escrowed funds from the sale of our majority equity investment in 2006.

Realized losses for the three months ended March 31, 2008 and 2007, were as follows:

(\$ in millions)

	2008		Amount
<b>Portfolio Company</b>			
<b>Private Finance:</b>			
Crescent Equity Corp. Longview Cable & Data, LLC		\$	8.4
Mid-Atlantic Venture Fund IV, L.P.			5.2
WMA Equity Corporation and Affiliates			4.5
Driven Brands, Inc.			1.9
Direct Capital Corporation			1.7
EarthColor, Inc.			1.7
Sweet Traditions, Inc.			1.0
Other			4.9
Total private finance			29.3
<b>Commercial Real Estate:</b>			
Other			0.3
Total commercial real estate			0.3
Total realized losses		\$	29.6
	2007		
<b>Portfolio Company</b>			Amount
<b>Private Finance:</b>			
Legacy Partners Group, LLC		\$	5.8
Other			(0.3)
Total realized losses		\$	5.5

**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 (1940 Act), 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 in accordance with our valuation policy and the provisions of the 1940 Act and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement). We determine fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. At March 31, 2008, portfolio investments

recorded at fair value using level 3 inputs (as defined under the Statement) were approximately 91% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market quotation in an active market, 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 approach 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 determine that the fair value of a security is less than its cost basis, and we will record unrealized appreciation when we determine that the fair value is greater than its cost basis. 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 portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. 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.* We adopted SFAS 157 on a prospective basis in the first quarter of 2008. SFAS 157 requires us to assume that the portfolio investment is assumed to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. In accordance with the Statement, we have considered our principal market, or the market in which we exit our portfolio investments with the greatest volume and level of activity.

We have determined that for our buyout investments, where we have control or could gain control through an option or warrant security, both the debt and equity securities of the portfolio investment would exit in the merger and acquisition ( M&A ) market as the principal market generally through a sale or recapitalization of the portfolio company. We believe that the in-use premise of value (as defined in SFAS 157), which assumes the debt and equity securities are sold together, is appropriate as this would provide maximum proceeds to the seller. As a result, we will continue to use the enterprise value methodology to determine the fair value of these investments under SFAS 157. Enterprise value means the entire value of the company to a market participant, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. Enterprise value is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. We allocate the enterprise value to these securities in order of the legal priority of the securities.

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

In determining a multiple to use for valuation purposes, we generally look to private merger and acquisition statistics, the entry multiple for the transaction, discounted public trading multiples or industry practices. In estimating a

reasonable multiple, we consider not only the fact that our portfolio company may be a private company relative to a peer group of public comparables, but we also consider the size and scope of our portfolio company and its specific strengths and weaknesses. In some cases, the best valuation methodology may be a discounted cash flow analysis based on future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.



While we typically exit our securities upon the sale or recapitalization of the portfolio company in the M&A market, for investments in portfolio companies where we do not have control or the ability to gain control through an option or warrant security, we cannot typically control the exit of our investment into the principal market (the M&A market). As a result, in accordance with SFAS 157, we are required to determine the fair value of these investments assuming a sale of the individual investment in a hypothetical market to a hypothetical market participant (the in-exchange premise of value). We continue to perform an enterprise value analysis for investments in this category to assess the credit risk of the loan or debt security and to determine the fair value of our equity investment in these portfolio companies. The determined equity values are generally discounted when we have a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors. For loan and debt securities, we perform a yield analysis assuming a hypothetical current sale of the investment. The yield analysis requires us to estimate the expected repayment date of the instrument and a market participant's required yield. Our estimate of the expected repayment date of a loan or debt security is generally shorter than the legal maturity of the instruments as our loans have historically been repaid prior to the maturity date. The yield analysis considers changes in interest rates and changes in leverage levels of the loan or debt security as compared to market interest rates and leverage levels. Assuming the credit quality of the loan or debt security remains stable, we will use the value determined by the yield analysis as the fair value for that security. A change in the assumptions that we use to estimate the fair value of our loans and debt securities using the yield analysis could have a material impact on the determination of fair value. If there is deterioration in credit quality or a loan or debt security is in workout status, we may consider other factors in determining the fair value of a loan or debt security, including the value attributable to the loan or debt security from the enterprise value of the portfolio company or the proceeds that would be received in a liquidation analysis.

Our equity investments in private debt and equity funds are generally valued at the fund's net asset value, unless other factors lead to a determination of fair value at a different amount. The value of our equity securities in public companies for which quoted prices in an active market are readily available is based on the closing public market price on the measurement date.

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

We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and will record unrealized appreciation when we determine that the fair value is greater than its cost basis. Because of the inherent uncertainty of valuation, the values determined at the measurement date 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. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the values determined at the measurement date.

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

The valuation analysis prepared by management is submitted to our Board of Directors who is ultimately responsible for the determination of fair value of the portfolio in good faith. Valuation assistance from Duff & Phelps, LLC (Duff & Phelps) for our private finance portfolio consisted of certain limited procedures (the Procedures) we identified and requested them to perform. Based upon the performance of the Procedures on a selection of our final portfolio company valuations, Duff & Phelps concluded that the fair value of those portfolio companies subjected to the Procedures did not appear unreasonable. In addition, we also received third-party valuation assistance from other third-party consultants for certain private finance portfolio companies. For the three months ended March 31, 2008 and 2007, we received third-party valuation assistance as follows:

	2008	2007
Number of private finance portfolio companies reviewed	124	88
Percentage of private finance portfolio reviewed at value	94.0%	91.8%

Professional fees for third-party valuation assistance were \$1.8 million for the year ended December 31, 2007, and are estimated to be approximately \$2.3 million for 2008.

*Net Change in Unrealized Appreciation or Depreciation.* Net change in unrealized appreciation or depreciation for the three months ended March 31, 2008 and 2007, consisted of the following:

(\$ in millions)	2008 <sup>(1)</sup>	2007 <sup>(1)</sup>
Net unrealized appreciation (depreciation)	\$ (95.9)	\$ 92.2
Reversal of previously recorded unrealized appreciation associated with realized gains	(32.5)	(32.1)
Reversal of previously recorded net unrealized appreciation associated with dividends received	(13.5)	
Reversal of previously recorded unrealized depreciation associated with realized losses	28.5	5.8
Net change in unrealized appreciation or depreciation	\$ (113.4)	\$ 65.9

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

The primary drivers of the net unrealized depreciation of \$95.9 million resulting from changes in portfolio value for the quarter ended March 31, 2008, were (i) non-buyout debt investments, which depreciated by \$9.3 million as a result of using a yield analysis in connection with the adoption of SFAS 157, (ii) additional depreciation of \$39.3 million on our investment in Ciena resulting from the decline in value of their residual interest assets and other financial assets as discussed below, and (iii) depreciation in our other financial services and asset management portfolio companies, and our CLO/CDO investments, which totaled \$39.4 million.

**Valuation of Ciena Capital LLC.** Our investment in Ciena totaled \$327.8 million at cost and \$29.3 million at value, which included unrealized depreciation of \$298.5 million, at March 31, 2008, and \$327.8 million at cost and \$68.6 million at value, which included unrealized depreciation of \$259.2 million, at December 31, 2007.

Ciena relies on the asset-backed securitization market to finance its loan origination activity. That financing source continues to be unreliable in the current capital markets, and as a result, Ciena has substantially curtailed loan origination activity. To value our investment at March 31, 2008, we continued to attribute no value to Ciena's origination platform or enterprise due to the state of the securitization markets, among other factors. The decline in value at March 31, 2008, of \$39.3 million reflects the decline in value of Ciena's financial assets, including residual

interests, which reduced its book value. We valued our investment in Ciena at March 31, 2008, solely based on the estimated realizable value of Ciena's net assets, including the estimated realizable value of the cash flows generated from Ciena's retained interests in its current servicing portfolio, which includes portfolio servicing fees as well as cash flows from Ciena's equity investments in its securitizations and its interest-only strip. This resulted in a value to our investment, after repayment of senior debt outstanding, of \$29.3 million at March 31, 2008.

We also continued to consider Ciena's current regulatory issues and ongoing investigations and litigation in performing the valuation analysis at March 31, 2008. (See Private Finance, Ciena Capital LLC above.)

Net change in unrealized appreciation or depreciation included a net decrease of \$39.3 million for the three months ended March 31, 2008, and no change for the three months ended March 31, 2007. We received valuation assistance from Duff & Phelps for our investment in Ciena at March 31, 2008 and 2007. See Valuation Methodology Private Finance above for further discussion of the third-party valuation assistance we received.

**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 161.5 million and 152.8 million for the three months ended March 31, 2008 and 2007, respectively.

**Comparison of the Years Ended December 31, 2007, 2006, and 2005**

The following table summarizes our operating results for the years ended December 31, 2007, 2006, and 2005.

(in thousands, except per share amounts)	2007	2006	Change	Percent Change	2006	2005	Change
<b>Investment Related Portfolio Income</b>							
Dividends	\$ 417,576	\$ 386,427	\$ 31,149	8%	\$ 386,427	\$ 317,153	\$ 69,274
Other income	44,129	66,131	(22,002)	(33)%	66,131	56,999	9,132
Investment and related portfolio income	461,705	452,558	9,147	2%	452,558	374,152	78,406
Interest income	132,080	100,600	31,480	31%	100,600	77,352	23,248
Interest expense	89,155	92,902	(3,747)	(4)%	92,902	78,300	14,602
Stock options	35,233	15,599	19,634	126%	15,599		15,599
Other	50,580	39,005	11,575	30%	39,005	69,713	(30,708)
Operating expenses	307,048	248,106	58,942	24%	248,106	225,365	22,741
Investment income before income taxes	154,657	204,452	(49,795)	(24)%	204,452	148,787	55,665
Income tax expense, including excise tax	13,624	15,221	(1,597)	(10)%	15,221	11,561	3,660
Investment income	141,033	189,231	(48,198)	(25)%	189,231	137,226	52,005
<b>Net Change in Unrealized Gains</b>							
Net change in unrealized gains	268,513	533,301	(264,788)	(50)%	533,301	273,496	259,805
Net change in unrealized appreciation or depreciation	(256,243)	(477,409)	221,166	*	(477,409)	462,092	(939,501)
Net gains (losses)	12,270	55,892	(43,622)	*	55,892	735,588	(679,696)
Net income	\$ 153,303	\$ 245,123	\$ (91,820)	(37)%	\$ 245,123	\$ 872,814	\$ (627,691)
Net income per common share	\$ 0.99	\$ 1.68	\$ (0.69)	(41)%	\$ 1.68	\$ 6.36	\$ (4.68)
Average common shares							
Weighted average common shares - diluted	154,687	145,599	9,088	6%	145,599	137,274	8,325

\* Net change in unrealized appreciation or depreciation and net gains (losses) can fluctuate significantly from year to year.

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

**Interest and Dividends.** Interest and dividend income for the years ended December 31, 2007, 2006, and 2005, was composed of the following:

(\$ in millions)	2007	2006	2005
Interest			
Private finance loans and debt securities	\$ 376.1	\$ 348.4	\$ 247.8
Preferred shares/income notes of CLOs	18.0	11.5	3.2
CMBS and real estate-related CDO portfolio			29.4
Commercial mortgage loans	6.4	8.3	7.6
Cash, U.S. Treasury bills, money market and other securities	15.1	14.0	9.4
Total interest	415.6	382.2	297.4
Dividends	2.0	4.2	19.8
Total interest and dividends	\$ 417.6	\$ 386.4	\$ 317.2

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 year multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the yield on the interest-bearing investments in the portfolio at December 31, 2007, 2006, and 2005, were as follows:

(\$ in millions)	2007		2006		2005	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Loans and debt securities:						
Private finance	\$ 3,414.6	12.1%	\$ 3,185.2	11.9%	\$ 2,094.9	13.0%
Commercial mortgage loans	65.4	6.8%	71.9	7.5%	102.6	7.6%
Total loans and debt securities	3,480.0	12.0%	3,257.1	11.8%	2,197.5	12.8%
Equity securities:						
Preferred shares/income notes of CLOs	203.0	14.6%	97.2	15.5%	72.3	13.7%
Total interest bearing securities	\$ 3,683.0	12.1%	\$ 3,354.3	11.9%	\$ 2,269.8	12.8%

<sup>(1)</sup> The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total interest-bearing investments at value. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value. The weighted average yields are computed as of the balance sheet date.

Our interest income from our private finance loans and debt securities has increased year over year primarily as a result of the growth in this portfolio. The private finance loan and debt securities portfolio yield at December 31, 2007, of 12.1% as compared to the private finance portfolio yield of 11.9% and 13.0% at December 31, 2006 and 2005, respectively, reflects the mix of debt investments in the private finance loan and debt securities portfolio. The weighted average yield varies from year to year based on the current stated interest on loans and debt securities and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption Portfolio and Investment Activity Private Finance.

Interest income also includes the effective interest yield on our investments in the preferred shares/income notes of CLOs. Interest income from these investments has increased year over year primarily as a result of the growth in



these assets. The weighted average yield on the preferred shares/income notes of the CLOs at December 31, 2007, was 14.6%, as compared to the weighted average yield on the preferred shares/income notes of the CLOs yield of 15.5% and 13.7% at December 31, 2006 and 2005, respectively.

There was no interest income from the CMBS and real estate-related CDO portfolio in 2007 or 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.

Interest income from cash, U.S. Treasury bills, money market and other securities results primarily from interest earned on our liquidity portfolio and excess cash on hand. During the fourth quarter of 2005, we established a liquidity portfolio that was composed primarily of money market and other securities and U.S. Treasury bills. At December 31, 2007, the liquidity portfolio was composed primarily of money market securities. See *Financial Condition, Liquidity and Capital Resources* below. The value and weighted average yield of the liquidity portfolio was \$201.2 million and 4.6%, respectively, at December 31, 2007, \$201.8 million and 5.3%, respectively, at December 31, 2006, and \$200.3 million and 4.2%, respectively, at December 31, 2005.

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 year to year 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 years ended December 31, 2007 and 2006, did not include any dividends from Ciena. See *Private Finance, Ciena Capital LLC* above. Dividend income for the year ended December 31, 2005, included dividends from Ciena on the Class B equity interests held by us of \$14.0 million. 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.

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

Fees and other income for the years ended December 31, 2007, 2006, and 2005, included fees relating to the following:

<b>(\$ in millions)</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
Structuring and diligence	\$ 20.7	\$ 37.3	\$ 24.6
Management, consulting and other services provided to portfolio companies <sup>(1)</sup>	9.6	11.1	14.4
Commitment, guaranty and other fees from portfolio companies <sup>(2)</sup>	9.3	8.8	9.3
Fund management fees <sup>(3)</sup>	0.5		
Loan prepayment premiums	3.7	8.8	6.3
Other income	0.3	0.1	2.4
<b>Total fees and other income<sup>(4)</sup></b>	<b>\$ 44.1</b>	<b>\$ 66.1</b>	<b>\$ 57.0</b>

(1)

2006 includes \$1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See Portfolio and Investment Activity above for further discussion. 2005 includes \$6.5 million in management fees from Advantage. 2006 and 2005 included management fees from Ciena of \$1.7 million and \$2.9 million, respectively. We did not charge Ciena management fees in 2007 or in the fourth quarter of 2006. See Private Finance Ciena Capital LLC above.

