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ALLIED CAPITAL CORP

Form 10-Q

August 10, 2001

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FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

QUARTERLY REPORT PURSUANT TO
SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD
ENDED JUNE 30, 2001
COMMISSION FILE NUMBER:
0-22832

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

MARYLAND
(State or Jurisdiction of
Incorporation or Organization)
52-1081052
(IRS Employer
Identification No.)

1919 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, DC 20006
(Address of Principal Executive Offices)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (202) 331-1112

Indicate by check mark whether the Registrant (1) has filed all reports
required to be filed by Section 12 of 15(d) of the Securities Exchange Act of
1934 during the preceding 12 months (or for such shorter periods as the
Registrant was required to file such reports), and (2) has been subject to such
filing requirements for the past 90 days. YES [X] NO []

On August 9, 2001 there were 92,690,062 shares outstanding of the
Registrant's common stock, \$0.0001 par value.

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ALLIED CAPITAL CORPORATION

FORM 10-Q INDEX

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PART I: FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES CONSOLIDATED BALANCE SHEET

| | JUNE 30, 2001 | DECEMBER 31, 2000 |
|---|------------------|----------------------|
| (IN THOUSANDS, EXCEPT NUMBER OF SHARE AMOUNTS) | (UNAUDITED) | ----- |
| ASSETS | | |
| Portfolio at value: | | |
| Private finance (cost: 2001-\$1,374,096; 2000-\$1,262,529)..... | \$1,405,386 | \$1,282,467 |
| Commercial real estate finance (cost: 2001-\$592,901; 2000-\$503,366)..... | 595,176 | 505,534 |
| Total portfolio at value..... | 2,000,562 | 1,788,001 |
| Cash and cash equivalents..... | 3,433 | 2,449 |
| Other assets..... | 79,839 | 63,367 |
| Total assets..... | \$2,083,834 | \$1,853,817 |
| | ===== | ===== |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |

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|--|-------------|--|-------------|
| Liabilities: | | | |
| Notes payable and debentures..... | \$ 716,314 | | \$ 704,648 |
| Revolving credit facilities..... | 164,750 | | 82,000 |
| Accounts payable and other liabilities..... | 24,109 | | 30,477 |
| | ----- | | ----- |
| Total liabilities..... | 905,173 | | 817,125 |
| | ----- | | ----- |
| Commitments and Contingencies | | | |
| Preferred stock..... | 7,000 | | 7,000 |
| Shareholders' equity: | | | |
| Common stock, \$0.0001 par value, 200,000,000 shares authorized; 91,578,184 and 85,291,696 shares issued and outstanding at June 30, 2001 and December 31, 2000, respectively..... | 9 | | 9 |
| Additional paid-in capital..... | 1,176,587 | | 1,043,653 |
| Common stock held in deferred compensation trust (0 shares and 234,977 shares at June 30, 2001 and December 31, 2000, respectively)..... | -- | | -- |
| Notes receivable from sale of common stock..... | (26,237) | | (25,083) |
| Net unrealized appreciation on portfolio..... | 30,676 | | 19,378 |
| Distributions in excess of earnings..... | (9,374) | | (8,265) |
| | ----- | | ----- |
| Total shareholders' equity..... | 1,171,661 | | 1,029,692 |
| | ----- | | ----- |
| Total liabilities and shareholders' equity..... | \$2,083,834 | | \$1,853,817 |
| | ===== | | ===== |

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES CONSOLIDATED STATEMENT OF OPERATIONS

| | FOR THE THREE MONTHS ENDED JUNE 30, | | FOR THE SIX MONTHS ENDED JUNE 30, | |
|--|---|----------|--------------------------------------|----------|
| | 2001 | 2000 | 2001 | 2000 |
| | (UNAUDITED) | | (UNAUDITED) | |
| (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | | | | |
| Interest and related portfolio income: | | | | |
| Interest and dividends..... | \$58,824 | \$42,986 | \$113,699 | \$81,714 |
| Premiums from loan dispositions..... | 910 | 4,554 | 1,731 | 7,843 |
| Fees and other income..... | 9,005 | 2,425 | 18,380 | 4,305 |
| | ----- | ----- | ----- | ----- |
| Total interest and related portfolio income..... | 68,739 | 49,965 | 133,810 | 93,862 |
| | ----- | ----- | ----- | ----- |
| Expenses: | | | | |
| Interest..... | 15,951 | 14,280 | 31,881 | 26,591 |
| Employee..... | 7,547 | 5,191 | 13,965 | 9,760 |
| Administrative..... | 3,060 | 4,082 | 6,027 | 6,835 |
| | ----- | ----- | ----- | ----- |
| Total operating expenses..... | 26,558 | 23,553 | 51,873 | 43,186 |
| | ----- | ----- | ----- | ----- |

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| | | | | |
|---|----------|----------|-----------|----------|
| Formula and cut-off awards..... | 63 | 1,712 | 91 | 3,403 |
| | ----- | ----- | ----- | ----- |
| Net operating income before net realized and unrealized gains..... | 42,118 | 24,700 | 81,846 | 47,273 |
| | ----- | ----- | ----- | ----- |
| Net realized and unrealized gains: | | | | |
| Net realized gains..... | 3,837 | 12,865 | 4,991 | 15,041 |
| Net unrealized gains..... | 151 | (2,775) | 11,297 | 2,057 |
| | ----- | ----- | ----- | ----- |
| Total net realized and unrealized gains..... | 3,988 | 10,090 | 16,288 | 17,098 |
| | ----- | ----- | ----- | ----- |
| Net increase in net assets resulting from operations..... | \$46,106 | \$34,790 | \$ 98,134 | \$64,371 |
| | ===== | ===== | ===== | ===== |
| Basic earnings per common share..... | \$ 0.52 | \$ 0.50 | \$ 1.12 | \$ 0.94 |
| | ===== | ===== | ===== | ===== |
| Diluted earnings per common share..... | \$ 0.51 | \$ 0.50 | \$ 1.10 | \$ 0.94 |
| | ===== | ===== | ===== | ===== |
| Weighted average common shares outstanding -- basic..... | 89,356 | 69,968 | 87,441 | 68,128 |
| | ===== | ===== | ===== | ===== |
| Weighted average common shares outstanding -- diluted..... | 90,848 | 70,035 | 88,966 | 68,175 |
| | ===== | ===== | ===== | ===== |

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

| | FOR THE SIX MONTHS ENDED JUNE 30, | |
|---|--------------------------------------|-----------|
| | 2001 | 2000 |
| | (UNAUDITED) | |
| (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | | |
| Operations: | | |
| Net operating income before realized and unrealized gains..... | \$ 81,846 | \$ 47,273 |
| Net realized gains..... | 4,991 | 15,041 |
| Net unrealized gains..... | 11,297 | 2,057 |
| | ----- | ----- |
| Net increase in net assets resulting from operations..... | 98,134 | 64,371 |
| | ----- | ----- |
| Shareholder distributions: | | |
| Common stock dividends..... | (87,836) | (63,866) |
| Preferred stock dividends..... | (110) | (110) |
| | ----- | ----- |
| Net decrease in net assets resulting from shareholder distributions..... | (87,946) | (63,976) |
| | ----- | ----- |

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| | | |
|---|-------------|-----------|
| Capital share transactions: | | |
| Sale of common stock..... | 123,262 | 141,954 |
| Issuance of common stock for portfolio investments..... | -- | 1,485 |
| Issuance of common stock upon the exercise of stock options..... | 6,258 | 1,431 |
| Issuance of common stock in lieu of cash distributions..... | 3,415 | 2,420 |
| Net increase in notes receivable from sale of common stock..... | (1,154) | -- |
| Net decrease in common stock held in deferred compensation trust..... | -- | 3,427 |
| Other..... | -- | (572) |
| | ----- | ----- |
| Net increase in net assets resulting from capital share transactions..... | 131,781 | 150,145 |
| | ----- | ----- |
| Total increase in net assets..... | \$ 141,969 | \$150,540 |
| | ===== | ===== |
| Net assets at beginning of period..... | \$1,029,692 | \$667,513 |
| | ----- | ----- |
| Net assets at end of period..... | \$1,171,661 | \$818,053 |
| | ----- | ----- |
| Net asset value per common share..... | \$ 12.79 | \$ 10.96 |
| | ----- | ----- |
| Common shares outstanding at end of period..... | 91,578 | 74,636 |
| | ===== | ===== |

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS

| | | |
|---|--------------------------------------|-----------|
| | FOR THE SIX MONTHS ENDED JUNE 30, | |
| | ----- | ----- |
| | 2001 | 2000 |
| | ----- | ----- |
| (IN THOUSANDS) | (UNAUDITED) | |
| Cash flows from operating activities: | | |
| Net increase in net assets resulting from operations..... | \$ 98,134 | \$ 64,371 |
| Adjustments | | |
| Net unrealized gains..... | (11,297) | (2,057) |
| Depreciation and amortization..... | 479 | 423 |
| Amortization of loan discounts and fees..... | (7,722) | (6,211) |
| Changes in other assets and liabilities..... | (10,455) | (9,484) |
| | ----- | ----- |
| Net cash provided by operating activities..... | 69,139 | 47,042 |
| | ----- | ----- |
| Cash flows from investing activities: | | |
| Portfolio investments..... | (320,409) | (431,600) |
| Repayments of investment principal..... | 44,149 | 58,833 |
| Proceeds from loan sales..... | 74,648 | 117,092 |
| Other investing activities..... | (1,846) | 3,280 |
| | ----- | ----- |

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| | | |
|---|-----------|-----------|
| Net cash used in investing activities..... | (203,458) | (252,395) |
| Cash flows from financing activities: | | |
| Sale of common stock..... | 123,262 | 141,954 |
| Collections of notes receivable from sale of common stock..... | 3,002 | 2,567 |
| Common dividends and distributions paid..... | (84,422) | (61,446) |
| Preferred stock dividends paid..... | (110) | (110) |
| Net borrowings under notes payable and debentures..... | 11,666 | 8,000 |
| Net borrowings under revolving lines of credit..... | 82,750 | 125,500 |
| Other financing activities..... | (845) | (543) |
| Net cash provided by financing activities..... | 135,303 | 215,922 |
| Net increase in cash and cash equivalents..... | \$ 984 | \$ 10,569 |
| Cash and cash equivalents at beginning of period..... | \$ 2,449 | \$ 18,155 |
| Cash and cash equivalents at end of period..... | \$ 3,433 | \$ 28,724 |

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS

| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | JUNE (UN COST |
|---|--|---------------------|
| Ability One Corporation | Loans | \$ 10,30 |
| ACE Products, Inc. | Loans | 14,73 |
| Acme Paging, L.P. | Debt Securities Limited Partnership Interest | 6,98 1,45 |
| Allied Office Products, Inc. | Debt Securities Warrants | 9,39 62 |
| American Barbecue & Grill, Inc. | Warrants | 12 |
| American Home Care Supply, LLC | Debt Securities Warrants | 6,87 57 |
| Aspen Pet Products, Inc. | Loans Series A Preferred Stock (1,860 shares) Series A Common Stock (1,400 shares) | 14,13 1,90 14 |
| ASW Holding Corporation | Warrants | 2 |
| Aurora Communications, LLC | Loans Equity Interest | 15,26 2,46 |

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| | | |
|---|---|-------------------------------|
| Autania AG(1) | Debt Securities Common Stock (250,000 shares) | 4,29 2,14 |
| Avborne, Inc. | Debt Securities Warrants | 12,14 1,18 |
| Bakery Chef, Inc. | Loans | 16,44 |
| Blue Rhino Corporation(1) | Debt Securities Warrants | 13,72 1,20 |
| Border Foods, Inc. | Debt Securities Series A Convertible Preferred Stock (50,919 shares) Warrants | 9,28 2,00 66 |
| Business Loan Express, Inc. | Debt Securities Preferred Stock (25,111 shares) Common Stock (25,503,043 shares) Guaranty (\$51.7 million -- See Note 3) | 68,53 25,11 104,51 - |
| Camden Partners Strategic Fund II, L.P. | Limited Partnership Interest | 89 |
| CampGroup, LLC | Debt Securities Warrants | 2,63 22 |
| Candlewood Hotel Company(1) | Preferred Stock (3,250 shares) | 3,25 |
| Celebrities, Inc. | Loan Warrants | 25 1 |
| Classic Vacation Group, Inc.(1) | Loan | 6,03 |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | JUNE (UN COST |
|---|--|-----------------------|
| Colibri Holding Corporation | Loans Common Stock (3,362 shares) Warrants | \$ 3,45 1,25 29 |
| The Color Factory Inc. | Loan Preferred Stock | 4,43 25 |

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| | | |
|---|---|-------|
| | Common Stock (980 shares) | 6,53 |
| Component Hardware Group, Inc. | Debt Securities | 10,53 |
| | Class A Preferred Stock (18,000 shares) | 1,80 |
| | Common Stock (2,000 shares) | 20 |
| Convenience Corporation of America | Debt Securities | 8,35 |
| | Series A Preferred Stock (31,521 shares) | 33 |
| | Warrants | - |
| Cooper Natural Resources, Inc. | Debt Securities | 3,72 |
| | Warrants | - |
| CorrFlex Graphics, LLC | Loan | 6,96 |
| | Debt Securities | 4,96 |
| | Warrants | - |
| | Options | - |
| Coverall North America, Inc. | Loan | 9,69 |
| | Debt Securities | 5,24 |
| | Warrants | - |
| CPM Acquisition Corp. | Loan | 9,45 |
| Csabai Canning Factory Rt. | Hungarian Quotas (9.2%) | 70 |
| CTT Holdings | Loan | 1,30 |
| CyberRep | Loan | 1,04 |
| | Debt Securities | 11,06 |
| | Warrants | 66 |
| The Debt Exchange Inc. | Series B Convertible Preferred Stock (921,829 shares) | 1,25 |
| Directory Investment Corporation | Common Stock (470 shares) | 10 |
| Directory Lending Corporation | Series A Common Stock (34 shares) | - |
| | Series B Common Stock (6 shares) | - |
| | Series C Common Stock (10 shares) | 2 |
| Drilltec Patents & Technologies Company, Inc. | Loan | 10,91 |
| | Debt Securities | 1,50 |
| | Warrants | - |
| eCentury Capital Partners, L.P. | Limited Partnership Interest | 1,87 |
| EDM Consulting, LLC | Debt Securities | 1,80 |
| | Common Stock (100 shares) | 25 |
| El Dorado Communications, Inc. | Loans | 30 |
| Elexis Beta GmbH | Options | 42 |
| Eparfin S.A. | Loan | 2 |
| Esquire Communications Ltd.(1) | Warrants | - |

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | JUNE (UN ----- COST |
|---|--|------------------------------|
| E-Talk Corporation | Debt Securities Warrants | \$ 8,85 1,15 |
| Executive Greetings, Inc. | Debt Securities Warrants | 15,90 36 |
| ExTerra Credit Recovery, Inc. | Series A Preferred Stock (500 shares) Common Stock (2,500 shares) Warrants | 59 - - |
| Fairchild Industrial Products Company | Debt Securities Warrants | 5,84 28 |
| Galaxy American Communications, Inc. | Debt Securities Options | 43,13 - |
| Garden Ridge Corporation | Debt Securities Preferred Stock (1,130 shares) Common Stock (471 shares) | 26,83 1,13 61 |
| Genesis Worldwide, Inc.(1) | Loan | 1,06 |
| Gibson Guitar Corporation | Debt Securities Warrants | 16,80 52 |
| Ginsey Industries, Inc. | Loans Convertible Debentures Warrants | 5,00 50 - |
| Global Communications, LLC | Debt Securities Equity Interest Options | 12,93 11,06 1,63 |
| Grant Broadcasting Systems II | Warrants | 8 |
| Grant Television, Inc. | Equity Interest | 66 |
| Grotech Partners, VI, L.P. | Limited Partnership Interest | 1,17 |
| The Hartz Mountain Corporation | Debt Securities Common Stock (200,000 shares) Warrants | 27,29 2,00 2,61 |

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| | | |
|------------------------------------|--|-------|
| HealthASPex, Inc. | Series A Convertible Preferred Stock (1,036,700 shares) | 4,14 |
| | Series A Preferred Stock (414,680 shares) | 76 |
| | Common Stock (1,451,380 shares) | |
| ----- | | |
| HMT, Inc. | Debt Securities | 9,96 |
| | Common Stock (300,000 shares) | 3,00 |
| | Warrants | — |
| ----- | | |
| Hotelevision, Inc. | Preferred Stock (315,100 shares) | 31 |
| ----- | | |
| Icon International, Inc. | Class A Common Stock (12,114 shares) | 1,14 |
| | Class C Common Stock (25,707 shares) | 7 |
| ----- | | |
| Impact Innovations Group | Debt Securities | 6,47 |
| | Warrants | 1,67 |
| ----- | | |
| Intellirisk Management Corporation | Loans | 21,87 |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | JUNE (UN ----- COST |
|---|--|------------------------------|
| International Fiber Corporation | Debt Securities | \$ 21,95 |
| | Common Stock (1,029,068 shares) | 5,48 |
| | Warrants | 55 |
| ----- | | |
| iSolve Incorporated | Series A Preferred Stock (14,853 shares) | 87 |
| | Common Stock (13,306 shares) | 1 |
| ----- | | |
| Jakel, Inc. | Loan | 19,66 |
| ----- | | |
| JRI Industries, Inc. | Debt Securities | 1,96 |
| | Warrants | 7 |
| ----- | | |
| Julius Koch USA, Inc. | Debt Securities | 1,68 |
| | Warrants | 25 |
| ----- | | |
| Kirker Enterprises, Inc. | Warrants | 34 |
| | Equity Interest | |
| ----- | | |
| Kirkland's, Inc. | Debt Securities | 7,09 |
| | Preferred Stock (917 shares) | 41 |
| | Warrants | 9 |
| ----- | | |
| Kyrus Corporation | Debt Securities | 7,77 |

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| | Warrants | 34 |
|---------------------------------------|--|----------------|
| Liberty-Pittsburgh Systems, Inc. | Debt Securities Common Stock (64,535 shares) | 4,23 14 |
| The Loewen Group, Inc.(1) | High-Yield Senior Secured Debt | 15,15 |
| Logic Bay Corporation | Preferred Stock (1,131,222 shares) | 5,00 |
| Love Funding Corporation | Series D Preferred Stock (26,000 shares) | 35 |
| Magna Card, Inc. | Debt Securities Preferred Stock (1,875 shares) Common Stock (4,687 shares) | 15 9 - |
| Master Plan, Inc. | Loan Common Stock (156 shares) | 1,20 4 |
| MedAssets.com, Inc. | Series B Convertible Preferred Stock (227,665 shares) Warrants | 2,04 13 |
| Mid-Atlantic Venture Fund IV, L.P. | Limited Partnership Interest | 2,47 |
| Midview Associates, L.P. | Warrants | - |
| Monitoring Solutions, Inc. | Debt Securities Common Stock (33,333 shares) Warrants | 1,82 - - |
| MortgageRamp.com, Inc. | Class A Common Stock (800,000 shares) | 4,00 |
| Morton Grove Pharmaceuticals, Inc. | Loan Redeemable Convertible Preferred Stock (106,947 shares) | 15,74 5,00 |
| MVL Group | Debt Securities Warrants | 14,40 64 |
| NETtel Communications, Inc. | Debt Securities | 13,48 |

(1) Public company.