- (2) Includes guaranty and other fees from Ciena of \$5.4 million, \$6.1 million, and \$6.3 million for 2007, 2006, and 2005, respectively. See Private Finance Ciena Capital LLC above.
- (3) See Portfolio and Investment Activity Managed Funds above.
- (4) Fees and other income related to the CMBS and CDO portfolio were \$4.1 million for 2005. As noted above, we sold our CMBS and CDO portfolio on May 3, 2005.

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from year to year depending on the level of investment activity, the types of services provided and the level of assets in managed funds for which we earn management or other fees. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Structuring and diligence fees primarily relate to the level of new investment originations. Private finance investments funded were \$1.8 billion for the year ended December 31, 2007, as compared to \$2.4 billion and \$1.5 billion for the years ended December 31, 2006 and 2005, respectively. This resulted in lower structuring and diligence fees in 2007 versus 2006.

Loan prepayment premiums for the year ended December 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 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.

See Portfolio and Investment Activity above for further information regarding our total interest and related portfolio income for Ciena, Mercury, and Advantage.

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

**Interest Expense.** The fluctuations in interest expense during the years ended December 31, 2007, 2006, and 2005, were primarily attributable to changes in the level of our borrowings under various notes payable and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and debt financing costs, at and for the years ended December 31, 2007, 2006, and 2005, were as follows:

(\$ in millions)	2007	2006	2005
Total outstanding debt	\$ 2,289.5	\$ 1,899.1	\$ 1,284.8
Average outstanding debt	\$ 1,924.2	\$ 1,491.0	\$ 1,087.1
Weighted average cost <sup>(1)</sup>	6.5%	6.5%	6.5%

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

In addition, interest expense included interest paid to the Internal Revenue Service related to installment sale gains totaling \$5.8 million, \$0.9 million, and \$0.6 million for the years ended December 31, 2007, 2006, and 2005, respectively. See Dividends and Distributions below.

Interest expense also included interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$0.7 million and \$1.4 million for the years ended December 31, 2006 and 2005, respectively.



*Employee Expense.* Employee expenses for the years ended December 31, 2007, 2006, and 2005, were as follows:

(\$ in millions)	2007	2006	2005
Salaries and employee benefits	\$ 83.9	\$ 73.8	\$ 57.3
Individual performance award (IPA)	9.8	8.1	7.0
IPA mark to market expense (benefit)	(14.0)	2.9	2.0
Individual performance bonus (IPB)	9.5	8.1	6.9
Transition compensation, net <sup>(1)</sup>			5.1
Total employee expense <sup>(2)</sup>	\$ 89.2	\$ 92.9	\$ 78.3
Number of employees at end of period	177	170	131

<sup>(1)</sup> Transition compensation for the year ended December 31, 2005, included \$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 were reduced by \$1.1 million for salary reimbursements from CWCapital under a transition services agreement.

<sup>(2)</sup> Excludes stock options expense. See below.

The change in salaries and employee benefits reflects the effect of compensation increases, the change in mix of employees given their area of responsibility and relevant experience level and an increase in the number of employees. The overall increase in salaries and employee benefits also reflects the competitive environment for attracting and retaining talent in the private equity industry. Salaries and employee benefits include an accrual for employee bonuses, which are generally paid annually after the completion of the fiscal year. Salaries and employee benefits included bonus expense of \$40.1 million, \$38.2 million, and \$26.9 million for the years ended December 31, 2007, 2006, and 2005, respectively.

The IPA is an incentive compensation program for certain officers and is generally determined annually at the beginning of each year. Through December 31, 2007, the IPA was deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The trustee was required to use the cash to purchase shares of our common stock in the open market. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA has been deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income until distributions are made from the trust.

On December 14, 2007, our Board of Directors made a determination that it is in Allied Capital's best interest to terminate our deferred compensation plans. The Board of Directors' decision was primarily in response to increased complexity resulting from recent changes in the regulation of deferred compensation arrangements. The Board of Directors resolved that our deferred compensation plans would be terminated in accordance with the provisions of each of the plans and the accounts under the plans would be distributed to participants in full on March 18, 2008, the termination and distribution date, or as soon as reasonably practicable thereafter, in accordance with the transition rule for payment elections under Section 409A of the Internal Revenue Code of 1986. The termination and distribution of the plans was completed in the first quarter of 2008. Distributions from the plans were made in cash or shares of our common stock, net of required withholding taxes. See Results of Operations Comparison of the Three Months Ended March 31, 2008 and 2007 Employee Expense above. See also Compensation of Executive Officers and Directors Termination of Deferred Compensation Arrangements.

The assets of the rabbi trust related to The Allied Capital Corporation Non-Qualified Deferred Compensation Plans (DCPs I) were primarily invested in assets other than shares of our common stock. At December 31, 2007, the liability to participants related to DCPs I was valued at \$21.1 million in the aggregate, and that liability is fully funded by assets held in the rabbi trust.

The assets of the rabbi trust related to The Allied Capital Corporation Non-Qualified Deferred Compensation Plans II(DCPs II) were primarily invested in shares of our common stock. At December 31, 2007, the liability to participants related to DCPs II was valued at \$31.4 million in the aggregate, and that liability was fully funded by

assets held in the rabbi trust. At December 31, 2007, the DCPs II rabbi trust held approximately 1.4 million shares of our common stock.

The account balances in the plans accumulated as a result of prior compensation earned by the participants. The contributions to the plans reflect a combination of participant elective compensation deferrals and non-elective employer contributions, including contributions related to previously earned individual performance awards. The distribution of the DCPs I and DCPs II assets will result in a tax deduction for 2008, subject to the limitations set by Section 162(m) of the Code for persons subject to such section.

The IPB is distributed in cash to award recipients throughout the year (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee of the Board of Directors and the Board of Directors have determined the IPA and the IPB for 2008 and they are currently estimated to be approximately \$9.6 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. For 2008, the Compensation Committee has determined that the IPAs will be paid in cash in two equal installments during the year, as long as the recipient remains employed by us. If a recipient terminates employment during the year, any remaining payments under the IPA or IPB would be forfeited.

*Stock Options Expense.* Effective January 1, 2006, we adopted Statement No. 123 (Revised 2004), *Share-Based Payment* (SFAS 123R) using the modified prospective method of application, which required us to recognize compensation costs on a prospective basis beginning January 1, 2006. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, will be recognized over the remaining service period in the statement of operations beginning in 2006, using the fair value amounts determined for proforma disclosure under SFAS 123R. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized in the consolidated statement of operations over the service period. Our employee stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the related service period. The stock option expense for the years ended December 31, 2007 and 2006, was as follows:

(\$ in millions)	2007	2006
Employee Stock Option Expense:		
Options granted:		
Previously awarded, unvested options as of January 1, 2006	\$ 10.1	\$ 13.2
Options granted on or after January 1, 2006	10.7	2.4
Total options granted	20.8	15.6
Options cancelled in connection with tender offer (see below)	14.4	
Total employee stock option expense	\$ 35.2	\$ 15.6

*Options Granted.* In addition to the employee stock option expense for both options granted, for both the years ended December 31, 2007 and 2006, administrative expense included \$0.2 million of expense related to options granted to directors during each year. Options were granted to non-officer directors in the second quarters of 2007 and 2006. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

During the second quarter of 2007, options were granted for 6.4 million shares. One-third of the options granted to employees vested on June 30, 2007; therefore, approximately one-third of the expense related to this grant, or \$5.9 million, was recorded in the second quarter of 2007. Of the remaining options granted, one-half will vest on June 30, 2008, and one-half will vest on June 30, 2009. See Results of Operations for the Three Months Ended March 31, 2008 and 2007 Stock Options Expense above for the estimate of employee-related stock option expense for future periods.

*Options Cancelled in Connection with Tender Offer.* On July 18, 2007, we completed a tender offer to our optionees who held vested in-the-money stock options as of June 20, 2007, where optionees received an option



cancellation payment (OCP), equal to the in-the-money value of the stock options cancelled determined using a Weighted Average Market Price of \$31.75 paid one-half in cash and one-half in unregistered shares of our common stock. We accepted for cancellation 10.3 million vested options held by employees and non-officer directors, which in the aggregate had a weighted average exercise price of \$21.50. This resulted in a total option cancellation payment of approximately \$105.6 million, of which \$52.8 million was paid in cash and \$52.8 million was paid through the issuance of 1.7 million unregistered shares of the Company's common stock. Our stockholders approved the issuance of the shares of our common stock in exchange for the cancellation of vested in-the-money stock options at our 2006 Annual Meeting of Stockholders. Cash payments to employee optionees were paid net of required payroll and income tax withholdings.

The OCP was equal to the in-the-money value of the stock options cancelled, determined using the Weighted Average Market Price of \$31.75, and was paid one-half in cash and one-half in unregistered shares of the Company's common stock. In accordance with the terms of the tender offer, the Weighted Average Market Price represented the volume weighted average price of our common stock over the fifteen trading days preceding the first day of the offer period, or June 20, 2007. Because the Weighted Average Market Price at the commencement of the tender offer on June 20, 2007, was higher than the market price of our common stock at the close of the offer on July 18, 2007, SFAS 123R required us to record a non-cash employee-related stock option expense of \$14.4 million and administrative expense related to stock options cancelled that were held by non-officer directors of \$0.4 million. The same amounts were recorded as an increase to additional paid-in capital and, therefore, had no effect on our net asset value. The portion of the OCP paid in cash of \$52.8 million reduced our additional paid-in capital and therefore reduced our net asset value. For income tax purposes, our tax deduction resulting from the OCP will be similar to the tax deduction that would have resulted from an exercise of stock options in the market. Any tax deduction resulting from the OCP or an exercise of stock options in the market is limited by Section 162(m) of the Code.

*Administrative Expense.* Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, travel costs, stock record expenses, directors' fees and related stock options expense, and various other expenses. Administrative expenses for the years ended December 31, 2007, 2006, and 2005, were as follows:

(\$ in millions)	2007	2006	2005
Administrative expenses	\$ 44.8	\$ 34.0	\$ 33.3
Investigation and litigation costs	5.8	5.0	36.4
Total administrative expenses	\$ 50.6	\$ 39.0	\$ 69.7

Administrative expenses, excluding investigation and litigation costs, for the year ended December 31, 2007, included costs of \$1.4 million incurred in the first quarter of 2007 to engage a third party to conduct a review of Ciena's internal control systems. See *Private Finance, Ciena Capital LLC* above. In addition, administrative expenses for the year ended December 31, 2007, included \$2.5 million in placement fees related to securing equity commitments to the Allied Capital Senior Debt Fund, L.P. in the second quarter of 2007. See *Managed Funds Allied Capital Senior Debt Fund, L.P.* above.

Administrative expenses, excluding investigation and litigation costs and the costs outlined above, were \$40.9 million for the year ended December 31, 2007, which is an increase of \$6.9 million from 2006. The increase was primarily due to increased expenses related to directors' fees of \$1.6 million, an increase in stock record expenses of \$0.7 million

due to the increase in our shareholder base, an increase in rent expense of \$0.7 million, and an increase in costs related to evaluating potential new investments of \$0.7 million. Costs related to debt investments 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.

Investigation and litigation costs are difficult to predict and may vary from year to year. See [Legal Proceedings](#) below.

**Income Tax Expense, Including Excise Tax.** Income tax expense for the years ended December 31, 2007, 2006, and 2005, was as follows:

(\$ in millions)	2007	2006	2005
Income tax expense (benefit)	\$ (2.7)	\$ 0.1	\$ 5.4
Excise tax expense <sup>(1)</sup>	16.3	15.1	6.2
Income tax expense, including excise tax	\$ 13.6	\$ 15.2	\$ 11.6

<sup>(1)</sup> While excise tax expense is presented in the Consolidated Statement of Operations as a reduction to net investment income, excise tax relates to both net investment income and net realized gains.

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

Our estimated annual taxable income for 2007 exceeded our dividend distributions to shareholders from such taxable income in 2007, and such estimated excess taxable income will be distributed in 2008. Therefore, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions for the year. We have recorded an estimated excise tax of \$16.3 million for the year ended December 31, 2007. See Dividends and Distributions.

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

**Realized Gains and Losses.** Net realized gains primarily result from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. In 2005, net realized gains also resulted from the sale of real estate-related CMBS bonds and CDO bonds and preferred shares. Net realized gains for the years ended December 31, 2007, 2006, and 2005, were as follows:

(\$ in millions)	2007	2006	2005
Realized gains	\$ 400.5	\$ 557.5	\$ 343.1
Realized losses	(132.0)	(24.2)	(69.6)
Net realized gains	\$ 268.5	\$ 533.3	\$ 273.5

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, 2007, 2006, and 2005, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

(\$ in millions)	2007	2006	2005 <sup>(1)</sup>
Reversal of previously recorded net unrealized appreciation associated with realized gains	\$ (332.6)	\$ (501.5)	\$ (108.0)
Reversal of previously recorded net unrealized depreciation associated with realized losses	139.8	22.5	68.0
Total reversal	\$ (192.8)	\$ (479.0)	\$ (40.0)

<sup>(1)</sup> 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, 2007, 2006, and 2005, were as follows:

(\$ in millions)

<b>Portfolio Company</b>	<b>2007</b>	<b>Amount</b>
<b>Private Finance:</b>		
Mercury Air Centers, Inc.	\$	262.4
HMT, Inc.		39.9
Healthy Pet Corp.		36.6
Palm Coast Data, LLC		20.0
Woodstream Corporation		14.6
Wear Me Apparel Corporation		6.1
Mogas Energy, LLC		5.7
Tradesmen International, Inc.		3.8
ForeSite Towers, LLC		3.8
Advantage Sales & Marketing, Inc.		3.4
Geotrace Technologies, Inc.		1.1
Other		3.0
Total private finance		400.4
<b>Commercial Real Estate:</b>		
Other		0.1
Total commercial real estate		0.1
Total realized gains	\$	400.5

<b>Portfolio Company</b>	<b>2006</b>	<b>Amount</b>
<b>Private Finance:</b>		
Advantage Sales & Marketing, Inc. <sup>(1)</sup>	\$	434.4
STS Operating, Inc.		94.8
Oriental Trading Company, Inc.		8.9
Advantage Sales & Marketing, Inc. <sup>(2)</sup>		4.8
United Site Services, Inc.		3.3
Component Hardware Group, Inc.		2.8
Opinion Research Corporation		1.9
Nobel Learning Communities, Inc.		1.5
MHF Logistical Solutions, Inc.		1.2
The Debt Exchange, Inc.		1.1
Other		1.5

Total private finance		556.2
<b>Commercial Real Estate:</b>		
Other		1.3
Total commercial real estate		1.3
Total realized gains	\$	557.5

## 2005

Portfolio Company		Amount
<b>Private Finance:</b>		
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
<b>Commercial Real Estate:</b>		
CMBS/CDO assets, net <sup>(3)</sup>		227.7
Other		9.3
Total commercial real estate		237.0
Total realized gains	\$	343.1

(1) Represents the realized gain on our majority equity investment only. See Private Finance above.