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

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

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| (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | COST |
|---|--|-------------------------------|
| Nobel Learning Communities, Inc.(1) | Debt Securities Series D Convertible Preferred Stock (265,957 shares) Warrants | \$ 9,61 2,00 57 |
| North American Archery, LLC | Loans Convertible Debentures | 1,39 2,24 |
| Northeast Broadcasting Group, L.P. | Debt Securities | 33 |
| Novak Biddle Venture Fund III, LP | Equity Interest | 15 |
| Nursefinders, Inc. | Debt Securities Warrants | 11,05 90 |
| Onyx Television GmbH | Preferred Units (600,000 shares) | 20 |
| Opinion Research Corporation(1) | Debt Securities Warrants | 14,10 99 |
| Oriental Trading Company, Inc. | Loan Debt Securities Preferred Equity Interest Common Equity Interest Warrants | 12 12,58 1,50 - 1 |
| Outsource Partners, Inc. | Debt Securities Warrants | 23,87 82 |
| Packaging Advantage Corporation | Debt Securities Common Stock (200,000 shares) Warrants | 11,54 2,00 96 |
| Physicians Specialty Corporation | Debt Securities Common Stock (79,567,042 shares) | 39,40 1,00 |
| Pico Products, Inc.(1) | Loan Debt Securities Common Stock (208,000 shares) Warrants | 1,30 4,59 5 - |
| Polaris Pool Systems, Inc. | Debt Securities Warrants | 6,53 1,05 |
| Powell Plant Farms, Inc. | Loan | 16,46 |
| Proeducation GmbH | Loan | 4 |
| Professional Paint, Inc. | Debt Securities Preferred Stock (15,000 shares) Common Stock (110,000 shares) | 20,75 15,00 6 |
| Progressive International Corporation | Debt Securities Preferred Stock (500 shares) Common Stock (197 shares) Warrants | 3,95 50 1 - |
| Raytheon Aerospace LLC | Debt Securities Common LLC Interest | 5,00 - |

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|--------------------|-----------------|------|
| Redox Brands, Inc. | Debt Securities | 9,28 |
| | Warrants | 58 |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | JUNE (UN ----- COST |
|---|---|------------------------------|
| Schwinn Holdings Corporation | Debt Securities | \$ 10,55 |
| | Warrants | 39 |
| Seasonal Expressions, Inc. | Series A Preferred Stock (1,000 shares) | 50 |
| Soff-Cut Holdings, Inc. | Debt Securities | 8,60 |
| | Preferred Stock (300 shares) | 30 |
| | Common Stock (2,000 shares) | 20 |
| | Warrants | 44 |
| Southern Communications, LLC | Equity Interest | 9,77 |
| Southwest PCS, LLC | Loan | 7,93 |
| Spa Lending Corporation | Preferred Stock (28,625 shares) | 50 |
| | Common Stock (6,208 shares) | 2 |
| Staffing Partners Holding Company, Inc. | Debt Securities | 4,99 |
| | Series A Redeemable Preferred Stock (414,600 shares) | 2,07 |
| | Class A1 Common Stock (1,000 shares) | |
| | Class A2 Common Stock (40,000 shares) | 4 |
| | Class B Common Stock (9,200 shares) | |
| | Warrants | 1 |
| Startec Global Communications, Corporation(1) | Debt Securities | 20,73 |
| | Loan | 15,00 |
| | Common Stock (258,064 shares) | 3,00 |
| | Warrants | - |
| Sunsource Inc.(1) | Debt Securities | 29,66 |
| | Loan | 8,50 |
| | Warrants | 45 |

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| | | |
|---------------------------------------|---|-----------------------|
| SunStates Refrigerated Services, Inc. | Loans Debt Securities | 6,06 2,44 |
| Sure-Tel, Inc. | Loan Preferred Stock (1,116,902 shares) Warrants Options | 20 4,60 66 - |
| Sydran Food Services II, L.P. | Debt Securities | 12,97 |
| Total Foam, Inc. | Debt Securities Common Stock (910 shares) | 26 1 |
| Tubbs Snowshoe Company, LLC | Debt Securities Warrants Equity Interests | 3,90 5 50 |
| United Pet Group, Inc. | Debt Securities Warrants | 4,96 1 |
| Update Venture Partners, II, L.P. | Limited Partnership Interest | 1,90 |
| Velocita, Inc. | Debt Securities Warrants | 11,60 3,54 |
| Venturehouse Group, LLC | Common Equity Interest | 66 |
| Walker Investment Fund II, LLLP | Limited Partnership Interest | 1,00 |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | JUNE (UN COST |
|---|-----------------------------|---------------------|
| Warn Industries, Inc. | Debt Securities Warrants | \$ 18,63 1,42 |
| Williams Brothers Lumber Company | Warrants | 2 |
| Wilmar Industries, Inc. | Debt Securities Warrants | 32,30 3,16 |
| Wilshire Restaurant Group, Inc. | Debt Securities Warrants | 15,34 - |

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| | | |
|---|------------------------------|------------|
| Wilton Industries, Inc. | Loan | 12,83 |
| Woodstream Corporation | Debt Securities | 7,61 |
| | Equity Interests | 1,70 |
| | Warrants | 45 |
| Wyo-Tech Acquisition Corporation | Debt Securities | 12,57 |
| | Preferred Stock (100 shares) | 3,70 |
| | Common Stock (99 shares) | 10 |
| Total private finance (128 investments) | | \$1,374,09 |

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

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

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| (IN THOUSANDS, EXCEPT NUMBER OF LOANS) | INTEREST RATE RANGES | NUMBER OF LOANS | JUNE 30, 2001 (UNAUDITED) | |
|--|----------------------|-----------------|------------------------------|----------|
| | | | COST | VALUE |
| COMMERCIAL REAL ESTATE FINANCE | | | | |
| Commercial Mortgage Loans | Up to 6.99% | 3 | \$ 894 | \$ 2,593 |
| | 7.00%- 8.99% | 15 | 32,171 | 34,271 |
| | 9.00%-10.99% | 28 | 23,859 | 23,816 |
| | 11.00%-12.99% | 18 | 14,121 | 13,884 |
| | 13.00%-14.99% | 9 | 13,204 | 13,178 |
| | 15.00% and above | 2 | 92 | 68 |
| Total commercial mortgage loans | | 75 | \$84,341 | \$87,810 |

| | STATED INTEREST | FACE | | | |
|--|-----------------|-----------|----|--------|-----------|
| Purchased CMBS | | | | | |
| Mortgage Capital Funding, Series 1998-MC3 | 5.5% | \$ 54,491 | \$ | 26,427 | \$ 26,427 |
| Morgan Stanley Capital I, Series 1999-RM1 | 6.4% | 51,046 | | 21,574 | 21,574 |
| COMM 1999-1 | 5.6% | 74,879 | | 34,889 | 34,888 |
| Morgan Stanley Capital I, Series 1999-FNV1 | 6.1% | 45,536 | | 22,201 | 22,200 |
| DLJ Commercial Mortgage Trust 1999-CG2 | 6.1% | 96,432 | | 44,776 | 44,777 |
| Commercial Mortgage Acceptance Corp., Series | | | | | |

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| | | | | |
|---|------|-----------|-------------|-------------|
| 1999-C1 | 6.8% | 34,856 | 16,444 | 16,444 |
| LB Commercial Mortgage Trust, Series 1999-C2 | 6.7% | 29,005 | 11,161 | 11,161 |
| Chase Commercial Mortgage Securities Corp., Series 1999-2 | 6.5% | 43,046 | 20,702 | 20,702 |
| FUNB CMT, Series 1999-C4 | 6.5% | 49,287 | 22,472 | 22,622 |
| Heller Financial, HFCMC Series 2000 PH-1 | 6.6% | 45,456 | 18,853 | 18,853 |
| SBMS VII, Inc., Series 2000-NL1 | 7.2% | 24,230 | 13,290 | 13,290 |
| DLJ Commercial Mortgage Trust, Series 2000-CF1 | 7.0% | 40,502 | 19,393 | 19,393 |
| Deutsche Bank Alex. Brown, Series Comm 2000-C1 | 6.9% | 41,084 | 19,376 | 19,376 |
| LB-UBS Commercial Mortgage Trust, Series 2000-C4 | 6.9% | 31,471 | 11,562 | 11,562 |
| Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1 | 5.9% | 58,786 | 28,936 | 28,936 |
| Crest 2001-1, Ltd. (collateralized debt obligation) | 0.0% | 24,625 | 24,914 | 24,914 |
| JP Morgan-CIBC-Deutsche 2001 | 5.8% | 60,889 | 29,487 | 29,487 |
| Lehman Brothers-UBS Warburg 2001-C4 | 6.4% | 80,434 | 43,834 | 43,834 |
| Total purchased CMBS | | \$886,055 | \$ 430,291 | \$ 430,422 |
| Residual CMBS | | | \$ 72,850 | \$ 72,850 |
| Residual Interest Spread | | | 2,324 | 2,022 |
| Real Estate Owned | | | 3,095 | 2,062 |
| Total commercial real estate finance | | | \$ 592,901 | \$ 595,172 |
| Total portfolio | | | \$1,966,997 | \$2,000,562 |

(1) Public company.

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

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS

| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | DECEMBER COST |
|---|---|------------------|
| Ability One Corporation | Loans | \$ 9,972 |
| ACE Products, Inc. | Loans | 14,272 |
| Acme Paging, L.P. | Debt Securities Limited Partnership Interest | 6,982 1,452 |
| Allied Office Products, Inc. | Debt Securities Warrants | 9,362 622 |

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| | | |
|---|---|--------------------------|
| American Barbecue & Grill, Inc. | Warrants | 12 |
| American Home Care Supply, LLC | Debt Securities Warrants | 6,85 57 |
| Aspen Pet Products, Inc. | Loans Series A Preferred Stock (1,860 shares) Series A Common Stock (1,400 shares) | 13,86 1,86 14 |
| ASW Holding Corporation | Warrants | 2 |
| Aurora Communications, LLC | Loans Equity Interest | 14,41 1,50 |
| Avborne, Inc. | Debt Securities Warrants | 12,25 1,18 |
| Bakery Chef, Inc. | Loans | 15,89 |
| Border Foods, Inc. | Debt Securities Series A Convertible Preferred Stock (50,919 shares) Warrants | 9,90 2,00 - |
| Business Loan Express, Inc. | Debt Securities Preferred Stock (25,111 shares) Common Stock (25,503,043 shares) | 74,46 25,11 104,50 |
| Camden Partners Strategic Fund II, L.P. | Limited Partnership Interest | 61 |
| CampGroup, LLC | Debt Securities Warrants | 2,57 22 |
| Candlewood Hotel Company(1) | Preferred Stock (3,250 shares) | 3,25 |
| Celebrities, Inc. | Loan Warrants | 27 1 |
| Classic Vacation Group, Inc.(1) | Debt Securities | 5,68 |
| Colibri Holding Corporation | Loans Common Stock (3,362 shares) Warrants | 3,43 1,25 29 |
| Component Hardware Group | Debt Securities Class A Preferred Stock (18,000 shares) Common Stock (2,000 shares) | 10,30 1,80 20 |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | DECEMBER COST |
|---|--|------------------------|
| Convenience Corporation of America | Debt Securities Series A Preferred Stock (31,521 shares) Warrants | \$ 8,35 33 - |
| Cooper Natural Resources, Inc. | Debt Securities Warrants | 3,42 - |
| CorrFlex Graphics, LLC | Loan Debt Securities Warrants Options | 6,95 4,95 - - |
| Cosmetic Manufacturing Resources, LLC | Loan Debt Securities Options | 12 5,84 8 |
| Coverall North America, Inc. | Loan Debt Securities Warrants | 9,69 4,96 - |
| Csabai Canning Factory Rt. | Hungarian Quotas (9.2%) | 70 |
| CTT Holdings | Loan | 1,22 |
| CyberRep | Loan Debt Securities Warrants | 94 10,29 66 |
| Directory Investment Corporation | Common Stock (470 shares) | 10 |
| Directory Lending Corporation | Series A Common Stock (34 shares) Series B Common Stock (6 shares) Series C Common Stock (10 shares) | - - 2 |
| Drilltec Patents & Technologies Company, Inc. | Loan Debt Securities Warrants | 10,91 1,50 - |
| eCentury Capital Partners, L.P. | Limited Partnership Interest | 1,87 |
| EDM Consulting, LLC | Debt Securities Common Stock (100 shares) | 1,87 25 |
| El Dorado Communications, Inc. | Loans | 30 |
| Elexis Beta GmbH | Options | 42 |
| Eparfin S.A. | Loan | 2 |
| Esquire Communications Ltd.(1) | Warrants | - |
| E-Talk Corporation | Debt Securities Warrants | 8,80 1,15 |

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| | | |
|--|--|--------------|
| Ex Terra Credit Recovery, Inc. | Series A Preferred Stock (500 shares) Common Stock (2,500 shares) Warrants | 59 — — |
| Executive Greetings, Inc. | Debt Securities Warrants | 15,88 36 |
| Fairchild Industrial Products Company | Debt Securities Warrants | 5,81 28 |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | DECEMBER COST |
|---|--|------------------------|
| FTI Consulting, Inc. (1) | Warrants | \$ 97 |
| Galaxy American Communications, Inc. | Debt Securities Warrants | 33,39 50 |
| Garden Ridge Corporation | Debt Securities Preferred Stock (1,130 shares) Common Stock (471 shares) | 26,53 1,13 61 |
| Genesis Worldwide, Inc. (1) | Loan | 1,06 |
| Gibson Guitar Corporation | Debt Securities Warrants | 16,44 52 |
| Ginsey Industries, Inc. | Loans Convertible Debentures Warrants | 5,00 50 — |
| Global Communications, LLC | Debt Securities Equity Interest Options | 12,73 10,46 1,63 |
| Grant Broadcasting Systems II | Warrants | 8 |
| Grant Television, Inc. | Equity Interest | 66 |
| Grotech Partners, VI, L.P. | Limited Partnership Interest | 86 |
| The Hartz Mountain Corporation | Debt Securities Common Stock (200,000 shares) | 27,16 2,00 |

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| | Warrants | 2,61 |
|------------------------------------|--|-------|
| HealthASPex, Inc. | Series A Convertible Preferred Stock (396,908 shares) | 1,34 |
| | Series A Preferred Stock (225,112 shares) | 76 |
| | Common Stock (1,036,700 shares) | - |
| HMT, Inc. | Debt Securities | 9,95 |
| | Common Stock (300,000 shares) | 3,00 |
| | Warrants | - |
| Hotelevision, Inc. | Preferred Stock (315,100 shares) | 31 |
| Icon International, Inc. | Class A Common Stock (12,114 shares) | 1,14 |
| | Class C Common Stock (25,707 shares) | 7 |
| Impact Innovations Group | Debt Securities | 6,36 |
| | Warrants | 1,67 |
| Intellirisk Management Corporation | Loans | 21,44 |
| International Fiber Corporation | Debt Securities | 21,62 |
| | Common Stock (1,029,068 shares) | 5,48 |
| | Warrants | 55 |
| iSolve Incorporated | Series A Preferred Stock (14,853 shares) | 87 |
| | Common Stock (13,306 shares) | 1 |
| Jakel, Inc. | Loan | 19,23 |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | DECEMBER COST |
|---|-----------------|------------------|
| JRI Industries, Inc. | Debt Securities | \$ 1,95 |
| | Warrants | 7 |
| Julius Koch USA, Inc. | Debt Securities | 2,29 |
| | Warrants | 25 |
| Kirker Enterprises, Inc. | Warrants | 34 |
| | Equity Interest | |

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| | | |
|--|---|--------------------|
| Kirkland's, Inc. | Debt Securities Preferred Stock (917 shares) Warrants | 6,34 41 9 |
| Kyrus Corporation | Debt Securities Warrants | 7,73 34 |
| Liberty-Pittsburgh Systems, Inc. | Debt Securities Common Stock (64,535 shares) | 3,47 14 |
| The Loewen Group, Inc.(1) | High-Yield Senior Secured Debt | 15,15 |
| Logic Bay Corporation | Preferred Stock (1,131,222 shares) | 5,00 |
| Love Funding Corporation | Series D Preferred Stock (26,000 shares) | 35 |
| Master Plan, Inc. | Loan Common Stock (156 shares) | 2,00 4 |
| MedAssets.com, Inc. | Series B Convertible Preferred Stock (227,665 shares) Warrants | 2,04 13 |
| Mid-Atlantic Venture Fund IV, L.P. | Limited Partnership Interest | 2,47 |
| Midview Associates, L.P. | Warrants | - |
| Monitoring Solutions, Inc. | Debt Securities Common Stock (33,333 shares) Warrants | 1,82 - |
| MortgageRamp.com, Inc. | Class A Common Stock (800,000 shares) | 4,00 |
| Morton Grove Pharmaceuticals, Inc. | Loan Redeemable Convertible Preferred Stock (106,947 shares) | 15,35 5,00 |
| MVL Group | Debt Securities Warrants | 14,12 64 |
| NETtel Communications, Inc. | Debt Securities | 13,47 |
| Nobel Learning Communities, Inc.(1) | Debt Securities Series D Convertible Preferred Stock (265,957 shares) Warrants | 9,57 2,00 57 |
| North American Archery, LLC | Loans Convertible Debentures | 1,39 2,24 |
| Northeast Broadcasting Group, L.P. | Debt Securities | 34 |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | DECEMBER ----- COST |
|---|---|-------------------------------|
| Nursefinders, Inc. | Debt Securities Warrants | \$ 11,00 90 |
| Old Mill Holdings, Inc. | Debt Securities | 14 |
| Onyx Television GmbH | Common Stock (600,000 shares) | 20 |
| Opinion Research Corporation(1) | Debt Securities Warrants | 14,03 99 |
| Oriental Trading Company, Inc. | Debt Securities Loan Preferred Equity Interest Common Equity Interest Warrants | 12,45 12 1,48 1 - |
| Outsource Partners, Inc. | Debt Securities Warrants | 23,85 82 |
| Packaging Advantage Corporation | Debt Securities Common Stock (200,000 shares) Warrants | 11,49 2,00 96 |
| Physicians Specialty Corporation | Debt Securities Redeemable Preferred Stock (850 shares) Convertible Preferred Stock (97,411 shares) Warrants | 14,80 85 15 47 |
| Pico Products, Inc.(1) | Loan Debt Securities Common Stock (208,000 shares) Warrants | 1,30 4,59 5 - |
| Polaris Pool Systems, Inc. | Debt Securities Warrants | 6,48 1,05 |
| Powell Plant Farms, Inc. | Loan | 15,70 |
| Proeducation GmbH | Loan | 4 |
| Professional Paint, Inc. | Debt Securities Preferred Stock (15,000 shares) Common Stock (110,000 shares) | 20,00 15,00 6 |
| Progressive International Corporation | Debt Securities Preferred Stock (500 shares) Common Stock (197 shares) | 3,94 50 1 |

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| | Warrants | |
|------------------------------|---|-------|
| Schwinn Holdings Corporation | Debt Securities | 10,36 |
| | Warrants | 39 |
| Seasonal Expressions, Inc. | Series A Preferred Stock (1,000 shares) | 50 |
| Soff-Cut Holdings, Inc. | Debt Securities | 8,45 |
| | Preferred Stock (300 shares) | 30 |
| | Common Stock (2,000 shares) | 20 |
| | Warrants | 44 |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | DECEMBER COST |
|---|--|------------------------|
| Southern Communications, LLC | Equity Interest | \$ 9,77 |
| Southwest PCS, LLC | Loan | 7,50 |
| Southwest PCS, L.P. | Debt Securities | 6,51 |
| Spa Lending Corporation | Preferred Stock (28,625 shares) Common Stock (6,208 shares) | 54 2 |
| Staffing Partners Holding Company, Inc. | Debt Securities Series A Redeemable Preferred Stock (414,600 shares) Class A1 Common Stock (1,000 shares) Class A2 Common Stock (40,000 shares) Class B Common Stock (9,200 shares) Warrants | 4,99 2,07 4 1 |
| Startec Global Communications, Corporation(1) | Debt Securities Common Stock (258,064 shares) Warrants | 20,20 3,00 - |
| Sunsource Inc.(1) | Debt Securities Warrants | 29,85 - |
| SunStates Refrigerated Services, Inc. | Loans Debt Securities | 6,06 2,44 |

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| | | |
|----------------------------------|------------------------------------|-------|
| Sure-Tel, Inc. | Loan | 20 |
| | Preferred Stock (1,116,902 shares) | 4,55 |
| | Warrants | 66 |
| | Options | - |
| ----- | | |
| Sydran Food Services II, L.P. | Debt Securities | 12,97 |
| ----- | | |
| Total Foam, Inc. | Debt Securities | 26 |
| | Common Stock (910 shares) | 1 |
| ----- | | |
| Tubbs Snowshoe Company, LLC | Debt Securities | 3,89 |
| | Warrants | 5 |
| | Equity Interests | 50 |
| ----- | | |
| United Pet Group | Debt Securities | 4,95 |
| | Warrants | 1 |
| ----- | | |
| Velocita, Inc. | Debt Securities | 11,53 |
| | Warrants | 3,54 |
| ----- | | |
| Venturehouse Group, LLC | Common Equity Interest | 33 |
| ----- | | |
| Walker Investment Fund II, LLLP | Limited Partnership Interest | 80 |
| ----- | | |
| Warn Industries, Inc. | Debt Securities | 19,33 |
| | Warrants | 1,42 |
| ----- | | |
| Williams Brothers Lumber Company | Warrants | 2 |
| ----- | | |
| Wilmar Industries, Inc. | Debt Securities | 31,72 |
| | Warrants | 3,16 |
| ----- | | |
| Wilshire Restaurant Group, Inc. | Debt Securities | 15,19 |
| | Warrants | - |
| ----- | | |

(1) Public company.