(2) Represents a realized gain on our minority equity investment only. See Private Finance above.

(3) Net of net realized losses from related hedges of \$0.7 million for the year ended December 31, 2005.

Realized losses for the years ended December 31, 2007, 2006, and 2005, were as follows:

(\$ in millions)

<b>Portfolio Company</b>	<b>2007</b>	<b>Amount</b>
<b>Private Finance:</b>		
Global Communications, LLC	\$	34.3
Jakel, Inc.		24.8
Startec Global Communications, Inc.		20.2
Gordian Group, Inc.		19.3
Powell Plant Farms, Inc.		11.6
Universal Environmental Services, LLC		8.6
PresAir, LLC		6.0
Legacy Partners Group, LLC		5.8
Alaris Consulting, LLC		1.0
Other		0.4
Total realized losses	\$	132.0

<b>Portfolio Company</b>	<b>2006</b>	<b>Amount</b>
<b>Private Finance:</b>		
Staffing Partners Holding Company, Inc.	\$	10.6
Acme Paging, L.P.		4.7
Cooper Natural Resources, Inc.		2.2
Aspen Pet Products, Inc.		1.6
Nobel Learning Communities, Inc.		1.4
Other		1.6
Total private finance		22.1
<b>Commercial Real Estate:</b>		
Other		2.1
Total commercial real estate		2.1
Total realized losses	\$	24.2

<b>Portfolio Company</b>	<b>2005</b>	<b>Amount</b>
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**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
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**Commercial Real Estate:**

Other		5.6
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Total commercial real estate		5.6
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Total realized losses	\$	69.6
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***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 December 31, 2007, portfolio investments recorded at fair value were approximately 92% 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 determine that the fair value of a security is less than its cost basis, and we will record unrealized appreciation when we determine that the fair value is greater than its cost basis. 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, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. 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.

In the first quarter of 2008, we adopted Statement No. 157, *Fair Value Measurements*, on a prospective basis. See Results of Operations – Comparison of the Three Months Ended March 31, 2008 and 2007 – Change in Unrealized Appreciation or Depreciation – above.

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

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

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

If there is adequate enterprise value to support the repayment of our debt, the fair value of our loan or debt security normally corresponds to cost unless the borrower's condition or other factors lead to a determination of fair value at a different amount. The fair value of equity interests in portfolio companies is determined based on various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other preference capital, and other pertinent factors such as recent offers to purchase a portfolio company, recent

transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. The determined equity values are generally discounted when we have a minority position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

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

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

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

The valuation analysis prepared by management is submitted to our Board of Directors who is ultimately responsible for the determination of fair value of the portfolio in good faith. Valuation assistance from Duff & Phelps, LLC (Duff & Phelps) for our private finance portfolio consisted of certain limited procedures (the Procedures) we identified and requested them to perform. Based upon the performance of the Procedures on a selection of our final portfolio company valuations, Duff & Phelps concluded that the fair value of those portfolio companies subjected to the Procedures did not appear unreasonable. In addition, we also received third-party valuation assistance from other third-party consultants for certain private finance portfolio companies. For the years ended December 31, 2007, 2006, and 2005, we received third-party valuation assistance as follows:

	<b>2007</b>			
	<b>Q4</b>	<b>Q3</b>	<b>Q2</b>	<b>Q1</b>
Number of private finance portfolio companies reviewed	112	135	92	88
Percentage of private finance portfolio reviewed at value	91.1%	92.1%	92.1%	91.8%
	<b>2006</b>			
	<b>Q4</b>	<b>Q3</b>	<b>Q2</b>	<b>Q1</b>
Number of private finance portfolio companies reviewed	81	105	78	78
Percentage of private finance portfolio reviewed at value	82.9%	86.5%	89.6%	87.0%

	2005			
	Q4	Q3	Q2	Q1
Number of private finance portfolio companies reviewed	80	89	72	36
Percentage of private finance portfolio reviewed at value	92.4%	89.3%	83.0%	74.5%

Professional fees for third-party valuation assistance for the years ended December 31, 2007, 2006, and 2005, were \$1.8 million, \$1.5 million, and \$1.4 million, respectively.

*Net Change in Unrealized Appreciation or Depreciation.* Net change in unrealized appreciation or depreciation for the years ended December 31, 2007, 2006, and 2005, consisted of the following:

(\$ in millions)	2007 <sup>(1)</sup>	2006 <sup>(1)</sup>	2005 <sup>(1)</sup>
Net unrealized appreciation (depreciation) <sup>(2)</sup>	\$ (63.4)	\$ 1.6	\$ 502.1
Reversal of previously recorded unrealized appreciation associated with realized gains	(332.6)	(501.5)	(108.0)
Reversal of previously recorded unrealized depreciation associated with realized losses	139.8	22.5	68.0
Net change in unrealized appreciation or depreciation	\$ (256.2)	\$ (477.4)	\$ 462.1

- (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.
- (2) The sale of certain of our portfolio investments to Goldman Sachs that occurred in the first quarter of 2008 provided transaction values for 59 portfolio investments that were used in the December 31, 2007, valuation process.

**Valuation of Ciena Capital LLC.** Our investment in Ciena totaled \$327.8 million at cost and \$68.6 million at value, which included unrealized depreciation of \$259.2 million, at December 31, 2007, and \$295.3 million at cost and \$210.7 million at value, which included unrealized depreciation of \$84.6 million, at December 31, 2006.

Ciena relies on the asset-backed securitization market to finance its loan origination activity. That financing source is an unreliable one in the current capital markets, and as a result, Ciena has significantly curtailed loan origination activity. To value our investment at December 31, 2007, we determined that no value could be attributed to Ciena's origination platform or enterprise due to the state of the securitization markets, among other factors. In addition, Ciena's book value declined during the quarter ended December 31, 2007. We valued our investment in Ciena at December 31, 2007 solely based on the estimated realizable value of Ciena's net assets, including the estimated realizable value of the cash flows generated from Ciena's retained interests in its current servicing portfolio, which includes portfolio servicing fees as well as cash flows from Ciena's equity investments in its securitizations and its interest-only strip. This resulted in a value to our investment, after repayment of senior debt outstanding, of \$68.6 million at December 31, 2007.

We also continued to consider Ciena's current regulatory issues and ongoing investigations and litigation in performing the valuation analysis at December 31, 2007. (See Private Finance, Ciena Capital LLC above.)

Net change in unrealized appreciation or depreciation included a net decrease of \$174.5 million and \$142.3 million for the years ended December 31, 2007 and 2006, respectively, and a net increase of \$2.9 million for the year ended December 31, 2005, related to our investment in Ciena. We received valuation assistance from Duff & Phelps for our investment in Ciena at December 31, 2007, 2006, and 2005. See Valuation Methodology Private Finance above for further discussion of the third-party valuation assistance we received.

**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 154.7 million, 145.6 million, and 137.3 million for the years ended December 31, 2007, 2006, and 2005, 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.

Dividends are paid to shareholders from taxable income. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses generally are not included in taxable income until they are realized. In addition, gains realized for financial reporting purposes may differ from

gains included in taxable income as a result of our election to recognize gains using installment sale treatment, which generally results in the deferment of gains for tax purposes until notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash. See Dividends and Distributions below.

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

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

## **DIVIDENDS AND DISTRIBUTIONS**

Dividends to common shareholders were \$0.65 per common share for the first quarter of 2008 and \$0.63 per common share for the first quarter of 2007. Total regular quarterly dividends to common shareholders were \$2.57, \$2.42, and \$2.30 per common share for the years ended December 31, 2007, 2006, and 2005, respectively. An extra cash dividend of \$0.07, \$0.05, and \$0.03 per common share was declared during 2007, 2006, and 2005, respectively, and was paid to shareholders on December 27, 2007, January 19, 2007, and January 27, 2006, respectively. The Board of Directors has declared a dividend of \$0.65 per common share for the second quarter of 2008.

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

Taxable income includes our taxable interest, dividend and fee income, as well as taxable net capital gains. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences

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



investments are collected in cash. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends, which includes contractual payment-in-kind interest, and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

The summary of our taxable income and distributions of such taxable income for the years ended December 31, 2007, 2006, and 2005, is as follows:

(\$ in millions)	2007 (ESTIMATED) <sup>(1)</sup>	2006	2005
Taxable income <sup>(2)</sup>	\$ 407.6	\$ 601.2	\$ 445.0
Taxable income earned in current year and carried forward for distribution in next year	(403.1)	(402.8)	(156.5)
Taxable income earned in prior year and carried forward and distributed in current year	402.8	156.5	26.0
Total dividends to common shareholders	\$ 407.3	\$ 354.9	\$ 314.5

- (1) Our taxable income for 2007 is an estimate and will not be finally determined until we file our 2007 tax return in September 2008. Therefore, the final taxable income and the taxable income earned in 2007 and carried forward for distribution in 2008 may be different than the estimate above. See **Risk Factors** above and Note 10, **Dividends and Distributions and Taxes** of our Notes to our annual Consolidated Financial Statements.
- (2) See Note 10, **Dividends and Distributions and Taxes** of our Notes to our annual Consolidated Financial Statements for further information on the differences between net income for book purposes and taxable income.

Our estimated annual taxable income for 2007 exceeded our dividend distributions to shareholders for 2007 from such taxable income, and, therefore, we have carried over excess taxable income, which is currently estimated to be \$403.1 million, for distribution to shareholders in 2008. Estimated excess taxable income for 2007 represents approximately \$50.0 million of ordinary income and approximately \$353.1 million of net long-term capital gains. The maximum amount of excess taxable income that may be carried over for distribution in the next year under the Code is the total amount of dividends paid in the following year, subject to certain declaration and payment guidelines. Excess taxable income carried over and paid out in the next year is generally subject to a 4% excise tax. For the years ended December 31, 2007, 2006, and 2005, excise tax expense was \$16.3 million, \$15.1 million, and \$6.2 million, respectively. See **Other Matters** **Regulated Investment Company Status** above.

Dividends paid in 2008 will first be paid out of the excess taxable income carried over from 2007. Given our regular quarterly dividend payout, which for the first quarter of 2008 was \$108.1 million, we expect that a majority of the 2008 dividend payments will be made from excess 2007 taxable earnings. Given the significant amount of estimated excess taxable income carried forward from 2007 for distribution in 2008, we currently expect that our excess taxable income carried over from 2007 plus our estimated annual taxable income for 2008 will be in excess of our estimated dividend distributions to shareholders in 2008, therefore, we expect to carry over excess taxable income earned in 2008 for distribution to shareholders in 2009. We expect that we will generally be required to pay a 4% excise tax on the excess of 98% of our taxable income for 2008 over the amount of actual distributions from such taxable income in 2008. For the three months ended March 31, 2008, we have recorded an excise tax of \$2.3 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 2008 may be adjusted as appropriate in the remainder of 2008 to reflect changes in our estimate of

the carry over amount and additional excise tax may be accrued during the remainder of 2008 as additional excess taxable income is earned, if any. Our ability to earn the estimated annual taxable income for 2008 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, we currently estimate that we have cumulative deferred taxable income related to installment sale gains of approximately \$234.5 million as of December 31, 2007, which is composed of cumulative deferred taxable income of \$211.5 million as of December 31, 2006, and approximately \$23.0 million for the year ended December 31, 2007. These gains have been recognized for financial reporting purposes in the respective years they were realized, but generally will be deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. The installment sale gains for 2007 are estimates and will not be finally determined until we file our 2007 tax return in September 2008. See **Other Matters** **Regulated Investment Company Status** above.

To the extent that installment sale gains are deferred for recognition in taxable income, we pay interest to the Internal Revenue Service. Installment-related interest expense for the three months ended March 31, 2008 and 2007, and for the years ended December 31, 2007, 2006, and 2005, was \$1.9 million, \$0.3 million, \$5.8 million, \$0.9 million, and \$0.6 million, respectively. This interest is included in interest expense in our Consolidated Statement of Operations.

### FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

At March 31, 2008, and December 31, 2007 and 2006, our cash, U.S. Treasury bills, 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)	2008	2007	2006
Cash, U.S. Treasury bills, investments in money market and other securities (including U.S. Treasury bills, money market and other securities: 2008-\$120.4; 2007-\$201.2; 2006-\$202.2)	\$ 201.6	\$ 204.8	\$ 203.9
Total assets	\$ 5,082.2	\$ 5,214.6	\$ 4,887.5
Total debt outstanding	\$ 2,191.6	\$ 2,289.5	\$ 1,899.1
Total shareholders' equity	\$ 2,828.4	\$ 2,771.8	\$ 2,841.2
Debt to equity ratio	0.77	0.83	0.67
Asset coverage ratio <sup>(1)</sup>	229%	221%	250%

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

Cash generated from the portfolio includes cash flow from net investment income and net realized gains and principal collections related to investment repayments or sales. Cash flow provided by our operating activities before new investment activity for the three months ended March 31, 2008 and 2007, and for the years ended December 31, 2007, 2006, and 2005, was as follows:

(\$ in millions)	For the Three Months Ended		For the Year Ended		
	2008	2007	2007	2006	2005
Net cash provided by (used in)					
operating activities	\$ 111.3	\$ 19.4	\$ (112.2)	\$ (597.5)	\$ 116.0
Add: portfolio investments funded	275.1	170.2	1,846.0	2,257.8	1,668.1

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Total cash provided by operating activities before new investments	\$	386.4	\$	189.6	\$	1,733.8	\$	1,660.3	\$	1,784.1
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In addition to the net cash flow provided by our operating activities before funding investments, we have sources of liquidity through our cash, U.S. Treasury bills, investments in money market and other securities and revolving line of credit as discussed below.

At March 31, 2008, and December 31, 2007 and 2006, the value and yield of the cash, U.S. Treasury bills, investments in money market and other securities were as follows:

(\$ in millions)	2008		2007		2006	
	Value	Yield	Value	Yield	Value	Yield
U.S. Treasury bills <sup>(1)</sup>	\$ 120.0	1.6%	\$	%	\$	%
Money market securities	0.4	3.2%	201.2	4.6%	161.6	5.3%
Certificate of Deposit					40.6	5.6%
Cash	81.2	1.5%	3.6	2.9%	1.7	3.8%
Total	\$ 201.6	1.5%	\$ 204.8	4.6%	\$ 203.9	5.3%

<sup>(1)</sup> The Treasury bills matured in April 2008. We reinvested the proceeds from the matured Treasury bills in short-term Treasury bills of \$100 million and cash of \$20 million.

We maintain this pool of liquid assets within our balance sheet given that our investment portfolio is primarily composed of private, illiquid assets for which there is no readily available market. We assess the amount held in and the composition of these investments throughout the year. As the capital markets became increasingly uncertain in March 2008, we moved our liquidity portfolio entirely into cash and very short-term treasuries.