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

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

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| PRIVATE FINANCE PORTFOLIO COMPANY (IN THOUSANDS, EXCEPT NUMBER OF SHARES) | INVESTMENT (2) | DECEMBER COST |
|---|------------------|------------------|
| ----- | | ----- |
| Wilton Industries, Inc. | Loan | \$ 12,83 |
| ----- | | |
| Woodstream Corporation | Debt Securities | 7,59 |
| | Equity Interests | 1,70 |
| | Warrants | 45 |

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| | | |
|---|------------------------------|------------|
| Wyo-Tech Acquisition Corporation | Debt Securities | 15,67 |
| | Preferred Stock (100 shares) | 3,70 |
| | Common Stock (99 shares) | 10 |
| Total private finance (122 investments) | | \$1,262,52 |

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

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

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| (IN THOUSANDS, EXCEPT NUMBER OF LOANS) | INTEREST RATE RANGES | NUMBER OF LOANS | DECEMBER 31, 2000 | |
|--|----------------------|-----------------|-------------------|-----------|
| | | | COST | VALUE |
| COMMERCIAL REAL ESTATE FINANCE | | | | |
| Commercial Mortgage Loans | Up to 6.99% | 3 | \$ 882 | \$ 2,582 |
| | 7.00%- 8.99% | 13 | 30,032 | 32,132 |
| | 9.00%-10.99% | 17 | 22,302 | 22,190 |
| | 11.00%-12.99% | 38 | 35,250 | 35,042 |
| | 13.00%-14.99% | 12 | 14,391 | 14,391 |
| | 15.00% and above | 2 | 100 | 76 |
| Total commercial mortgage loans | | 85 | \$102,957 | \$106,413 |

| | STATED INTEREST | FACE | | | |
|---|-----------------|-----------|-----------|-----------|-----------|
| Purchased CMBS | | | | | |
| Mortgage Capital Funding, Series 1998-MC3 | 5.5% | \$ 54,491 | \$ 25,681 | \$ 25,681 | \$ 25,681 |
| Morgan Stanley Capital I, Series 1999-RM1 | 6.4% | 59,640 | 27,429 | 27,429 | 27,429 |
| COMM 1999-1 | 5.6% | 74,879 | 34,352 | 34,352 | 34,352 |
| Morgan Stanley Capital I, Series 1999-FNV1 | 6.1% | 45,536 | 21,972 | 21,972 | 21,972 |
| DLJ Commercial Mortgage Trust 1999-CG2 | 6.1% | 96,432 | 44,332 | 44,332 | 44,332 |
| Commercial Mortgage Acceptance Corp., Series 1999-C1 | 6.8% | 34,856 | 16,397 | 16,397 | 16,397 |
| LB Commercial Mortgage Trust, Series 1999-C2 | 6.7% | 29,005 | 10,910 | 10,910 | 10,910 |
| Chase Commercial Mortgage Securities Corp., Series 1999-2 | 6.5% | 43,046 | 20,552 | 20,552 | 20,552 |
| FUNB CMT, Series 1999-C4 | 6.5% | 49,287 | 22,515 | 22,515 | 22,515 |
| Heller Financial, HFCMC Series 2000 PH-1 | 6.6% | 45,456 | 19,039 | 19,039 | 19,039 |
| SBMS VII, Inc., Series 2000-NL1 | 7.2% | 30,079 | 17,820 | 17,820 | 18,000 |

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| | | | | |
|--|------|-----------|-------------|-------------|
| DLJ Commercial Mortgage Trust, Series 2000-CF1 | 7.0% | 40,502 | 19,166 | 19,166 |
| Deutsche Bank Alex. Brown, Series Comm 2000-C1 | 6.9% | 41,084 | 19,170 | 19,170 |
| LB-UBS Commercial Mortgage Trust, Series 2000-C4 | 6.9% | 31,471 | 11,552 | 11,552 |
| ----- | | | | |
| Total purchased CMBS | | \$675,764 | \$ 310,887 | \$ 311,320 |
| ----- | | | | |
| Residual CMBS | | | \$ 78,723 | \$ 78,723 |
| Residual Interest Spread | | | 3,297 | 2,997 |
| Real Estate Owned | | | 7,502 | 6,080 |
| ----- | | | | |
| Total commercial real estate finance | | | \$ 503,366 | \$ 505,530 |
| ----- | | | | |
| Total portfolio | | | \$1,765,895 | \$1,788,000 |
| ----- | | | | |

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

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION

Allied Capital Corporation, a Maryland corporation, is a closed-end management investment company that has elected to be regulated as a business development company ("BDC") under the Investment Company Act of 1940 ("1940 Act"). Allied Capital Corporation ("ACC") has a wholly owned subsidiary that has also elected to be regulated as a BDC. Allied Investment Corporation ("Allied Investment") is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company ("SBIC"). In April 2001, ACC established a consolidated wholly owned subsidiary, A.C. Corporation ("AC Corp."), which provides consulting, structuring and diligence services on private finance and commercial real estate transactions, as well as consulting, structuring and management services to existing portfolio companies. In addition, the Company has a real estate investment trust subsidiary, Allied Capital REIT, Inc. ("Allied REIT") and several single-member limited liability companies established primarily to hold real estate properties.

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

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company invests in private and undervalued public companies in a variety of different industries and in diverse geographic locations.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

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The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries that make investments or are operating companies that provide services to the Company. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2000 balances to conform with the 2001 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with generally accepted accounting principles ("GAAP") for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of and for the six months ended June 30, 2001 and 2000 and the results of operations, changes in net assets, and cash flows for these periods. The results of operations for the six months ended June 30, 2001 are not necessarily indicative of the operating results to be expected for the full year.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

NOTE 3. PORTFOLIO

PRIVATE FINANCE

At June 30, 2001 and December 31, 2000, the private finance portfolio consisted of the following:

| (\$ IN THOUSANDS) | 2001 | | | 2000 | | |
|------------------------------|-------------|-------------|-------|-------------|-------------|-------|
| | COST | VALUE | YIELD | COST | VALUE | YIELD |
| Loans and debt securities... | \$1,076,659 | \$1,044,541 | 14.6% | \$ 983,887 | \$ 966,257 | 14.6% |
| Equity interests..... | 297,437 | 360,845 | | 278,642 | 316,210 | |
| Total..... | \$1,374,096 | \$1,405,386 | | \$1,262,529 | \$1,282,467 | |

Private finance investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a nominal price.

Debt securities typically have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary.

Equity interests consist primarily of securities issued by privately owned companies and may be subject to restrictions on their resale or may be otherwise illiquid. Equity securities generally do not produce a current return, but are held for investment appreciation and ultimate gain on sale.

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At June 30, 2001 and December 31, 2000, equity interests include the Company's common stock and preferred stock investment in Business Loan Express, Inc. ("BLX") of \$120,015,000 and \$25,111,000 and \$104,504,000 and \$25,111,000 at value, respectively. During the first quarter of 2001, BLX secured a 3-year \$117.5 million unsecured revolving credit facility. As the controlling shareholder of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest and other fees) of BLX on the line of credit. The amount guaranteed by the Company at June 30, 2001 was \$51.7 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at June 30, 2001. In consideration for providing this guaranty, BLX will pay the Company an annual guaranty fee of \$2.9 million.

At June 30, 2001 and December 31, 2000, approximately 98% of the Company's private finance loan portfolio was composed of fixed interest rate loans. At June 30, 2001 and December 31, 2000, loans and debt securities with a value of \$81,330,000 and \$72,966,000, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

NOTE 3. PORTFOLIO, CONTINUED

The geographic and industry compositions of the private finance portfolio at value at June 30, 2001 and December 31, 2000 were as follows:

| | 2001 | 2000 |
|---------------------------|------|------|
| | ---- | ---- |
| GEOGRAPHIC REGION | | |
| Mid-Atlantic..... | 41% | 43% |
| Midwest..... | 21 | 18 |
| West..... | 16 | 17 |
| Southeast..... | 15 | 12 |
| Northeast..... | 6 | 8 |
| International..... | 1 | 2 |
| | --- | --- |
| Total..... | 100% | 100% |
| | === | === |
| INDUSTRY | | |
| Consumer Products..... | 27% | 26% |
| Business Services..... | 23 | 24 |
| Financial Services..... | 15 | 16 |
| Industrial Products..... | 9 | 9 |
| Retail..... | 5 | 5 |
| Broadcasting & Cable..... | 5 | 5 |
| Telecommunications..... | 5 | 6 |
| Education..... | 3 | 3 |
| Other..... | 8 | 6 |
| | --- | --- |
| Total..... | 100% | 100% |
| | === | === |

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COMMERCIAL REAL ESTATE FINANCE

At June 30, 2001 and December 31, 2000, the commercial real estate finance portfolio consisted of the following:

| (\$ IN THOUSANDS) | 2001 | | | 2000 | | |
|-------------------|-----------|-----------|-------|-----------|-----------|-------|
| | COST | VALUE | YIELD | COST | VALUE | YIELD |
| Loans..... | \$ 84,341 | \$ 87,810 | 8.2% | \$102,957 | \$106,413 | 9.1% |
| CMBS..... | 505,465 | 505,297 | 14.6% | 392,907 | 393,040 | 14.2% |
| REO..... | 3,095 | 2,069 | | 7,502 | 6,081 | |
| | ----- | ----- | | ----- | ----- | |
| Total..... | \$592,901 | \$595,176 | | \$503,366 | \$505,534 | |

LOANS

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

At June 30, 2001 and December 31, 2000, approximately 78% and 22% and 69% and 31% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

NOTE 3. PORTFOLIO, CONTINUED

loans, respectively. As of June 30, 2001 and December 31, 2000, loans with a value of \$11,350,000 and \$14,433,000, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

In December 2000, the Company purchased commercial mortgage loans with a face amount of \$6.5 million for \$5.5 million from Business Mortgage Investors, Inc., a company managed by ACC.

The geographic composition and the property types securing the commercial mortgage loan portfolio at value at June 30, 2001 and December 31, 2000 were as follows:

| | 2001 | 2000 |
|-------------------|------|------|
| GEOGRAPHIC REGION | | |
| Southeast..... | 37% | 39% |
| Northeast..... | 21 | 5 |
| Midwest..... | 20 | 14 |
| Mid-Atlantic..... | 12 | 22 |
| West..... | 10 | 20 |
| | ---- | ---- |
| Total..... | 100% | 100% |

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| | === | === |
|------------------|------|------|
| PROPERTY TYPE | | |
| Hospitality..... | 34% | 28% |
| Retail..... | 25 | 19 |
| Office..... | 22 | 30 |
| Recreation..... | 4 | 9 |
| Other..... | 15 | 14 |
| | --- | --- |
| Total..... | 100% | 100% |
| | === | === |

CMBS

At June 30, 2001 and December 31, 2000, the CMBS portfolio consisted of the following:

| | 2001 | | 2000 | |
|-------------------------------|-----------|-----------|-----------|-----------|
| | COST | VALUE | COST | VALUE |
| (IN THOUSANDS) | | | | |
| Purchased CMBS..... | \$430,291 | \$430,423 | \$310,887 | \$311,320 |
| Residual CMBS..... | 72,850 | 72,850 | 78,723 | 78,723 |
| Residual interest spread..... | 2,324 | 2,024 | 3,297 | 2,997 |
| | ----- | ----- | ----- | ----- |
| Total..... | \$505,465 | \$505,297 | \$392,907 | \$393,040 |
| | ===== | ===== | ===== | ===== |

PURCHASED CMBS The Company has Purchased CMBS bonds with a face amount of \$886,055,000 and a cost of \$430,291,000, with the difference representing original issue discount. As of June 30, 2001 and December 31, 2000, the estimated yield to maturity on the Purchased CMBS was approximately 15.4%. The Company's yield on its Purchased CMBS is based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples include the timing and magnitude of credit losses on the mortgage loans

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

NOTE 3. PORTFOLIO, CONTINUED

underlying the Purchased CMBS that are a result of the general condition of the real estate market (including competition for tenants and their related credit quality) and changes in market rental rates. At June 30, 2001 and December 31, 2000, the yield on the Purchased CMBS portfolio was computed assuming a 1% loss estimate for its entire underlying collateral mortgage pool. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

The non-investment grade and unrated tranches of the Purchased CMBS bonds are junior in priority for payment of principal to the more senior tranches of the related commercial securitization. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow

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is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, the subordinate tranche will bear this loss first.