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

We employ an asset-liability management approach that focuses on matching the estimated maturities of our investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to finance our business pending 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. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate debt portfolio and our equity portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

During the three months ended March 31, 2008 and 2007, and the years ended December 31, 2007 and 2006, we sold new equity of \$170.9 million, \$93.8 million, \$171.3 million and \$295.8 million, respectively, in public offerings. We did not sell new equity in a public offering during the year ended December 31, 2005. During the year ended December 31, 2005, we issued \$7.2 million of our common stock as consideration for investments. In addition, shareholders' equity increased through capital share transactions by \$3.9 million, \$5.8 million, \$31.5 million, \$27.7 million, and \$77.5 million through the exercise of stock options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the three months ended March 31, 2008 and 2007, and the years ended December 31, 2007, 2006, and 2005, respectively. In addition, shareholders' equity increased by \$26.4 million during the three months ended March 31, 2008, as a result of the distribution of the common stock held in deferred compensation trusts. See Note 8, Employee Compensation Plans from our Notes to Consolidated Financial Statements for the first quarter of 2008. For the year ended December 31, 2007, shareholders' equity decreased by \$52.8 for the cash portion of the option cancellation payment made in connection with our tender offer. See Results of Operations, Stock Option Expense, Options Cancelled in Connection

with Tender Offer. See Note 13, Financial Highlights from our Notes to the Consolidated Financial Statements for further detail on the change in shareholders' equity for the periods.

We generally 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 March 31, 2008, our debt to equity ratio net of cash, U.S. Treasury bills and other securities was 0.70:1.00. In April 2008, we completed a public offering of 3.2 million shares of common stock for net proceeds, after the underwriting discount and estimated offering expenses, of \$56.3 million.

At March 31, 2008, and December 31, 2007 and 2006, we had outstanding debt as follows:

Facility Amount	2008			Facility Amount	2007			Facility Amount	2006		
	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Annual Return to Cover Interest Payments <sup>(2)</sup>		Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Annual Return to Cover Interest Payments <sup>(2)</sup>		Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Annual Return to Cover Interest Payments <sup>(2)</sup>
\$ 1,042.8	\$ 1,042.8	6.1%	1.3%	\$ 1,042.2	\$ 1,042.2	6.1%	1.2%	\$ 1,041.4	\$ 1,041.4	6.1%	
880.0	880.0	6.7%	1.2%	880.0	880.0	6.7%	1.1%	650.0	650.0	6.6%	
1,922.8	1,922.8	6.4%	2.4%	1,922.2	1,922.2	6.4%	2.3%	1,691.4	1,691.4	6.3%	
922.5	268.8 <sup>(5)</sup>	3.8% <sup>(3)</sup>	0.3%	922.5	367.3	5.9% <sup>(3)</sup>	0.5%	922.5	207.7	6.4%	
\$ 2,845.3	\$ 2,191.6	6.2% <sup>(4)</sup>	2.7%	\$ 2,844.7	\$ 2,289.5	6.5% <sup>(4)</sup>	2.8%	\$ 2,613.9	\$ 1,899.1	6.5%	

(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 return to cover interest payments is calculated as the March 31, 2008, December 31, 2007 and 2006, annualized cost of debt per class of financing outstanding divided by total assets at March 31, 2008, December 31, 2007 and 2006, respectively.

(3) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit in effect at the balance sheet date. 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 \$3.7 million, \$3.7 million and \$3.9 million at March 31, 2008, December 31, 2007 and 2006, respectively.

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

(5) On April 9, 2008, we entered into a three-year unsecured revolving line of credit with total commitments of \$632.5 million, which replaced our previous line of credit. Under this new revolving line of credit, in addition to the current interest rate payable, the annual costs of commitment fees, other facility fees and amortization of debt financing costs will be approximately \$6.7 million. See discussion below.

**Privately Issued Unsecured Notes Payable.** We have privately issued unsecured long-term notes to institutional investors, primarily insurance companies. The notes have five- or seven-year maturities and fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity. At March 31, 2008, the notes had maturities from May 2008 to May 2013. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreements.

We have issued five-year unsecured long-term notes denominated in Euros and Sterling for a total U.S. dollar equivalent of \$15.2 million. The notes have fixed interest rates and have substantially the same terms as our other unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. These notes mature in March 2009. Simultaneous with issuing the notes, we entered into a cross currency swap with a financial institution which fixed our interest and principal payments in U.S. dollars for the life of the debt.

**Publicly Issued Unsecured Notes Payable.** At March 31, 2008, we had outstanding publicly issued unsecured notes as follows:

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



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

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

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

**Revolving Line of Credit.** At March 31, 2008, and December 31, 2007 and 2006, we had an unsecured revolving line of credit with a committed amount of \$922.5 million that was scheduled to expire on September 30, 2008.

On April 9, 2008, we entered into a three-year unsecured revolving line of credit with total commitments of \$632.5 million, with Bank of America, N.A., as a lender and as administrative agent, and the other lenders thereunder, which replaced our previous revolving line of credit. We may obtain additional commitments up to a total committed facility of \$1.5 billion, subject to customary conditions. The revolving line of credit expires on April 11, 2011.

At our option, borrowings under the revolving line of credit effective April 9, 2008, generally bear interest at a rate per annum equal to (i) LIBOR (for the period selected by us) plus 2.00% 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 0.50% 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 prior to entering into the new three-year facility in April 2008, was \$3.7 million at March 31, 2008. Subsequent to entering into the new facility in April 2008, the annual cost of commitment fees, other facility fees and amortization of debt financing costs will be approximately \$6.7 million.

At April 9, 2008, there was \$210.8 million outstanding on our unsecured revolving line of credit. The amount available under the line at April 9, 2008, was \$325.4 million, net of amounts committed for standby letters of credit of \$96.3 million. Net repayments on the revolving line of credit for the three months ended March 31, 2008, were \$98.5 million. Net borrowings under the revolving lines of credit for the years ended December 31, 2007 and 2006, were \$159.5 million and \$116.0 million, respectively.

**Covenant Compliance.** We have various financial and operating covenants required by the revolving line of credit and the privately issued unsecured notes payable outstanding at March 31, 2008, December 31, 2007 and 2006. These covenants require us to maintain certain financial ratios, including asset coverage, debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of March 31, 2008, and December 31, 2007 and 2006, we were in compliance with these covenants. The financial and operating covenants under the new revolving line of credit are substantially similar to the previous facility.

We have certain financial and operating covenants that are required by the publicly issued unsecured notes payable, including that we will maintain a minimum ratio of 200% of total assets to total borrowings, as required by

the Investment Company Act of 1940, as amended, while these notes are outstanding. At March 31, 2008, December 31, 2007 and 2006, we were in compliance with these covenants.

**Contractual Obligations.** The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of March 31, 2008.

(\$ in millions)	Total	Payments Due By Year					After 2012
		2008	2009	2010	2011	2012	
Unsecured notes payable	\$ 1,922.8	\$ 153.0	\$ 270.3	\$ 408.0	\$ 472.5	\$ 339.0	\$ 280.0
Revolving line of credit <sup>(1)</sup>	268.8	268.8					
Operating leases	19.1	3.3	4.6	4.5	1.8	1.8	3.1
Total contractual obligations	\$ 2,210.7	\$ 425.1	\$ 274.9	\$ 412.5	\$ 474.3	\$ 340.8	\$ 283.1

<sup>(1)</sup> At March 31, 2008, \$268.8 million was borrowed on the revolving line of credit and \$96.3 million of standby letters of credit were issued under the credit facility. In April 2008, we entered into a new unsecured revolving line of credit, which replaced the previous revolving line of credit, with total commitments of \$632.5 million. See Revolving Line of Credit above.

### Off-Balance Sheet Arrangements

In the ordinary course of business, we have issued guarantees and have extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. We have generally issued guarantees of debt and lease obligations. Under these arrangements, we would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The following table shows our guarantees and standby letters of credit that may have the effect of creating, increasing, or accelerating our liabilities as of March 31, 2008.

(\$ in millions)	Total	Amount of Commitment Expiration Per Year					After 2012
		2008	2009	2010	2011	2012	
Guarantees	\$ 394.0	\$ 0.3	\$ 387.3	\$	\$ 4.4	\$ 0.1	\$ 1.9
Standby letters of credit <sup>(1)</sup>	96.3	96.3					
Total commitments <sup>(2)</sup>	\$ 490.3	\$ 96.6	\$ 387.3	\$	\$ 4.4	\$ 0.1	\$ 1.9

<sup>(1)</sup> Standby letters of credit are issued under our revolving line of credit that expires in September 2008. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit will expire contemporaneously with the expiration of our line of credit that was in effect at March 31, 2008, which was scheduled to expire in September 2008. In April 2008, we entered into a new three-year revolving line of credit that expires in April 2011.

<sup>(2)</sup> Our most significant commitments relate to our investment in Ciena Capital LLC (Ciena), which commitments totaled \$444.3 million at March 31, 2008. At March 31, 2008, the principal components of these guarantees included a guarantee of 100% of the outstanding total obligations on Ciena's revolving line of credit, which

matures in March 2009, for a total guaranteed amount of \$384.8 million and standby letters of credit issued totaling \$59.5 million in connection with term securitizations completed by Ciena. See Private Finance, Ciena Capital LLC above for further discussion.

In addition, we had outstanding commitments to fund investments totaling \$885.3 million at March 31, 2008, including \$845.3 million related to private finance investments and \$40.0 million related to commercial real estate finance investments. Outstanding commitments related to private finance investments included \$493.5 million to the Unitranche Fund LLC, which we believe will be funded over a two to three year period as investments are funded by the Unitranche Fund. See Portfolio and Investment Activity Outstanding Commitments above. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

## CRITICAL ACCOUNTING POLICIES

The consolidated financial statements are based on the selection and application of critical accounting policies, which require management to make significant estimates and assumptions. Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management's most difficult, complex, or subjective judgments. Our critical accounting policies are those applicable to the valuation of investments, certain revenue recognition matters and certain tax matters as discussed below.

**Valuation of Portfolio Investments.** We, as a BDC, have invested in illiquid securities including debt and equity securities of portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. 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 and the provisions of the Investment Company Act of 1940 and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement). We determine fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests and that fair value for its investments must typically be determined using unobservable inputs. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio.

We adopted SFAS 157 on a prospective basis in the first quarter of 2008. In accordance with the Statement, we have considered our principal market, or the market in which we exit our portfolio investments with the greatest volume and level of activity. SFAS 157 requires us to assume that the portfolio investment is assumed to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact.

We have determined that for our buyout investments, where we have control or could gain control through an option or warrant security, both the debt and equity securities of the portfolio investment would exit in the merger and acquisition (M&A) market as the principal market generally through a sale or recapitalization of the portfolio company. We believe that the in-use premise of value (as defined in SFAS 157), which assumes the debt and equity securities are sold together, is appropriate as this would provide maximum proceeds to the seller. As a result, we will continue to use the enterprise value methodology to determine the fair value of these investments under SFAS 157. Enterprise value means the entire value of the company to a market participant, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. Enterprise value is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. We allocate the enterprise value to these securities in order of the legal priority of the securities.

While we typically exit our securities upon the sale or recapitalization of the portfolio company in the M&A market, for investments in portfolio companies where we do not have control or the ability to gain control through an option or warrant security, we cannot typically control the exit of our investment into our principal market (the M&A market). As a result, in accordance with SFAS 157, we are required to determine the fair value of these investments assuming a sale of the individual investment in a hypothetical market to a hypothetical market participant (the in-exchange premise of value). We continue to perform an enterprise value analysis for the investments in this category to assess the credit risk of the loan or debt security and to determine the fair value of our equity investment in these portfolio companies. The determined equity values are generally discounted when we have a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors. For loan and debt securities, we perform a yield analysis assuming a hypothetical current sale of

the investment. The yield analysis requires us to estimate the expected repayment date of the instrument and a market participant's required yield. The yield analysis considers changes in interest rates and changes in leverage levels of the loan or debt security as compared to current market interest rates and leverage levels. Assuming the credit quality of the loan or debt security remains stable, we will use the value determined by the yield analysis as the fair value for that security. If there is deterioration in credit

quality or a loan or debt security is in workout status, we may consider other factors in determining the fair value of a loan or debt security, including the value attributable to the loan or debt security from the enterprise value of the portfolio company or the proceeds that would be received in a liquidation analysis.

The value of our equity investments in private debt and equity funds are generally valued at the fund's net asset value, unless other factors lead to a determination of fair value at a different amount. The value of our equity securities in public companies for which quoted prices in an active market are readily available is based on the closing public market price on the measurement date.

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

We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and will record unrealized appreciation when we determine that the fair value is greater than its cost basis.

The impact on our consolidated financial statements for periods subsequent to the period of adoption cannot be determined at this time as it will be influenced by the estimates of fair value for those periods, the number and amount of investments we originate, acquire or exit, and the effect of any additional guidance or any changes in the interpretation of this statement.

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

***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 depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

***Interest and Dividend Income.*** 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.

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



We recognize interest income on the CLO preferred shares/income notes using the effective interest method, based on the anticipated yield that is determined using the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred shares/income notes from the date the estimated yield was changed. CLO and CDO bonds have stated interest rates. The weighted average yield on the CLO/CDO Assets is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective yield on the preferred shares/income notes, divided by (b) CLO/CDO Assets at value. The weighted average yields are computed as of the balance sheet date.

**Fee Income.** Fee income includes fees for loan prepayment premiums, guarantees, commitments, and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Loan prepayment premiums are recognized at the time of prepayment. Guaranty and commitment fees are generally recognized as income over the related period of the guaranty or commitment, respectively. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management, consulting and other services fees, including fund management fees, are generally recognized as income as the services are rendered. Fees are not accrued if we have doubt about collection of those fees.

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

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

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.

**Recent Accounting Pronouncements.** In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We have adopted this statement on a prospective basis beginning in the quarter ended March 31, 2008. Adoption of this statement did not have a material effect on our consolidated financial statements for the period ended March 31, 2008. However, the impact on our consolidated financial statements for periods subsequent to the period of adoption cannot be determined at this time as it will be influenced by the estimates of fair value for those periods, the number and amount of investments we originate, acquire or exit and the effect of any additional guidance or any

changes in the interpretation of this statement.

**QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

Our business activities contain elements of risk. We consider the principal types of market risk to be fluctuations in interest rates. We consider the management of risk essential to conducting our businesses. Accordingly, our risk management systems and procedures are designed to identify and analyze our risks, to set

appropriate policies and limits and to continually monitor these risks and limits by means of reliable administrative and information systems and other policies and programs.

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

Assuming that the balance sheet as of March 31, 2008, 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.

In addition, we may have risk regarding portfolio valuation. See [Business Portfolio Valuation](#) above.