The Company entered into one short sale contract with a financial institution as part of a strategy to manage interest rate risk with respect to certain CMBS bonds. The Company used the short sale for hedging and risk management only and not for speculative purposes. At June 30, 2001, the fair value of the contract was a loss of \$95,000. The fair value of this contract has been reflected in net unrealized gains. The Company held no derivative financial instruments at December 31, 2000.

The underlying rating classes of the Purchased CMBS are as follows:

| (\$ IN THOUSANDS) | JUNE 30, 2001 | | DECEMBER 31, 2000 | |
|-------------------|---------------|------------------------|-------------------|------------------------|
| | VALUE | PERCENTAGE OF TOTAL | VALUE | PERCENTAGE OF TOTAL |
| BB+..... | \$ 6,074 | 1.4% | \$ -- | --% |
| BB..... | 30,624 | 7.1 | 8,472 | 2.7 |
| BB-..... | 49,006 | 11.4 | 37,061 | 11.9 |
| B+..... | 77,968 | 18.1 | 59,827 | 19.3 |
| B..... | 108,344 | 25.2 | 89,999 | 28.9 |
| B-..... | 63,704 | 14.8 | 56,665 | 18.2 |
| CCC..... | 8,846 | 2.1 | 7,857 | 2.5 |
| Unrated..... | 85,857 | 19.9 | 51,439 | 16.5 |
| | ----- | ----- | ----- | ----- |
| Total..... | \$430,423 | 100.0% | \$311,320 | 100.0% |
| | ===== | ===== | ===== | ===== |

RESIDUAL CMBS AND RESIDUAL INTEREST SPREAD. The Residual CMBS primarily consists of a retained interest from a post-Merger asset securitization whereby bonds were sold in three classes rated "AAA," "AA" and "A."

The Company sold \$295 million of loans, and received cash proceeds, net of costs, of approximately \$223 million. The Company retained a trust certificate for its residual interest in the loan pool sold, and will receive interest income from this Residual CMBS as well as the Residual Interest Spread from the interest earned on the loans sold less the interest paid on the bonds over the life of the bonds.

NOTE 3. PORTFOLIO, CONTINUED

As a result of this securitization, the Company recorded a gain of \$14.8 million, which represents the difference between the cost basis of the assets sold and the fair value of the assets received, net of the costs of the securitization and the cost of settlement of interest rate swaps. As of June 30, 2001 and December 31, 2000, the mortgage loan pool had an approximate weighted average stated interest rate of 9.3%. The three bond classes sold had an aggregate weighted average interest rate of 6.6% as of June 30, 2001, and 6.5%

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as of December 31, 2000.

The Company uses a discounted cash flow methodology for determining the value of its retained Residual CMBS and Residual Interest Spread ("Residual"). In determining the cash flow of the Residual, the Company assumes a prepayment speed of 15% after the applicable prepayment lockout period and credit losses of 1% of the total principal balance of the underlying collateral throughout the life of the collateral. The value of the resulting Residual cash flows is then determined by applying a discount rate of 9% which, in the Company's view, is commensurate with the market's perception of risk of comparable assets.

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

| | 2001 | 2000 |
|-------------------|------|------|
| | ---- | ---- |
| GEOGRAPHIC REGION | | |
| West..... | 31% | 31% |
| Mid-Atlantic..... | 24 | 23 |
| Midwest..... | 21 | 22 |
| Southeast..... | 18 | 19 |
| Northeast..... | 6 | 5 |
| | --- | --- |
| Total..... | 100% | 100% |
| | === | === |
| PROPERTY TYPE | | |
| Retail..... | 32% | 32% |
| Housing..... | 28 | 30 |
| Office..... | 24 | 21 |
| Hospitality..... | 8 | 8 |
| Other..... | 8 | 9 |
| | --- | --- |
| Total..... | 100% | 100% |
| | === | === |

SMALL BUSINESS FINANCE

The Company, through its wholly owned subsidiary, Allied SBLC, participated in the SBA's Section 7(a) Guaranteed Loan Program ("7(a) loans"). As discussed in Note 1, Allied SBLC is no longer a consolidated subsidiary of the Company at December 31, 2000. As a result, the Company's small business portfolio had no balance at and after December 31, 2000.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

NOTE 4. DEBT

At June 30, 2001 and December 31, 2000, the Company had the following debt:

| 2001 | 2000 |
|-------|-------|
| ----- | ----- |

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| (IN THOUSANDS) | FACILITY AMOUNT | AMOUNT DRAWN | FACILITY AMOUNT | AMOUNT DRAWN |
|--|--------------------|-----------------|--------------------|-----------------|
| | ----- | ----- | ----- | ----- |
| Notes payable and debentures: | | | | |
| Unsecured long-term notes payable..... | \$ 544,000 | \$544,000 | \$ 544,000 | \$544,000 |
| SBA debentures..... | 101,800 | 87,000 | 87,350 | 78,350 |
| Auction rate reset note..... | 79,614 | 79,614 | 76,598 | 76,598 |
| OPIC loan..... | 5,700 | 5,700 | 5,700 | 5,700 |
| | ----- | ----- | ----- | ----- |
| Total notes payable and debentures..... | 731,114 | 716,314 | 713,648 | 704,648 |
| | ----- | ----- | ----- | ----- |
| Revolving credit facilities: | | | | |
| Revolving line of credit..... | 417,500 | 164,750 | 417,500 | 82,000 |
| Master loan and security agreement..... | -- | -- | -- | -- |
| | ----- | ----- | ----- | ----- |
| Total revolving credit facilities... | 417,500 | 164,750 | 417,500 | 82,000 |
| | ----- | ----- | ----- | ----- |
| Total..... | \$1,148,614 | \$881,064 | \$1,131,148 | \$786,648 |
| | ===== | ===== | ===== | ===== |

NOTES PAYABLE AND DEBENTURES

UNSECURED LONG-TERM NOTES PAYABLE. In June 1998, May 1999, November 1999 and October 2000, the Company issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have terms of five or seven years. The weighted average interest rate on the notes was 7.8% at June 30, 2001 and December 31, 2000. The notes may be prepaid in whole or in part together with an interest premium, as stipulated in the note agreement.

SBA DEBENTURES. At June 30, 2001 and December 31, 2000, the Company had debentures payable to the SBA with terms of ten years and at fixed interest rates ranging from 4.3% to 9.1%. The weighted average interest rate was 6.9% and 7.6% at June 30, 2001 and December 31, 2000, respectively. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to maturity.

AUCTION RATE RESET NOTE. The Company has a \$79,614,000 Auction Rate Reset Senior Note Series A that matures on December 2, 2002 and bears interest at the three-month London Interbank Offer Rate ("LIBOR") plus 1.75%, which adjusts quarterly. Interest is due quarterly and the Company, at its option, may pay or defer and capitalize such interest payments. The amount outstanding on the note will increase as interest due is deferred and capitalized.

As a means to repay the note, the Company has entered into an agreement to issue \$79,614,000 of debt, equity or other securities in one or more public or private transactions, or prepay the Auction Rate Reset Note, on or before August 31, 2002. If the note is prepaid, the Company will pay a fee equal to 0.5% of the aggregate amount of the note outstanding.

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Scheduled future maturities of notes payable and debentures at June 30, 2001 are as follows:

| YEAR ---- | AMOUNT MATURING ----- (IN THOUSANDS) |
|-----------------|--|
| 2001..... | \$ -- |
| 2002..... | 79,614 |
| 2003..... | 140,000 |
| 2004..... | 221,000 |
| 2005..... | 179,000 |
| Thereafter..... | 96,700 |
| | ----- |
| Total..... | \$716,314 ===== |

REVOLVING CREDIT FACILITIES

REVOLVING LINE OF CREDIT. At June 30, 2001, the Company has an unsecured revolving line of credit for \$417,500,000. The facility may be expanded up to \$500,000,000. At the Company's option, the facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The interest rate adjusts at the beginning of each new interest period, usually every thirty days. The interest rates were 5.2% and 7.9% at June 30, 2001 and December 31, 2000, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The line expires in March 2002. The line of credit requires monthly interest payments and all principal is due upon its expiration.

On August 3, 2001, the Company increased the capacity on the revolving line of credit to \$467,500,000, which may be expanded up to \$600,000,000, and extended the maturity to August 2003, with the right to extend the maturity for one additional year at the Company's sole option, under substantially similar terms.

MASTER LOAN AND SECURITY AGREEMENT. The Company had a facility to borrow up to \$100,000,000, using certain commercial mortgage loans as collateral. The agreement charged interest at the one-month LIBOR plus 1.0%, adjusted daily. The agreement matured on October 27, 2000 and was not renewed.

The average debt outstanding on the revolving credit facilities was \$89,043,000 and \$154,853,000 for the six months ended June 30, 2001 and for the year ended December 31, 2000, respectively. The maximum amount borrowed under these facilities and the weighted average interest rate for the six months ended June 30, 2001 and for the year ended December 31, 2000, were \$181,500,000 and \$257,000,000, and 6.4% and 7.6%, respectively.

NOTE 5. PREFERRED STOCK

Allied Investment has outstanding a total of 60,000 shares of \$100 par value, 3% cumulative preferred stock and 10,000 shares of \$100 par value, 4% redeemable cumulative preferred stock issued to the SBA pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended. The 3% cumulative preferred stock does not have a required redemption date. Allied Investment has the option to redeem in whole or in part the preferred stock by paying the SBA the par value of such

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

NOTE 5. PREFERRED STOCK, CONTINUED

securities and any dividends accumulated and unpaid to the date of redemption. The 4% redeemable cumulative preferred stock has a required redemption date in June 2005.