**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, 2007, 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.

<b>Class and Year</b>	<b>Total Amount Outstanding Exclusive of Treasury Securities<sup>(1)</sup></b>	<b>Asset Coverage Per Unit<sup>(2)</sup></b>	<b>Involuntary Liquidating Preference Per Unit<sup>(3)</sup></b>	<b>Average Market Value Per Unit<sup>(4)</sup></b>
<b>Privately Issued Unsecured Notes Payable</b>				
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 <sup>(5)</sup>	1,041,400,000	2,496		N/A
2007 <sup>(5)</sup>	1,042,200,000	2,211		N/A
March 31, 2008 (unaudited) <sup>(8)</sup>	1,042,800,000	2,291		N/A
<b>Publicly Issued Unsecured Notes Payable</b>				
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 <sup>(5)</sup>	650,000,000	2,496	\$	1,000
2007 <sup>(5)</sup>	880,000,000	2,211	\$	745
March 31, 2008 (unaudited) <sup>(8)</sup>	880,000,000	2,291	\$	745
<b>Revolving Lines of Credit</b>				
1998	\$ 95,000,000	\$ 2,734	\$	N/A

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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	207,750,000	2,496	N/A
2007	367,250,000	2,211	N/A
March 31, 2008 (unaudited) <sup>(8)</sup>	268,750,000	2,291	N/A

<b>Class and Year</b>	<b>Total Amount Outstanding Exclusive of Treasury Securities<sup>(1)</sup></b>	<b>Asset Coverage Per Unit<sup>(2)</sup></b>	<b>Involuntary Liquidating Preference Per Unit<sup>(3)</sup></b>	<b>Average Market Value Per Unit<sup>(4)</sup></b>
<b>Small Business Administration Debentures<sup>(6)</sup></b>				
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	0	0		N/A
2007	0	0		N/A
March 31, 2008 (unaudited)	0	0		N/A
<b>Overseas Private Investment Corporation Loan</b>				
1998	\$ 5,700,000	\$ 2,734	\$	N/A
1999	5,700,000	2,283		N/A
2000	5,700,000	2,445		N/A
2001	5,700,000	2,453		N/A
2002	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	0	0		N/A
2007	0	0		N/A
March 31, 2008 (unaudited)	0	0		N/A
<b>Auction Rate Reset Note</b>				
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	0	0		N/A

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2007	0	0	N/A
March 31, 2008 (unaudited)	0	0	N/A

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76

<b>Class and Year</b>	<b>Total Amount Outstanding Exclusive of Treasury Securities<sup>(1)</sup></b>	<b>Asset Coverage Per Unit<sup>(2)</sup></b>	<b>Involuntary Liquidating Preference Per Unit<sup>(3)</sup></b>	<b>Average Market Value Per Unit<sup>(4)</sup></b>
<b>Master Repurchase Agreement and Master Loan and Security Agreement</b>				
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	0	0		N/A
2007	0	0		N/A
March 31, 2008 (unaudited)	0	0		N/A
<b>Redeemable Cumulative Preferred Stock<sup>(6)(7)</sup></b>				
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	0	0		N/A
2007	0	0		N/A
March 31, 2008 (unaudited)	0	0		N/A
<b>Non-Redeemable Cumulative Preferred Stock<sup>(6)</sup></b>				
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	0	0		N/A
2007	0	0		N/A
March 31, 2008 (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, except for publicly issued unsecured notes payable, as other senior securities are not registered for public trading. The average market value of the publicly issued unsecured notes payable is calculated as the weighted average face value of the notes. On May 30, 2008, the closing price of our \$230 million 6.875% Notes due 2047 was \$17.45 per share.
- (5) See Note 4 to our December 31, 2007, consolidated financial statements for a description of the terms.
- (6) Issued by our small business investment company subsidiary to the Small Business Administration. These categories of senior securities were not subject to the asset coverage requirements of the 1940 Act. During 2006, our small business investment company (SBIC) subsidiary surrendered its SBIC license and was merged into its parent.
- (7) The Redeemable Cumulative Preferred Stock was reclassified to Other Liabilities on the accompanying financial statements during 2003 in accordance with SFAS No. 150.
- (8) See Note 4 to our March 31, 2008, Consolidated Financial Statements for a description of the terms.

## **BUSINESS**

### **General**

We are a business development company, or BDC, in the private equity business and we are internally managed. 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 through March 31, 2008, we have invested more than \$13 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 and that are well positioned for growth. We are not venture capitalists, and we generally do not provide seed, or early stage, capital. At March 31, 2008, our private finance portfolio included investments in 124 companies that generate aggregate annual revenues of over \$13 billion and employ more than 98,000 people.

Our investment objective is to achieve current income and capital gains. In order to achieve this objective, we primarily invest in debt and equity securities of private companies in a variety of industries. However, from time to time, we may invest in companies that are public but lack access to additional public capital.

We have also participated in commercial real estate finance over our history. Over the past few years, we have not actively participated in commercial real estate finance as we believed that the market for commercial real estate had become too aggressive and that investment opportunities were not priced appropriately. As a result, our commercial real estate finance portfolio totaled \$115.8 million at value, or 2.3% of our total assets, at March 31, 2008. As the capital markets evolve and should commercial real estate investment opportunities improve, we may become more active investors in commercial real estate finance for our own portfolio or through a future managed fund. See **Managed Funds** below.

In addition to managing our own assets, we manage certain funds that also invest in the debt and equity securities of primarily private middle market companies in a variety of industries. We may invest in the equity of these funds, along with other third parties, from which we may earn a current return and/or a future incentive allocation. We may also manage the assets held by these funds, for which we may earn management or other fees for our services. See **Managed Funds** below.

We are internally managed, led by an experienced management team with our senior officers and managing directors possessing, on average, 22 years of experience. At March 31, 2008, we had 186 employees, who are focused on transaction sourcing, origination and execution, portfolio monitoring, accounting, valuation and other operational and administrative activities. We are headquartered in Washington, DC, with offices in New York, NY, Chicago, IL, and Los Angeles, CA and have centralized investment approval and portfolio management processes.

### **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-capitalized 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. These investments are generally long-term in nature and 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 generally increased returns are associated with the 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 have focused on investments in the debt and equity of primarily private middle market companies 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 investments in equity instruments or from equity features, such as nominal cost warrants. For the years 1998 through 2007, we have realized \$1.4 billion 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.

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 March 31, 2008, our combined aggregate cash flow internal rate of return, or IRR, has been approximately 21% for private finance and real estate-related CMBS/CDO investments exited during this period. The IRR is calculated using the aggregate portfolio cash flow for all investments exited over this period. For investments exited during this period, we invested capital totaling \$4.7 billion. The weighted average holding period of these investments was 39 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 20% 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 49 months and 22 months, respectively, 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 investing in illiquid assets. 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 (the 1940 Act), 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 investments. 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-capitalized balance sheet

We generally target investments in companies in the following industries:

Business Services	Financial Services
Consumer Products	Consumer Services
Industrial Products	Retail

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. Our strategy is to manage risk in these investments through the structure and terms of our debt and equity investments. 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 \$150 million and buyout investments of up to \$300 million of invested capital.

Debt investments may include senior loans, unitranche debt (an instrument that combines both senior and subordinated financing, generally in a first lien position), 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. We may make equity investments for a minority equity stake in portfolio companies or may receive equity features, such as nominal cost warrants, in conjunction with our debt investments.

Senior loans may carry a fixed rate of interest or a floating rate of interest, usually set as a spread over LIBOR, and may require payments of both principal and interest throughout the life of the loan. Senior loans generally have contractual maturities of three to six years and interest is generally paid to us monthly or quarterly. Unitranche debt generally carries a fixed rate of interest. Unitranche debt generally requires payments of both principal and interest throughout the life of the loan. Unitranche debt generally has contractual maturities of five to six years and interest is generally paid to us quarterly. Subordinated debt generally carries a fixed rate of interest generally with contractual maturities of five to ten years and generally has interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest on subordinated debt is generally paid to us quarterly.

We may underwrite or arrange senior loans related to our portfolio investments or for other companies that are not in our portfolio. When we underwrite or arrange senior loans, we may earn a fee for such activities. Senior loans underwritten or arranged by us may or may not be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, or funds managed by Callidus or by us, including the Allied Capital Senior Debt Fund, L.P. or Knightsbridge CLO 2007-1 Ltd. After completion of the loan sales, we may or may not retain a position in these senior loans. We generally earn a fee on the senior loans we underwrite or arrange whether or not we fund the underwritten commitment. In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Principal collections include repayments of senior debt funded by us that was subsequently sold by us or refinanced or repaid by the portfolio companies.

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, or by us. The CLOs and CDOs in which we invest are invested primarily in first lien loans to corporate borrowers. We are not an investor in CLOs and CDOs that hold subprime residential real estate loans.

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 loans and debt securities, 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. 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 unitranche debt are generally in a first lien position, however in a liquidation scenario, the collateral, if any, 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, 2008, 80.6% of the private finance portfolio at value consisted of interest bearing securities and 19.4% consisted of equity securities. At March 31, 2008, 85% of our private finance loans and debt securities carried a fixed rate of interest and 15% carried a floating rate of interest. The mix of fixed and variable rate loans and debt securities in the portfolio may vary depending on the level of floating rate senior loans or unitranche debt in the portfolio at a given time. The weighted average yield on our private finance loans and debt securities was 12.2% at March 31, 2008.

At March 31, 2008, 25.7% of the private finance investments at value were in companies more than 25% owned, 8.4% were in companies 5% to 25% owned, and 65.9% were in companies less than 5% owned.

Our ten largest investments at value at March 31, 2008, were as follows:

(\$ in millions) Portfolio Company	Company Information	At March 31, 2008			Percentage of Total Assets
		Cost	Unrealized Appreciation (Depreciation)	Value	
EarthColor, Inc.	Commercial printer focused on providing a one-stop printing solution of electronic pre-press, printing and finishing primarily for promotional products such as direct mail pieces, brochures, product information and free standing inserts.	\$ 180.7	\$ 3.0	\$ 183.7	3.6%
Advantage Sales & Marketing, Inc.	Sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry.	\$ 155.7	\$ 11.9	\$ 167.6	3.3%
BenefitMall, Inc.	Insurance general agency providing brokers with products, tools, and services that make selling employee benefits to small businesses more efficient.	\$ 115.3	\$ 42.9	\$ 158.2	3.1%
WMA Equity Corporation and Affiliates d/b/a/ Wear Me Apparel	Designer and marketer of licensed and private children's apparel.	\$ 175.3	\$ (36.8)	\$ 138.5	2.7%
Driven Brands, Inc.	Business format franchisor in the car care sector of the automotive aftermarket industry and in the general car care services with approximately 1,100 locations worldwide operating primarily under the Meineke Car Care Centers® and Econo Lube N Tune® brands.	\$ 149.3	\$ (20.4)	\$ 128.9	2.5%
Norwesco, Inc.	Designs, manufactures and markets a broad assortment of polyethylene tanks primarily to the agricultural and septic tank	\$ 65.2	\$ 61.2	\$ 126.4	2.5%

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Financial Pacific Company	markets. Specialized commercial finance company that leases business-essential equipment to small businesses nationwide.	\$ 89.5	\$ 20.0	\$ 109.5	2.2%
The Step2 Company, LLC	Manufacturer of branded plastic children's and home products manufactured through a rotational molding process.	\$ 97.6	\$ 1.3	\$ 98.9	2.0%
Huddle House, Inc.	Franchisor of value-priced, full service family dining restaurants primarily in the Southeast.	\$ 91.5	\$ 1.0	\$ 92.5	1.8%
Cook Inlet Alternative Risk, LLC	Provider of fee-based management services for self-insured groups.	\$ 90.1	\$ 1.6	\$ 91.7	1.8%

We monitor the portfolio to maintain diversity within the industries in which we invest. 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, 2008, and December 31, 2007, was as follows:

	2008	2007
<b>Industry</b>		
Business services	36%	37%
Consumer products	25	25
Industrial products	8	10
Financial services	5	6
CLO/CDO <sup>(1)</sup>	6	6
Retail	5	4
Consumer services	5	4
Healthcare services	3	3
Asset management	2	1
Other	5	4
Total	100%	100%

<sup>(1)</sup> These funds primarily invest in senior corporate loans. Certain of these funds are managed by Callidus Capital, a portfolio company of Allied Capital, and by us.

**Commercial Real Estate Finance Portfolio.** Since 1998, our commercial real estate investments were generally 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. 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. Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement, under which we have agreed not to primarily invest in non-investment grade 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.

At March 31, 2008, our commercial real estate finance portfolio consisted of commercial mortgage loans, real estate owned and equity interests, which totaled \$115.8 million at value, or 2.3% of our total assets.

### Managed Funds

We manage funds that invest in the debt and equity of primarily private middle market companies in a variety of industries (together, the Managed Funds). As of March 31, 2008, the funds that we manage had total assets of approximately \$1.2 billion. During 2007, we established the Allied Capital Senior Debt Fund, L.P. and the Unitranche Fund LLC, and in the first quarter of 2008, we formed the AGILE Fund I, LLC, and assumed management of Knightsbridge CLO 2007-1 Ltd., all discussed below. Our responsibilities to the Managed Funds may include deal origination, underwriting, and portfolio monitoring and development services consistent with the activities that we perform for our portfolio as outlined below. Each of the Managed Funds may separately invest in the debt or equity of a portfolio company. Our portfolio may include debt or equity investments issued by the same portfolio company as investments held by one or more Managed Funds, and these investments may be senior, pari passu or junior to the

debt and equity investments held by us. We may or may not participate in investments made by investment funds managed by us or one of our affiliates. We expect to continue to grow our managed capital base and have identified other private equity-related funds that we intend to develop. By growing our privately managed capital base, we are seeking to diversify our sources of capital, leverage our core investment expertise and increase fees and other income from asset management activities. See Risk Factors There are potential conflicts of interest between us and the funds managed by us.

**Allied Capital Senior Debt Fund, L.P.** The Allied Capital Senior Debt Fund, L.P. (ACSDF) is a private fund that generally invests in senior, unitranche and second lien debt. ACSDF has closed on \$125 million in equity capital commitments and had total assets of approximately \$432 million at March 31, 2008. A.C. Corporation (AC Corp), our wholly-owned subsidiary, is the investment manager and Callidus acts as special manager to ACSDF. One of our affiliates is the general partner of ACSDF, and AC Corp serves as collateral manager to a warehouse financing vehicle associated with ACSDF. AC Corp will earn a management fee of up to 2% per annum of the net asset value of ACSDF and will pay Callidus 25% of that management fee to compensate Callidus for its role as special manager.

We are a special limited partner in ACSDF, which is a portfolio investment, and have committed and funded \$31.8 million to ACSDF. At March 31, 2008, our investment in ACSDF totaled \$31.8 million at cost and \$32.6 million at value. As a special limited partner, we expect to earn an incentive allocation of 20% of ACSDF's annual net income earned in excess of a specified minimum return, subject to certain performance benchmarks.

From time to time, we may offer to sell loans to ACSDF or the warehouse financing vehicle. ACSDF or the warehouse financing vehicle may purchase loans from us. They also purchase loans from other third parties.