NOTE 6. SHAREHOLDERS' EQUITY

Sales of common stock for the six months ended June 30, 2001, and the year ended December 31, 2000 were as follows:

| (IN THOUSANDS) | 2001 ----- | 2000 ----- |
|---|---------------|---------------|
| Number of common shares..... | 5,824 | 14,812 |
| Gross proceeds..... | \$130,139 | \$263,460 |
| Less costs including underwriting fees..... | (6,877) | (12,548) |
| | ----- | ----- |
| Net proceeds..... | \$123,262 | \$250,912 |
| | ===== | ===== |

In addition, the Company issued 4,123,407 shares of common stock to acquire BLC Financial Services, Inc. in a stock-for-stock exchange on December 31, 2000 for proceeds of \$86,076,000.

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

Dividend reinvestment plan activity for the six months ended June 30, 2001 and for the year ended December 31, 2000 was as follows:

| (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | 2001 ----- | 2000 ----- |
|--|---------------|---------------|
| Shares issued..... | 148 | 254 |
| Average price per share..... | \$23.08 | \$18.79 |

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

NOTE 7. EARNINGS PER COMMON SHARE

Earnings per common share for the six months ended June 30, 2001 and 2000

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were as follows:

| | FOR THE SIX MONTHS ENDED JUNE 30, | |
|---|--------------------------------------|----------|
| (IN THOUSANDS EXCEPT PER SHARE AMOUNTS) | 2001 | 2000 |
| Net increase in net assets resulting from operations..... | \$98,134 | \$64,371 |
| Less preferred stock dividends..... | (110) | (110) |
| | \$98,024 | \$64,261 |
| Income available to common shareholders..... | 87,441 | 68,128 |
| Basic shares outstanding..... | 1,525 | 47 |
| | 88,966 | 68,175 |
| Diluted shares outstanding..... | \$ 1.12 | \$ 0.94 |
| BASIC EARNINGS PER COMMON SHARE..... | \$ 1.10 | \$ 0.94 |
| DILUTED EARNINGS PER COMMON SHARE..... | | |

NOTE 8. CUT-OFF AWARD AND FORMULA AWARD

The Predecessor Companies' existing stock option plans were canceled and the Company established a cut-off dollar amount for all existing, but unvested options as of the date of the Merger (the "Cut-off Award"). The Cut-off Award was computed for each unvested option as of the Merger date. The Cut-off Award was equal to the difference between the market price on August 14, 1997 (the Merger announcement date) of the shares of stock underlying the option less the exercise price of the option. The Cut-off Award was payable for each unvested option upon the future vesting date of that option. The Cut-off Award was designed to cap the appreciated value in unvested options at the Merger announcement date, in order to set the foundation to balance option awards upon the Merger. The Cut-off Award approximated \$2.9 million in the aggregate and has been expensed as the Cut-off Award vests. For the six months ended June 30, 2001 and for the year ended December 31, 2000, \$91,000 and \$535,000, respectively, of the Cut-off Award vested.

The Formula Award was established to compensate employees from the point when their unvested options would cease to appreciate in value (the Merger announcement date), up until the time at which they would be able to receive option awards in ACC post-merger. In the aggregate, the Formula Award equaled 6% of the difference between an amount equal to the combined aggregated market capitalizations of the Predecessor Companies as of the close of the market on the day before the Merger date (December 30, 1997), less an amount equal to the combined aggregate market capitalizations of Allied Lending and the Predecessor Companies as of the close of the market on the Merger announcement date. Advisers' compensation committee allocated the Formula Award to individual officers on December 30, 1997. The amount of the Formula Award as computed at December 30, 1997 was \$18,994,000. This amount was contributed to the Company's deferred compensation trust and was used to purchase shares of the Company's stock (included in common stock held in deferred compensation trust). The Formula Award vested equally in three installments on December 31, 1998, 1999 and 2000. The Formula Award has been expensed in each year in which it vested. For the year ended December 31, 2000, \$5,648,000, was expensed as a result of the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

NOTE 8. CUT-OFF AWARD AND FORMULA AWARD, CONTINUED

Formula Award. At December 31, 2000, the liability related to the Formula Award was \$5,648,000, and has been included in common stock held in deferred compensation trust. Vested Formula Awards have been distributed to recipients by the Company, however, sale of the Company's stock by the recipients is restricted. Unvested Formula Awards were forfeited upon a recipient's separation from service and the related Company stock was retired. During 2000, \$563,000, of the Formula Award was forfeited.

NOTE 9. DIVIDENDS AND DISTRIBUTIONS

The Company's Board of Directors declared and the Company paid a \$0.99 per common share dividend or \$87,836,000 for the six months ended June 30, 2001.

ITEM 2.

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

The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included herein and in the Company's annual report on Form 10-K. This Management's Discussion and Analysis contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives, loan portfolio growth and availability of funds. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth below in the Investment Considerations section. Other factors that could cause actual results to differ materially include the uncertainties of economic, competitive and market conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond the control of the Company. Although the Company believes that the assumptions underlying the forward-looking statements included herein are reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurance that the forward-looking statements included herein will prove to be accurate. Therefore, the inclusion of such information should not be regarded as a representation by the Company or any other person that the objectives and plans of the Company will be achieved.

OVERVIEW

The Company provides private investment capital to private and undervalued public companies in a variety of different industries and in diverse geographic locations. Our lending and investment activity is focused in private finance and commercial real estate finance, primarily the purchase of commercial mortgage-backed securities.

The Company's portfolio composition at June 30, 2001, and December 31, 2000 was as follows:

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| | AT JUNE 30, 2001 | AT DECEMBER 31, 2000 |
|-------------------------------------|------------------------|----------------------------|
| | ----- | ----- |
| Private Finance..... | 70% | 72% |
| Commercial Real Estate Finance..... | 30% | 28% |
| Small Business Finance..... | --% | --% |

The Company's earnings depend primarily on the level of interest and related portfolio income and net realized and unrealized gains earned on the Company's investment portfolio after deducting interest paid on borrowed capital and operating expenses. Interest income results from the stated interest rate earned on a loan and the amortization of loan origination points and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield on the interest-bearing portfolio. The Company's ability to generate interest income is dependent on economic, regulatory and competitive factors that influence interest rates and loan originations, and the Company's ability to secure financing for its investment activities.

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PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields as of and for the three and six months ended June 30, 2001 and 2000 and as of and for the year ended December 31, 2000 were as follows:

| (\$ IN MILLIONS) | AT AND FOR THE THREE MONTHS ENDED JUNE 30, | | AT AND FOR THE SIX MONTHS ENDED JUNE 30, | | AT AND FOR THE YEAR ENDED DECEMBER 31, 2000 |
|-------------------------|--|-----------|--|-----------|---|
| | 2001 | 2000 | 2001 | 2000 | ----- |
| | ----- | ----- | ----- | ----- | ----- |
| Portfolio at Value..... | \$2,000.6 | \$1,488.3 | \$2,000.6 | \$1,488.3 | \$1,788.0 |
| Investments Funded..... | \$ 149.3 | \$ 184.0 | \$ 300.1 | \$ 402.3 | \$ 901.5 |
| Repayments..... | \$ 14.4 | \$ 5.3 | \$ 44.1 | \$ 58.8 | \$ 154.1 |
| Sales..... | \$ 39.5 | \$ 77.5 | \$ 74.6 | \$ 117.1 | \$ 280.2 |
| Yield..... | 14.2% | 13.6% | 14.2% | 13.6% | 14.1% |

PRIVATE FINANCE

Private finance investment activity and yields as of and for the three and six months ended June 30, 2001 and 2000 and as of and for the year ended December 31, 2000 were as follows:

| | AT AND FOR THE THREE MONTHS ENDED JUNE 30, | | AT AND FOR THE SIX MONTHS ENDED JUNE 30, | | AT AND FOR THE YEAR ENDED DECEMBER 31, 2000 |
|--|--|-------|--|-------|---|
| | 2001 | 2000 | 2001 | 2000 | ----- |
| | ----- | ----- | ----- | ----- | ----- |

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| (\$ IN MILLIONS) | ----- | ----- | ----- | ----- | ----- |
|-------------------------|-----------|---------|-----------|---------|-----------|
| Portfolio at Value..... | \$1,405.4 | \$871.6 | \$1,405.4 | \$871.6 | \$1,282.5 |
| Investments Funded..... | \$ 93.5 | \$126.4 | \$ 114.1 | \$239.0 | \$ 600.9 |
| Repayments..... | \$ 6.9 | \$ 2.4 | \$ 24.0 | \$ 39.2 | \$ 117.7 |
| Yield..... | 14.6% | 14.5% | 14.6% | 14.5% | 14.6% |

The private finance portfolio increased 10% from December 31, 2000 to June 30, 2001, and increased 98% during the year ended December 31, 2000. Buyout and private finance activity across the industry slowed during the first half of 2001 largely due to credit tightening among senior lenders. Equity-focused buyout firms generally need both senior and subordinated debt to leverage private equity investments, and during the first half of 2001, activity in the senior bank market, and in particular the senior syndicated loan market, has been slow. As a result, the Company's investment activity for the six months ended June 30, 2001 has been at a slower pace than the comparable period for the prior year.

During the second quarter, the Company announced that it intends to acquire SunSource Inc. to create a privately owned portfolio company controlled by the Company. The two companies have signed a definitive merger agreement, which provides that the Company will pay approximately \$72 million, or \$10.375 per SunSource common share, in cash for all of the outstanding common equity of SunSource. Management of SunSource will participate with the Company in the buyout transaction and will retain an approximate 6% ownership position on a fully diluted basis in the newly created portfolio company. It is anticipated that this transaction will close by September 30, 2001. SunSource is an existing portfolio company, and during the second quarter of 2001 the Company increased its investment in SunSource by purchasing a subordinated note for \$8.5 million from a third party.

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The Company's increasing capital base has enabled it to make larger private finance investments, supporting the increase in originations in 2000. Key investment characteristics for new private finance mezzanine investments were as follows:

FOR THE YEAR
ENDED
DECEMBER 31, 2000

| | |
|---|---------|
| New investment characteristics: | |
| Number of investments..... | 34 |
| Average investment size (millions)..... | \$ 14.0 |
| Average current yield..... | 14.7% |
| Average portfolio company revenue (millions)..... | \$153.5 |
| Average portfolio company years in business..... | 36 |

The average investment characteristics above are computed using simple averages based upon underwriting data for investment activity for that year. As a result, any one investment may have had individual investment characteristics that may vary significantly from the stated simple average. In addition, average investment characteristics may vary from year to year.