**Unitranche Fund LLC.** In December 2007, we formed the Unitranche Fund LLC (Unitranche Fund), which we co-manage with an affiliate of General Electric Capital Corporation (GE). The Unitranche Fund is a private fund that generally focuses on making first lien unitranche loans to middle market companies with Earning Before Interest, Taxes, Depreciation, and Amortization (EBITDA) of at least \$15 million. The Unitranche Fund may invest up to \$270 million in a single borrower. For financing needs greater than \$270 million, we and GE may jointly underwrite additional financing for a total unitranche financing of up to \$500 million. Allied Capital, GE and the Unitranche Fund may co-invest in a single borrower, with the Unitranche Fund holding at least a majority of the issuance. We may hold the portion of a unitranche loan underwritten by us. GE has committed \$3.075 billion to the Unitranche Fund consisting of \$3.0 billion of senior notes and \$0.075 billion of subordinated certificates and we have committed \$525.0 million of subordinated certificates. The Unitranche Fund will be capitalized as transactions are completed. At March 31, 2008, our investment in the Unitranche Fund totaled \$31.5 million at cost and at value.

The Unitranche Fund is governed by an investment committee with equal representation from Allied Capital and GE and both Allied Capital and GE and its affiliates provide origination, underwriting and portfolio management services to the Unitranche Fund. We will earn a management and sourcing fee totaling 0.375% per annum of managed assets.

**AGILE Fund I, LLC.** In January 2008, we entered into an investment agreement with the Goldman Sachs Private Equity Group, part of Goldman Sachs Asset Management (Goldman Sachs). As part of the investment agreement, we agreed to sell a pro-rata strip of private equity and debt investments to AGILE Fund I, LLC (AGILE), a private fund in which a fund managed by Goldman Sachs owns substantially all of the interests, for a total transaction value of \$167 million. The sales of the assets closed in the first quarter of 2008.

The sale to AGILE included 13.7% of our equity investments in 23 of our buyout portfolio companies and 36 of our minority equity portfolio companies for a total purchase price of \$104 million, which resulted in a net realized gain of \$8.8 million and dividend income of \$5.4 million. In addition, we sold approximately \$63 million in debt investments, which represented 7.3% of our unitranche, second lien and subordinated debt investments in the buyout investments included in the equity sale. AGILE generally has the right to co-invest in its proportional share of any future follow-on investment opportunities presented by the companies in its portfolio.

We are the managing member of AGILE, and will be entitled to an incentive allocation subject to certain performance benchmarks. We own the remaining interests in AGILE not held by Goldman Sachs. At March 31, 2008, AGILE has total assets of approximately \$174 million and our investment in AGILE totaled \$0.9 million at cost and at value.

In addition, pursuant to the investment agreement Goldman Sachs has committed to invest at least \$125 million in future investment vehicles managed by us and will have future opportunities to invest in our affiliates, or vehicles managed by them, and to co-invest alongside us in the future, subject to various terms and conditions.

As part of this transaction, we sold nine venture capital and private equity limited partnership investments for approximately \$28 million to a fund managed by Goldman Sachs, which will assume the \$4.7 million of unfunded commitments related to these limited partnership investments. The sales of these limited partnership investments closed at the end of the first quarter of 2008, and resulted in a net realized loss of \$5.5 million.

**Knightsbridge CLO 2007-1 Ltd.** On March 31, 2008, we assumed the management of Knightsbridge CLO 2007-1 Ltd. We earn a management fee of up to 0.6% per annum of the assets of the fund. Callidus may assist us in the management of the fund and we may pay Callidus a portion of the management fee earned for this assistance. This CLO invests primarily in middle market senior loans. At March 31, 2008, Knightsbridge CLO 2007-1 Ltd. had total assets of approximately \$500 million and our investment in this CLO totaled \$54.4 million at cost and \$53.0 million at value.

In aggregate, including the total assets on our balance sheet and capital committed to our Managed Funds, we have more than \$9 billion in managed capital.

## **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. We have business development professionals dedicated to sourcing investments through our 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.

We believe that our debt portfolio relationships and sponsor relationships are a significant source for buyout investments. We generally source our buyout transactions in ways other than going to broad auctions, which include capitalizing on existing relationships with companies and sponsors to participate in proprietary buyout opportunities. We work closely with these companies and sponsors while we are debt investors so that we may be positioned to partner with them on buyout opportunities in a subsequent transaction.

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 may 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 longer 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, 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 nominal cost warrants or options to buy a minority interest in the portfolio company. In a buyout transaction where our equity investment represents a significant portion of the equity, our equity ownership may or may not represent a controlling interest. If we invest in non-voting equity in a buyout, we generally have an option to acquire a controlling stake in the voting securities of the portfolio company at fair market value.

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, including peer review;

Final investment committee approval;

Approval by the Investment Review 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 Board Investment Review 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, two of whom serve as vice chairmen of the investment committee.

**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 is responsible for review and oversight of the investment portfolio, including reviewing the performance of selected portfolio companies, overseeing portfolio companies in workout status, reviewing and approving certain modifications or amendments to or certain additional investments in existing investments, reviewing and approving certain portfolio exits, reviewing and approving certain actions by portfolio companies whose voting securities are more than 50% owned by us, reviewing significant investment-related litigation matters where we are a named party, and reviewing and approving proxy votes with respect to our portfolio investments. 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), our private finance general counsel, and certain of our 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 for those investments from which a capital gain is expected. Grade 2 is for investments performing in accordance with plan. Grade 3 is for investments that require closer monitoring; however, no loss of investment return or principal is expected. Grade 4 is 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 for investments that are in workout and for which some loss of principal is expected. At March 31, 2008, Grade 1, 2, and 3 investments totaled \$4,522.6 million, or 97.6% of the total portfolio at value, and Grade 4 and 5 investments totaled \$113.0 million, or 2.4% of the total portfolio at value.

### **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 1940 Act, 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 in accordance with our valuation policy and the provisions of the 1940 Act and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement). We determine fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. At March 31, 2008, portfolio investments recorded at fair value using level 3 inputs (as defined under the Statement) were approximately 91% 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. Additionally, changes in the market environment and other events that may occur over the life of our investments may cause the gains or losses ultimately realized on our investments to be different than the values determined at the measurement date.

There is no single approach 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 determine that the fair value of a security is less than its cost basis, and we will record unrealized appreciation when we determine that the fair value is greater than its cost basis. Changes in fair value are recorded in the statement of operations as net change in unrealized appreciation or depreciation. See Management's Discussion and Analysis of Financial Condition and Results of Operations Results of Operations Change in Unrealized Appreciation or Depreciation for a discussion of our valuation methodology.

**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 an overview 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 investment professionals, led by the Managing Director or senior officer who is responsible for the portfolio company relationship (the Deal Team).

The CVO and third-party valuation consultants, as applicable (see below), review the preliminary valuation documentation as prepared by the Deal Team.

The CVO, members of the valuation team, and third-party consultants (see below), as applicable, 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 separately from the full Board of Directors with the third-party consultants (see below) to discuss the assistance provided and results. The CVO attends this meeting.

The CVO discusses and reviews the valuations with the Board of Directors.

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 is submitted to our Board of Directors who is ultimately responsible for the determination of fair value of the portfolio in good faith. Valuation assistance from Duff & Phelps, LLC (Duff & Phelps) for our private finance portfolio consists of certain limited procedures (the Procedures) we have identified and requested them to perform. In addition, we also received third-party valuation assistance from other third-party consultants for certain private finance portfolio companies. See Management's Discussion and Analysis of Financial Condition and Results of Operations above.

We work with third-party consultants to obtain valuation assistance for a portion of the private finance portfolio each quarter. 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, 2008, we received valuation assistance for 124 portfolio companies, which represented 94% of the private finance portfolio at value. See Management's Discussion and Analysis of Financial Condition and Results of Operations above.

**Disposition of Investments**

We manage our portfolio of investments in an effort to maximize our expected returns. We are generally repaid by our borrowers and exit our debt and equity investments as portfolio companies are sold, recapitalized or complete an initial public offering.

We may retain a position in the senior loans we originate or we may sell all or a portion of these investments. In our debt investments where we have equity features, we are generally 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 Internal Revenue Code of 1986 (the Code). Assuming that we continue to qualify as a regulated investment company, we generally will not be subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. We pay regular quarterly dividends based upon an estimate of annual taxable income available for distribution to shareholders, 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 generally are not included in taxable income until they are realized. In addition, gains realized for financial reporting purposes may differ from gains included in taxable income as a result of our election to recognize gains using installment sale treatment, which generally results in the deferment of gains for tax purposes until notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash. 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 and the amount of taxable income carried over from the prior year for distribution in the current year. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid from such taxable income for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Code. The maximum amount of excess taxable income that may be carried over for distribution in the next year under the Code is the total amount of dividends paid in the following year, subject to certain declaration and payment guidelines. Excess taxable income carried over and paid out in the next year is generally subject to a nondeductible 4% excise tax. See Management's Discussion and Analysis of Financial Condition and Results of Operation 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 through December 31, 2007, our average annual total return to shareholders (assuming all dividends were reinvested) was 16.9%. Over the past one, three, five and ten years (assuming each period ended on December 31, 2007), our total return to

shareholders (assuming all dividends were reinvested) has been (27.6%), 2.5%, 8.9% and 8.8%, 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 1987 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. 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, as well as transaction, management, consulting, and other services, including underwriting and arranging senior loans, to Allied Capital and our portfolio companies. A.C. Corporation also provides fund management services to certain funds managed by us.

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

### **Properties**

Our principal offices are located at 1919 Pennsylvania Avenue, N.W., Washington, DC 20006-3434. Our lease for approximately 56,000 square feet of office space at that location expires in December 2010. The office is equipped with an integrated network of computers for word processing, financial analysis, accounting and loan servicing. We believe our office space is suitable for our needs for the foreseeable future. We also maintain offices in New York, NY; Chicago, IL; and Los Angeles, CA.

### **Employees**

At March 31, 2008, we employed 186 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 were conducting an informal investigation of us. The investigation related to the valuation of securities in our private finance portfolio and other matters. On June 20, 2007, we announced that we entered into a settlement with the SEC that resolved the SEC's informal investigation. As part of the settlement and without admitting or denying the SEC's allegations, we agreed to the entry of an administrative order. In the order the SEC alleged that, between June 30, 2001, and March 31, 2003, we did not maintain books, records and accounts which, in reasonable detail, supported or accurately and fairly reflected valuations of certain securities in our private finance portfolio and, as a result, did not meet certain recordkeeping and internal controls provisions of the federal securities laws. In the administrative order, the SEC ordered us to continue to maintain certain of our current valuation-related controls. Specifically, for a period of two years, we have undertaken to: (1) continue to employ a Chief Valuation Officer, or a similarly structured officer-level employee, to oversee our quarterly valuation processes; and (2) continue to employ third-party valuation consultants to assist in our quarterly valuation processes.

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

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

On February 13, 2007, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned *Rena Nadoff v. Walton, et al.*, CA 001060-07, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. The complaint was summarily dismissed in July 2007. The complaint alleged breach of fiduciary duty by the Board of Directors arising from internal control failures and mismanagement of Business Loan Express, LLC, an Allied Capital portfolio company. On October 5, 2007, Rena Nadoff sent a letter to our Board of Directors with substantially the same claims and a request that the Board of Directors investigate the claims and take appropriate action. The Board of Directors subsequently established a committee, advised by its own counsel, to review the matter. Recently, the Board's committee concluded its review of the matter and recommended that the Board not take any further action with respect to Ms. Nadoff's claims. After discussing the matter, the Board accepted the recommendation.

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Thereafter, the court appointed new lead counsel and approved new lead plaintiffs. On July 30, 2007, plaintiffs served an amended complaint. Plaintiffs claim that, between November 7, 2005, and January 22, 2007, Allied Capital either failed to disclose or misrepresented

information about our portfolio company, Business Loan Express, LLC. Plaintiffs seek unspecified compensatory and other damages, as well as other relief. We believe the lawsuit is without merit, and we intend to defend the lawsuit vigorously. On September 13, 2007, we filed a motion to dismiss the lawsuit. The motion is pending.

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

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

## 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, 2008. 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, 2008, at pages F-75 to F-91.

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
<b>PRIVATE FINANCE</b>			
<b>Companies More Than 25% Owned</b>			
AGILE Fund I, LLC <sup>(1)</sup> 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Private Equity Fund	Equity Interests	0.5%
Alaris Consulting, LLC <sup>(1)(2)</sup> 1815 South Meyers Road Suite 1000 Oakbrook, IL 60181	Consulting Firm	Equity Interests	83.1%
AllBridgE Financial, LLC <sup>(1)</sup> 5080 Spectrum Drive Suite 1150 E Addison, TX 75001	Real Estate Finance Company	Class A Equity Interests	95.2%
Allied Capital Senior Debt Fund, L.P. <sup>(1)(12)</sup> 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Private Debt Fund	Class A-1 Limited Partnership Interest	41.0%

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Avborne, Inc. <sup>(1)(7)</sup> PO Box 52-2602 Miami, FL 33152	Aviation Services	Series B Preferred Stock Common Stock	23.8% 27.2%
Avborne Heavy Maintenance, Inc. <sup>(1)(7)</sup> PO Box 52-2602 Miami, FL 33152	Aviation Services	Series A Preferred Stock Common Stock	27.5% 27.5%
Aviation Properties Corporation <sup>(1)</sup> 1919 Pennsylvania Avenue, N.W. Washington, DC 20006	Aviation Services	Common Stock	100.0%
Border Foods, Inc. <sup>(1)</sup> 4065 I Street SE Deming, NM 88030	Mexican Ingredient & Food Product Manufacturer	Series A Preferred Stock Series A Common Stock	100.0% 100.0%
Calder Capital Partners, LLC <sup>(1)</sup> 321 North Clark Street, 8th Floor Chicago, IL 60610	Private Investment Firm	Equity Interests	65.0%
Callidus Capital Corporation <sup>(1)(4)</sup> 520 Madison Avenue New York, NY 10022	Asset Manager and Finance Company	Common stock	100.0%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Ciena Capital LLC <sup>(1)</sup> 1633 Broadway New York, NY 10019	Real-Estate Secured Lender	Class A Equity Interests Class B Equity Interests Class C Equity Interests Equity Interest in Ciena Subsidiary <sup>(3)</sup>	100.0% 100.0% 94.9% 20.0%
CitiPostal, Inc. <sup>(1)</sup> 5 North 11th Street Brooklyn, NY 11211	Document Storage and Management	Common Stock	63.1%
Coverall North America, Inc. <sup>(1)</sup>  5201 Congress Avenue Suite 275 Boca Raton, FL 33487	Corporate Cleaning Service Provider	Common Stock	85.2%
CR Holding, Inc. <sup>(1)</sup> 141 Venture Boulevard Spartanburg, SC 29306	Household Cleaning Products	Common Stock	70.9%
Crescent Equity Corp. <sup>(1)(11)</sup> 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Hotel Management Company and Multi-system Cable Operator	Common Stock	86.3%
Direct Capital Corporation <sup>(1)</sup> 155 Commerce Way Portsmouth, NH 03801	Business Equipment Leasing	Class A Common Stock	57.3%
Financial Pacific Company <sup>(1)</sup> 3455 South 344th Way Suite 300 Federal Way, WA 98001	Commercial Finance Leasing	Series A Preferred Stock Common Stock	85.7% 85.8%
ForeSite Towers, LLC <sup>(1)</sup> 5809 Feldspar Way Birmingham, AL 35244	Tower Leasing	Common Equity Interest	88.1%
Hot Light Brands, Inc. 11780 Manchester Road Suite 207 St. Louis, MO 63131	Retail	Common Stock	100.0%

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Hot Stuff Foods, LLC <sup>(1)</sup> 2930 W. Maple Street Sioux Falls, SD 57118	Foodservice to Convenience Stores	Class B Common Stock Class A Common Stock	95.0% 66.1%
Huddle House, Inc. <sup>(1)</sup> 5901-B Peachtree-Dunwoody Road Suite 450 Atlanta, Georgia 30328	Restaurant Franchisor	Common Stock	84.0%
Impact Innovations Group, LLC 2500 Northwinds Parkway Suite 200 Alpharetta, GA 30004	Information Technology Services Provider	Equity Interests in Affiliate <sup>(5)</sup>	50.0%
Insight Pharmaceuticals Corporation <sup>(1)</sup> 1170 Wheeler Way Suite 150 Langhorne, PA 19047	Marketer of Over-The- Counter Pharmaceuticals	Preferred Stock Common Stock	100.0% 99.7%
Legacy Partners Group, Inc. <sup>(1)</sup> 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Merger and Acquisition Advisor	Equity Interests	100.0%
Litterer Beteiligungs-GmbH 68165 Manheim Germany	Scaffolding Company	Equity Interest	25.0%
MHF Logistical Solutions, Inc. <sup>(1)(6)</sup> 800 Cranberry Woods Drive Suite 450 Cranberry Township, PA 16066	Third-Party Environmental Logistics	Class B Common Stock Series A Preferred Stock Class A Common Stock	58.3% 100.0% 98.9%
MVL Group, Inc. <sup>(1)</sup> 1061 E. Indiantown Road Suite 300 Jupiter, FL 33477	Market Research Services	Common Stock	55.9%
Old Orchards Brand, LLC <sup>(1)</sup> 1991 Twelve Mile Road Sparta, MI 49345	Beverage Manufacturer and Marketer	Equity Interests	78.8%



Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Penn Detroit Diesel Allison, LLC <sup>(1)</sup> 8330 State Road  Philadelphia, PA 19136	Distributor of Engines, Transmissions, and Parts	Equity Interests	78.1%
Service Champ, Inc. <sup>(1)</sup>  180 New Britain Boulevard Chalfont, PA 18914	Wholesale Distributor of Auto Parts	Common Stock	54.8%
Startec Equity, LLC 1919 Pennsylvania Avenue N.W. Washington, DC 20006	Telecommunications Services	Equity Interests	100.0%
Sweet Traditions, Inc. <sup>(1)</sup> 11780 Manchester Road Suite 207 St. Louis, MO 63131	Franchisor of Krispy Kreme Doughnut Corporation	Class B-2 Preferred Stock Class A-1 Common Stock	100.0% 51.0%
Unitranche Fund LLC <sup>(1)</sup> c/o Corporation Service Company 2711 Centerville Road Wilmington, DE 19808	Private Debt Fund	Equity Interests	87.5%
Worldwide Express Operations, LLC <sup>(1)</sup> 2828 Routh Street Suite 400 Dallas, TX 75201	Reseller of Shipping Services	Equity Interests Warrants to Purchase Equity Interests	53.8%  0.7%
<b>Companies 5% to 25% Owned</b>			
10th Street, LLC 5 North 11th Street Brooklyn, NY 11211	Document Storage	Equity Interests	10.0%
Advantage Sales & Marketing, Inc. <sup>(1)</sup> 19100 Von Karman Avenue Suite 600 Irvine, CA 92612	Sales and Marketing Agency	Equity Interests	4.2%
Air Medical Group Holdings LLC 306 Davis Drive P.O. Box 768	Air Ambulance Service	Series A Preferred Equity Interests Series B Preferred Equity	6.4%

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West Plains, MO 65775		Interests	6.2%
Alpine ESP Holdings, Inc. 3361 Rouse Road Suite 165 Orlando, FL 32817	Engineering and Technical Services	Preferred Stock Common Stock	11.3% 9.3%
Amerex Group, LLC <sup>(1)</sup> 512 Seventh Avenue New York, NY 10118	Outerwear Apparel Supplier	Class B Equity Interests	100.0%
BB&T Capital Partners/Windsor Mezzanine Fund, LLC 101 N. Cherry Street Suite 400 Winston-Salem, NC 27101	Private Equity Fund	Class A Equity Interests <sup>(6)</sup>	32.6%
Becker Underwood, Inc. 801 Dayton Avenue Ames, IA 50010	Speciality Chemical Manufacturer	Common Stock	4.8%
BI Incorporated 6400 Lookout Road Boulder, CO 80301	Electronic Monitoring Equipment	Common Stock	6.1%
Creative Group, Inc. <sup>(1)</sup> 1601 Broadway, 10th Floor New York, NY 10019	Concept-to-Completion Development	Class B Common Stock Warrants to Purchase Class B Common Stock	100.0% 100.0%
Drew Foam Companies, Inc. 1093 Highway 278 East Monticello, AR 71655	Polystyrene Block Plastic Foam Manufacturer	Preferred Stock Common Stock	7.6% 6.3%
Hilden America, Inc. 1044 Commerce Lane South Boston, VA 24592	Distributor of Luxury Sheets	Common Stock	8.1%
MedBridge Healthcare, LLC <sup>(1)</sup> 110 West North Street Suite 100 Greenville, SC 29601	Sleep Diagnostic Facilities	Debt Convertible into Equity Interests Class C Equity Interest	75.0% 100.0%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Multi-Ad Services, Inc. 1720 W. Detweiller Drive Peoria, IL 61615	Marketing Services	Series A Preferred Equity Interests Class A Common Equity Interests	17.4%  10.5%
Progressive International Corporation 6111 S. 228th Street Kent, WA 98032	Retail Kitchenware	Series A Redeemable Preferred Stock Class A Common Stock Warrants to Purchase Class A Common Stock	14.3% 1.0% 42.3%
Regency Healthcare Group, LLC 2151 Highland Avenue Suite 350 Birmingham, AL 35205	Hospice Services	Class A Equity Interests	8.8%
SGT India Private Limited <sup>(1)</sup> 5858 Westheimer Road Houston, TX 77057	Software/Business Process Developer	Common Stock	21.8%
Soteria Imaging Services, LLC 6009 Brownsboro Park Boulevard Suite H Louisville, KY 40207	Diagnostic Imaging Facilities Operator	Class A Preferred Equity Interests	10.8%
Universal Environmental Services, LLC 411 Dividend Drive Peachtree City, GA 30269	Used Oil Recycling	Preferred Equity Interests	15.0%
<b>Companies Less Than 5% Owned</b>			
Augusta Sportswear Group, Inc. 425 Park West Drive Augusta, GA 30907	Retail Athletic Apparel	Common Stock	1.6%
Axiom Healthcare Pharmacy, Inc. 550 Technology Park Lake Mary, FL 32746	Pharmaceutical Services	Common Stock	12.6%
Baird Capital Partners IV Limited Partnership 777 East Wisconsin Avenue Milwaukee, WI 53201	Private Equity Fund	Limited Partnership Interest	2.5%

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BenefitMall, Inc. 4851 LBJ Freeway, Suite 1100 Dallas, TX 75244	Insurance General Agency to Small Businesses	Series B Common Stock <sup>(10)</sup> Warrant to Purchase Class C Common Stock <sup>(10)</sup>	85.3%  100.0%
Callidus Debt Partners CLO Fund III, Ltd. <sup>(8)</sup> 520 Madison Avenue New York, NY 10022	CDO/CLO Fund	Preferred Shares	68.4%
Callidus Debt Partners CLO Fund IV, Ltd. <sup>(8)</sup> 520 Madison Avenue New York, NY 10022	CDO/CLO Fund	Income Notes	27.5%
Callidus Debt Partners CLO Fund V, Ltd. <sup>(8)</sup> 520 Madison Avenue New York, NY 10022	CDO/CLO Fund	Income Notes	43.1%
Callidus Debt Partners CLO Fund VI, Ltd. <sup>(8)</sup> 520 Madison Avenue New York, NY 10022	CDO/CLO Fund	Income Notes	100.0%
Callidus Debt Partners CLO Fund VII, Ltd. <sup>(8)</sup> 520 Madison Avenue New York, NY 10022	CDO/CLO Fund	Income Notes	50.9%
Callidus MAPS CLO Fund I LLC <sup>(8)</sup> 520 Madison Avenue New York, NY 10022	CDO/CLO Fund	Income Notes	86.5%
Callidus MAPS CLO Fund II, Ltd. <sup>(8)</sup> 520 Madison Avenue New York, NY 10022	CDO/CLO Fund	Income Notes	47.1%
Carlisle Wide Plank Floors, Inc. 1676 Route 9 Stoddard, NH 03464	Wide Plank Wood Flooring	Class A-1 Preferred Stock	4.5%
Catterton Partners VI, L.P. 599 West Putnam Avenue Greenwich, CT 06830	Private Equity Fund	Limited Partnership Interest	0.5%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Centre Capital Investors V, LP 30 Rockefeller Plaza New York, NY 10020	Private Equity Fund	Limited Partnership Interest	3.7%
CK Franchising, Inc. 6640 Poe Avenue Suite 200 Dayton, OH 45414	Non-Medical, In-Home Care Franchiser	Preferred Stock Class B Common Stock	28.5% 86.3%
Commercial Credit Group, Inc.  121 West Trade Street Suite 2100 Charlotte, NC 28202	Equipment Finance and Leasing	Series A-1 Preferred Stock Series B Preferred Stock Series C Preferred Stock Series D Preferred Stock Warrant to Purchase Common Stock <sup>(10)</sup>	43.1% 43.1% 86.3% 44.8% 66.4%
Cook Inlet Alternative Risk, LLC 10 British American Boulevard Latham, NY 12110	Management Services	Equity Interests	3.7%
Cortec Group Fund IV, L.P. 200 Park Avenue New York, NY 10166	Private Equity Fund	Limited Partnership Interest	2.5%
Digital VideoStream, LLC 2600 West Olive Avenue Burbank, CA 91505	Media Post Production	Debt Convertible into Equity Interests	20.8%
DirectBuy Holdings, Inc.  8450 Broadway Merrilville, IN 46410	Franchisor of Consumer Buying Centers	Equity Interests	4.6%
Distant Lands Trading Co.  801 Houser Way North Renton, WA 98055	Provider of Premium Coffee and Coffee Beans	Series A-1 Common Stock Class A Common Stock	8.5% 3.8%
Driven Brands, Inc. (d/b/a Meineke Car Care Centers® and Econo Lube N Tune®) 128 South Tryon Street	Franchisor of Car Care Centers	Class B Common Stock <sup>(10)</sup> Warrant to Purchase	84.7%

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Suite 900 Charlotte, NC 28202		Class A Common Stock <sup>(10)</sup>	51.0%
Dryden XVIII Leveraged Loan 2007 Limited Prudential Investment Management Four Gateway Center Newark, NJ 07102	CDO/CLO Fund	Income Notes	80.0%
Dynamic India Fund IV International Financial Services Limited IFS Court, Twenty Eight Cybercity, Ebene, Mauritius	Fund Focused on Real Estate in India	Equity Interests	5.4%
EarthColor, Inc. 249 Pomeroy Road Parsippany, NJ 07054	Full Service Commercial Printer	Class B Common Stock <sup>(10)</sup> Warrant to Purchase Class C Common Stock <sup>(10)</sup>	86.3% 100.0%
eCentury Capital Partners, L.P. 8180 Greensboro Drive Suite 1150 McLean, VA 22102	Private Equity Fund	Limited Partnership Interest <sup>(6)</sup>	25.0%
eInstruction Corporation 308 N. Carroll Blvd. Denton, TX 76201	Provider of Student Response Systems	Class A Common Stock	2.4%
FCP-BHI Holdings, LLC 9432 Southern Pine Boulevard Charlotte, NC 28273	Restaurants	Equity Interests	1.5%
Fidus Mezzanine Capital, L.P. 101 North Tryon Street Charlotte, NC 28246	Private Equity Fund	Limited Partnership Interest <sup>(6)</sup>	30.0%
Frozen Specialties, Inc. 720 Barre Road Archbold, OH 43502	Private Label Frozen Food Manufacturer	Warrants to Purchase Class A Common Stock	2.5%
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	8.9% 8.1%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Havco Wood Products LLC 3200 East Outer Road Scott City, MO 63780	Hardwood Flooring Products Manufacturer	Equity Interests	4.5%
Higginbotham Insurance Agency, Inc.  500 W. 13th Street Fort Worth, TX 76102	Insurance Brokerage Firm	Class B Common Stock Warrant to purchase Class C Common Stock	87.0%  100.0%
The Homax Group, Inc. P.O. Box 5643 Bellingham, WA 98227	Supplier of Branded Consumer Products	Preferred Stock Common Stock Warrant to Purchase Preferred Stock Warrant to Purchase Common Stock	0.1% 0.1%  1.0%  1.0%
International Fiber Corporation 50 Bridge Street North Tonawanda, NY 14120	Cellulose and Fiber Producer	Series A Preferred Stock	4.0%
Knightsbridge CLO 2007-1 Limited Deutsche Banc Securities Inc. 60 Wall Street New York, NY 10005	CDO/CLO Fund	Income Notes	70.0%
Kodiak Fund LP  2107 Wilson Boulevard Suite 400 Arlington, VA 22201	Real Estate Finance Fund	Equity Interests	4.1%
MedAssets, Inc. 100 North Pointe Center Suite 150 Alpharetta, GA 30022	Healthcare Outsourcing	Common Stock	0.5%
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.	Polyethylene Tanks	Class B Common Stock <sup>(10)</sup>	83.2%

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P.O. BOX 439 4365 Steiner St.  St. Bonifacius, MN 55375	Manufacturer	Warrants to Purchase Class A Common Stock <sup>(10)</sup>	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%
Passport Health Communications, Inc. 720 Cool Springs Blvd Suite 450 Franklin, TN 37067	Healthcare Technology	Preferred Stock Common Stock	5.8% 0.1%
Pendum, Inc.  4600 S. Ulster Street  Denver, CO 80237	Outsourced ATM Services  Provider	Series C-2 Preferred Stock Warrants to Purchase Class C-2 Common Stock	100.0%  100.0%
Performant Financial Corporation 333 N. Canyons Pkwy Suite 100 Livermore, CA 94551	Collections and Default Prevention Services	Common Stock	2.3%
Peter Brasseler Holdings, LLC One Brasseler Boulevard Savannah, GA 31419	Dental Equipment Distributor	Class A Equity Interests	5.5%
Postle Aluminum Company, LLC 511 Pine Creek Court Elkhart, IN 46516	Aluminum Extrusions Distributor and Manufacturer	Class B Equity Interests	100.0%
Pro Mach, Inc. 6279 Tri-Ridge Boulevard Suite 410 Loveland, OH 45140	Packaging Machinery Manufacturer	Equity Interests	2.2%
Reed Group, Ltd. 10155 Westmoor Drive Suite 210 Westminster, CO 80021	Publisher	Class A Equity Interests	4.2%



Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
S.B. Restaurant Company (d/b/a Elephant Bar) 14241 Firestone Boulevard Suite 315 La Mirada, CA 90638	Restaurants	Series B Convertible Preferred Stock Warrants to Purchase Series A Common Stock	2.1%  11.5%
Service Center Metals, LLC 5850 Quality Way Prince George, VA 23875	Manufacturer Aluminum Products	Series C Preferred Equity Interests	2.8%
Snow Phipps Group, L.P. 667 Madison Avenue New York, NY 10021	Private Equity Fund	Limited Partnership Interest	1.6%
SPP Mezzanine Funding II, L.P. 330 Madison Avenue, 28th Floor New York, NY 10017	Private Equity Fund	Limited Partnership Interest <sup>(6)</sup>	42.7%
Summit Energy Services, Inc. 10350 Ormsby Park Place Suite 400 Louisville, KY 40223	Provider of Energy Management and Procurement Services	Common Stock	2.0%
Tappan Wire and Cable Inc. 100 Bradley Parkway Blauvelt, NY 10913	Manufacturer and Distributor of Cable	Class B Common Stock Warrant to Purchase Class C Common Stock	86.3%  100.0%
The Step2 Company, LLC 10010 Aurora-Hudson Road Streetsboro, Ohio 44241	Manufacturer of Plastic Childrens and Home Products	Preferred Equity Interests Common Equity Interests	3.3% 3.3%
TransAmerican Auto Parts, LLC 801 West Artesia Boulevard Compton, CA 90220	Auto Parts and Accessories Retailer and Wholesaler	Preferred Equity Interests Common Equity Interests	1.4% 1.4%
Triax Holdings, LLC 20 Commerce Drive Suite 232 Cranford, NJ 07016	Pharmaceutical Marketer	Class A Equity Interests Class B Equity Interests Common Equity Interests	100.0% 100.0% 61.0%
Venturehouse-Cibernet Investors, LLC 509 Seventh Street, N.W. Washington, DC 20004	Third-Party Billing	Equity Interest	3.3%

VICORP Restaurants, Inc. 400 W. 48th Avenue Denver, CO 80216	Restaurants	Warrant to Purchase Preferred Stock	1.9%
		Warrant to Purchase Common Stock	3.4%
Walker Investment Fund II, LLLP 3060 Washington Road Suite 200 Glenwood, MD 21738	Private Equity Fund	Limited Partnership Interest	5.1%
WMA Equity Corporation and Affiliates <sup>(13)</sup> 31 West 34th Street New York, NY 10001	Marketer of Children's Apparel	Common Stock	86.3%
Webster Capital II, L.P.  950 Winter Street Suite 4200 Waltham, MA 02451	Private Equity Fund	Limited Partnership Interest	3.5%
Woodstream Corporation 69 North Locust Street Lititz, PA 17543	Pest Control Manufacturer	Common Stock	3.9%
York Insurance Services Group, Inc. 99 Cherry Hill Road Suite 102 Parsippany, NJ 07054	Insurance Claims Administrator	Common Stock	2.2%
<b>COMMERCIAL REAL ESTATE FINANCE<sup>(9)</sup></b>			
Aquila Binks Forest Development, LLC <sup>(1)</sup> 15430 Endeavour Drive Jupiter, FL 33478	Real Estate Developer	Equity Interest	50.0%
MGP Park Place Equity, LLC 6901 Rockledge Drive Suite 230 Bethesda, MD 20817	Commercial Real Estate Development	Equity Interest	70.0%

<b>Name and Address of Portfolio Company</b>	<b>Nature of its Principal Business</b>	<b>Title of Securities Held by the Company</b>	<b>Percentage of Class Held</b>
NPH, Inc. <sup>(1)</sup> 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Commercial Real Estate Developer	Common Stock	100.0%
Stemmons Freeway Hotel, LLC <sup>(1)</sup> 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Hotel	Equity Interests	100.0%
WSA Commons LLC 421 East 4th Street Cincinnati, OH 45202	Residential Real Estate Development	Equity Interests	50.0%
WSALD-CEH, LLC <sup>(1)</sup> 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Commercial Real Estate Developer	Equity Interest	50.0%
Van Ness Hotel, Inc. <sup>(1)</sup> 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% (subject to dilution) 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) Limited partnership interests are non-voting.

(7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

(8) Callidus Capital Management, LLC is the manager of the fund (see Note 4 above).

(9) These portfolio companies are included in the Commercial Real Estate Finance Equity Interests in the Consolidated Statement of Investments.

(10) 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.

(11) Crescent Equity Corp. holds investments in Crescent Hotels & Resorts, LLC and affiliates and Longview Cable & Data, LLC.

(12) Our affiliate holds 100% of the general partnership interests in the Allied Capital Senior Debt Fund, L.P. (the Fund). See Management's Discussion and Analysis and Results of Operations Allied Capital Senior Debt Fund, L.P. above. We hold 41% of the Class A-1 limited partnership interests in the Fund, however; we only own 26% of the total limited partnership interests in the Fund.

(13) WMA Equity Corporation and Affiliates hold 29.4% of the equity interests in Wear Me Apparel LLC.

## 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.

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 1940 Act, 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 in accordance with our valuation policy and the provisions of the 1940 Act and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement). We determine fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. At March 31, 2008, portfolio investments recorded at fair value using level 3 inputs (as defined under the Statement) were approximately 91% 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 approach 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 determine that the fair value of a security is less than cost basis, and we will record unrealized appreciation when we determine that the fair value is greater than cost basis. 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 portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. 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. See Business Portfolio Valuation and Management's Discussion and Analysis and Results of Operations Change in Unrealized Appreciation or Depreciation.

### Determinations In Connection With Offerings

We are not generally able to issue and sell our common stock at a price below net asset value per share. We may, however, sell our common stock, or sell warrants, options or rights to acquire such common stock, at a price below the current net asset value of the common stock if our board of directors determines that such sale is in our best interests

and the best interests of our stockholders, and our stockholders approve our policy and practice of making such sales. In any such case, the price at which our securities are to be issued and sold may not be less than a price which, in the determination of our board of directors, closely approximates the market value of such securities (less any distributing commission or discount).

In connection with each offering of shares of our common stock, the Board of Directors or a committee thereof is required to make the determination that we are not selling shares of our common stock at a price below our then current net asset value at the time at which the sale is made, subject to certain exceptions discussed above. The Board of Directors considers the following factors, among others, in making such determination:

the net asset value of our common stock disclosed in the most recent periodic report we filed with the SEC;

our management's assessment of whether any material change in the net asset value has occurred (including through the realization of net gains on the sale of our portfolio investments) from the period beginning on the date of the most recently disclosed net asset value to the period ending two days prior to the date of the sale of our common stock; and

the magnitude of the difference between the net asset value disclosed in the most recent periodic report we filed with the SEC and our management's assessment of any material change in the net asset value since the date of the most recently disclosed net asset value, and the offering price of the shares of our common stock in the proposed offering.

Importantly, this determination does not require that we calculate net asset value in connection with each offering of shares of our common stock, but instead it involves the determination by the Board of Directors or a committee thereof that we are not selling shares of our common stock at a price below the then current net asset value at the time at which the sale is made, subject to certain exceptions discussed above.

To the extent that there is even a remote possibility that we may issue shares of our common stock at a price below the then current net asset value of our common stock at the time at which the sale is made then the Board of Directors or a committee thereof will elect either to postpone the offering until such time that there is no longer the possibility of the occurrence of such event or to undertake to determine net asset value within two days prior to any such sale to ensure that such sale will not be below our then current net asset value. Moreover, to the extent that there is even a remote possibility that we may trigger the undertaking to suspend the offering of shares of our common stock pursuant to this prospectus if the net asset value fluctuates by certain amounts in certain circumstances until the prospectus is amended, (which we provided to the SEC in the registration statement to which this prospectus is a part) the Board of Directors or a committee thereof will elect to comply with such undertaking or to undertake to determine net asset value to ensure that such undertaking has not been triggered.

These processes and procedures are part of our compliance policies and procedures. Records will be made contemporaneously with all determinations described in this section and these records will be maintained with other records we are required to maintain under the 1940 Act.

## MANAGEMENT

Our Board of Directors oversees our management. The responsibilities of the Board of Directors include, among other things, the oversight of our investment activity, the quarterly valuation of our assets, oversight of our financing arrangements and corporate governance activities. The Board of Directors maintains an Executive Committee, Board Investment Review Committee, Audit Committee, Compensation Committee, and Corporate Governance/Nominating Committee, and may establish additional committees from time to time as necessary. 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 at May 30, 2008, is as follows:

Name	Age	Position	Director Since <sup>(1)</sup>	Expiration of Term
<b>Interested Directors</b>				
William L. Walton	58	Chairman, Chief Executive Officer and President	1986	2010
Joan M. Sweeney	48	Chief Operating Officer <sup>(2)</sup>	2004	2010
Robert E. Long	77	Director	1972	2010
<b>Independent Directors</b>				
Ann Torre Bates	50	Director	2003	2009
Brooks H. Browne	58	Director	1990	2010
John D. Firestone	64	Director	1993	2011
Anthony T. Garcia	51	Director	1991	2011
Edwin L. Harper	66	Director	2006	2009
Lawrence I. Hebert	61	Director	1989	2011
John I. Leahy	77	Director	1994	2009
Alex J. Pollock	65	Director	2003	2009
Marc F. Racicot	59	Director	2005	2011
Guy T. Steuart II	76	Director	1984	2009
Laura W. van Roijen	56	Director	1992	2011

<sup>(1)</sup> Includes service as a director of any of the predecessor companies of Allied Capital.

<sup>(2)</sup>

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On April 28, 2008, we announced that Ms. Sweeney intends to retire from the company at the end of 2008. Following her retirement, she will continue to serve on our Board of Directors and is expected to enter into a consulting agreement with us.

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 at May 30, 2008, is as follows:

<b>Name</b>	<b>Age</b>	<b>Position</b>
William L. Walton	58	Chairman, Chief Executive Officer and President
Joan M. Sweeney	48	Chief Operating Officer
Scott S. Binder	53	Chief Valuation Officer
John M. Fruehwirth	40	Managing Director and Deputy Head of Private Finance
Michael J. Grisius	44	Managing Director
Miriam G. Krieger	32	Chief Compliance Officer and Corporate Secretary
Thomas C. Lauer	41	Managing Director
Robert D. Long	51	Managing Director and Head of Asset Management
Justin S. Maccarone	49	Managing Director
Robert M. Monk	41	Managing Director
Diane E. Murphy	54	Executive Vice President and Director of Human Resources
Penni F. Roll	42	Chief Financial Officer
Daniel L. Russell	43	Managing Director
John M. Scheurer	55	Managing Director and Head of Commercial Real Estate Finance
John D. Shulman	45	Managing Director

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 Chairman, President and Chief Executive Officer of Allied Capital since 1997 and a director since 1986. Mr. Walton's previous experience includes serving as a Managing Director of Butler Capital Corporation, as personal investment advisor to William S. Paley, founder of CBS, and as 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 boards of the U.S. Chamber of Commerce, Freedom House, and the Financial Services Roundtable, and he is President of the National Symphony Orchestra.

*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 Asset Management, 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. He has served as a director of Allied Capital or one of its predecessors since 1972. 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 currently serves on the boards of Franklin Mutual Series Funds, the Franklin Mutual Recovery Fund, the Franklin Templeton Funds, 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 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 several non-profit organizations.

*Anthony T. Garcia* has been a private investor since March 2007. Previously, Mr. Garcia was Vice President of Finance of Kirusa, a developer of mobile services, from January to March 2007, and was a private investor from 2003 through 2006. Mr. Garcia was Vice President of Finance of Formity Systems, Inc., a developer of software products for business management of data networks, from 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 Chairman of Dominion Advisory Group, LLC, a provider of anti-money laundering consulting services, and served as Senior Advisor at PNC Bank from 2005 to 2007. He served as 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 Chairman of Integra Health Management, Inc. He is also Trustee Emeritus of the Sellinger School of Business at 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 currently serves as a director of the CME Group, Great Lakes Higher Education Corporation, the Great Books Foundation, the Illinois

Council on Economic Education and the International Union for Housing Finance.

*Marc F. Racicot* has served as President and Chief Executive Officer of the American Insurance Association since 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 from

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, and the Board of Visitors for the University of Montana School of Law.

*Guy T. Steuart II* has been a director 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 1980 to 1990.

***Executive Officers who are not Directors***

*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.

*John M. Fruehwirth*, Managing Director and Deputy Head of Private Finance, has been employed by Allied Capital since 2003. Previously, he worked at Wachovia Securities (previously First Union Securities) 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.

*Michael J. Grisius*, Managing Director, has been employed by Allied Capital 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.

*Miriam G. Krieger*, Chief Compliance Officer and Corporate Secretary, has been employed by Allied Capital since March 2008. Prior to joining Allied Capital, Ms. Krieger served as Senior Vice President and Chief Compliance Officer at MCG Capital Corporation from 2006 to 2008 and Vice President and Assistant General Counsel from 2004 to 2006. From 2001 to 2004, she was an associate in the Financial Services Group of the law firm of Sutherland Asbill & Brennan LLP.

*Thomas C. Lauer*, Managing Director, has been employed by Allied Capital 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 and Head of Asset Management, has been employed by Allied Capital since 2002 and currently manages business development activities. 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 Allied Capital since 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.

*Robert M. Monk*, Managing Director, has been employed by Allied Capital since 1993. Prior to joining Allied Capital, Mr. Monk worked in the leveraged finance group at First Union Securities (currently Wachovia Securities).

*Diane E. Murphy*, Executive Vice President and Director of Human Resources, has been employed by Allied Capital since 2000. Prior to joining Allied Capital, 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 Allied Capital 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 Allied Capital 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 and Head of Commercial Real Estate Finance, has been employed by Allied Capital since 1991. Mr. Scheurer is a former 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 Allied Capital since 2001. Prior to joining Allied Capital, Mr. Shulman served as the President and CEO of Onyx International, LLC, a private equity firm, from 1994 to 2001. He currently serves as a member of the investment committee of Greater China Private Equity Fund.

#### **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. In January 2008, the Board of Directors also established a Board Investment Review Committee. From time to time, the Board may establish special purpose committees to address particular matters on behalf of the Board. 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](http://www.alliedcapital.com) in the Investor Resources section and is also available in print to any stockholder or other interested party who requests a copy.

The following table indicates the current members of the committees of the Board of Directors. All of the directors are independent directors, except for Messrs. Walton and Long, and Ms. Sweeney, who are interested persons as defined in Section 2(a)(19) of the 1940 Act.

<b>Executive Committee</b>	<b>Board Investment Review Committee</b>	<b>Audit Committee</b>	<b>Compensation Committee</b>	<b>Corporate Governance/ Nominating Committee</b>
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