The current yield on the private finance portfolio will fluctuate over time

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depending on the equity "kicker" or warrants received with each debt financing. Private finance investments are generally structured such that equity kickers may provide an additional future investment return of up to 10%.

During 2000, the Company acquired BLC Financial Services, Inc. in a going private transaction, and the Company's investment in BLX is included in the private finance portfolio. See "Small Business Finance" discussion for more details below.

During the second quarter of 2000, the Company began an initiative to invest in and strategically partner with select private equity funds focused on venture capital investments. The strategy for these fund investments is to provide solid investment returns and build strategic relationships with the fund managers and their portfolio companies. The Company believes that it will have opportunities to co-invest with the funds as well as finance their portfolio companies as they mature.

The Company believes that the fund investment strategy is an effective means of participating in private equity investing through a diverse pooled investment portfolio. The fund concept allows the Company to participate in a pooled investment return without exposure to the risk of any single investment. Since the beginning of 2000, the Company has committed a total of \$44.5 million to eight private equity funds. The committed amount is expected to be invested over the next three years. The Company funded \$1.5 million, \$3.1 million and \$7.0 million of this commitment for the three and six months ended June 30, 2001 and for the year ended December 31, 2000, respectively.

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COMMERCIAL REAL ESTATE FINANCE

Commercial real estate finance investment activity and yields as of and for the three and six months ended June 30, 2001 and 2000 and as of and for the year ended December 31, 2000 were as follows:

| (\$ IN MILLIONS) | AT AND FOR THE THREE MONTHS ENDED JUNE 30, | | AT AND FOR THE SIX MONTHS ENDED JUNE 30, | | AT Y DE |
|-------------------------|--|---------|--|---------|---------------|
| | 2001 | 2000 | 2001 | 2000 | --- |
| Portfolio at Value..... | \$595.2 | \$548.8 | \$595.2 | \$548.8 | |
| Investments Funded..... | \$ 55.8 | \$ 27.2 | \$186.0 | \$ 91.1 | |
| Repayments..... | \$ 7.5 | \$ 1.3 | \$ 20.1 | \$ 14.3 | |
| Sales..... | \$ 39.4 | \$ 38.0 | \$ 74.6 | \$ 51.5 | |
| Yield..... | 13.6% | 13.0% | 13.6% | 13.0% | |

The commercial real estate finance portfolio increased 18% from December 31, 2000 to June 30, 2001, and decreased 3% for the year ended December 31, 2000. During 1998, the Company reduced its commercial mortgage loan origination activity for its own portfolio due to declining interest rates and began to sell its loans to other lenders. Then, beginning in the fourth quarter of 1998, the Company began to take advantage of a unique market opportunity to acquire non-investment grade commercial mortgage-backed securities ("CMBS") at significant discounts from the face amount of the bonds. Turmoil in the capital markets at that time created a lack of liquidity for the traditional buyers of non-investment grade bonds. As a result, yields on these collateralized bonds

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increased, thus providing an attractive investment opportunity. The Company believes that CMBS is an attractive asset class because of the yields that can be earned on a security that is fully secured by commercial mortgage loans. The Company has opportunistically purchased CMBS since the fourth quarter of 1998. The Company plans to continue its CMBS investment activity, however, in order to maintain a balanced portfolio the Company expects that purchased CMBS will continue to represent approximately 20% to 25% of total assets during 2001. The Company's CMBS investment activity level will be dependent upon its ability to purchase CMBS at attractive yields.

The Company purchases CMBS at an approximate discount of 50% from the face amount of the bonds. During the second quarter of 2001, the Company purchased \$54.9 million in CMBS with a face value of \$95.6 million and a weighted average yield to maturity of 14.9% after assuming a 1% loss rate on the underlying collateral mortgage pool. During the six months ended June 30, 2001 the Company purchased \$159.3 million in CMBS with a face value of \$277.9 million. In addition, the Company purchased \$24.6 million in non-investment grade securities related to a collateralized debt issuance secured by CMBS and investment grade real estate investment trust bonds. The weighted average yield to maturity on purchases made during the first six months of 2001 is 15.6% after assuming a 1% loss rate on the underlying collateral mortgage pool. During 2000, the Company purchased \$124.3 million in CMBS with a face amount of \$244.6 million and a weighted average yield to maturity of 14.7% after assuming a 1% loss rate on the underlying collateral mortgage pool.

As a part of the Company's strategy to maximize its return on equity capital, the Company sold CMBS bonds rated BB+, BB and BB- during the second quarter of 2001, the first six months of 2001 and the fourth quarter of 2000 totaling \$33.7 million, \$68.9 million and \$98.7 million, respectively. These bonds had an effective yield of 10.0%, 10.2% and 11.5%, and were sold for \$34.0 million, \$70.1 million and \$102.5 million, respectively, resulting in a realized gain on the sale. The sale of these lower-yielding bonds increased the Company's overall liquidity. The effective yield on the Company's remaining purchased CMBS portfolio at June 30, 2001 was 15.4%, after assuming a 1% loss on the entire underlying mortgage loan pool. At June 30, 2001 and December 31, 2000, the

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value of the purchased CMBS portfolio was \$430.4 million and \$311.3 million and the unamortized discount was \$455.8 million and \$364.9 million, respectively.

The original principal balance of the underlying pool of the approximately 3,000 loans that are collateral for the Company's CMBS had underwritten loan to value ("LTV") and underwritten debt service coverage ratios ("DSCR") as follows:

| LOAN TO VALUE RANGES | \$ | % |
|-----------------------|------------------|------|
| | (\$ IN MILLIONS) | |
| Less than 60%..... | \$ 1,847.1 | 12% |
| 60-65%..... | 1,330.3 | 8% |
| 65-70%..... | 2,645.4 | 17% |
| 70-75%..... | 5,262.3 | 33% |
| 75-80%..... | 4,695.5 | 29% |
| Greater than 80%..... | 208.1 | 1% |
| | \$15,988.7 | 100% |
| | ===== | ==== |

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Weighted average LTV..... 69.6%

| DEBT SERVICE COVERAGE RATIO RANGES | \$ | % |
|---------------------------------------|---------------------|------|
| ----- | ----- | --- |
| | (\$ IN MILLIONS) | |
| Greater than 2.00..... | \$ 510.1 | 3% |
| 1.76-2.00..... | 487.1 | 3% |
| 1.51-1.75..... | 1,848.6 | 12% |
| 1.26-1.50..... | 9,090.1 | 57% |
| 1.00-1.25..... | 4,052.8 | 25% |
| | ----- | --- |
| | \$15,988.7 | 100% |
| | ===== | === |
| Weighted average DSCR..... | 1.41 | |

The Company has been liquidating much of its whole commercial mortgage loan portfolio so that it can redeploy the proceeds into higher yielding assets and for the three and six months ended June 30, 2001, the Company sold \$5.8 million of commercial mortgage loans. For the year ended December 31, 2000, the Company sold \$53.1 million of commercial mortgage loans. At June 30, 2001, the Company's whole commercial real estate loan portfolio had been reduced to \$87.8 million from \$106.4 million at December 31, 2000.

SMALL BUSINESS FINANCE

On December 31, 2000, the Company acquired 95% of BLC Financial Services, Inc. in a "going private" buyout transaction for \$95.2 million. The Company issued approximately 4.1 million shares, or \$86.1 million of new equity, and paid \$9.1 million in cash to acquire BLC. The new portfolio company has changed its name to Business Loan Express, Inc. ("BLX").

As part of the transaction, the Company recapitalized its Allied Capital Express operations as an independently managed private portfolio company and merged it into BLX. As part of the recapitalization, the Company contributed certain assets, including the online rules-based underwriting technology and fixed assets, and transferred 37 employees into the private portfolio company. Upon completion of the transaction, the Company's investment in BLX totaled \$204.1 million and consisted of \$74.5 million of 25% subordinated debt, \$25.1 million of preferred stock, and \$104.5 million of common stock. BLX is included in the private finance portfolio.

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During the first quarter of 2001, BLX secured a 3-year \$117.5 million revolving credit facility ("BLX Credit Facility"). As the controlling shareholder of BLX, the Company has provided an unconditional guaranty to the BLX Credit Facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest and other fees) of BLX on the line of credit. The amount guaranteed by the Company at June 30, 2001 was \$51.7 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the BLX Credit Facility at June 30, 2001.

Prior to its contribution to BLX, Allied Capital Express loan activity and

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yields as of and for the year ended December 31, 2000 were as follows:

| (\$ IN MILLIONS) | 2000 |
|-------------------------|---------|
| ----- | ----- |
| Portfolio at Value..... | \$ -- |
| New Investments..... | \$151.6 |
| Repayments..... | \$ 11.6 |
| Sales..... | \$128.5 |
| Yield..... | -- |

Allied Capital Express loan origination activity for 2000 increased due to the opening of new regional office locations and from opportunities created by the Company's Internet site launched in the fall of 1999. Loans in the Allied Capital Express program were originated for sale; therefore, the increase in loan sales was the result of the increase in originations. In addition, beginning in 1999, the Company began to sell 90% of the unguaranteed portion of SBA 7(a) loans through a structured finance agreement with a commercial paper conduit. Allied Capital Express targeted small commercial real estate loans that were, in many cases, originated in conjunction with SBA 7(a) loans. SBA 7(a) loans were originated with variable interest rates priced at spreads ranging from 1.75% to 2.75% over the prime lending rate.

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RESULTS OF OPERATIONS

COMPARISON OF SIX MONTHS ENDED JUNE 30, 2001 AND 2000

The following table summarizes Allied Capital's operating results for the six months ended June 30, 2001 and 2000.

| (\$ IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | FOR THE SIX MONTHS ENDED JUNE 30, | | | PERCENT CHANGE |
|---|--------------------------------------|----------|-----------|-------------------|
| | 2001 | 2000 | CHANGE | |
| | ----- | ----- | ----- | ----- |
| INTEREST AND RELATED PORTFOLIO INCOME | | | | |
| Interest and dividends..... | \$113,699 | \$81,714 | \$ 31,985 | 39% |
| Premiums from loan dispositions..... | 1,731 | 7,843 | (6,112) | (78)% |
| Fees and other income..... | 18,380 | 4,305 | 14,075 | 327% |
| | ----- | ----- | ----- | ----- |
| Total interest and related portfolio income..... | 133,810 | 93,862 | 39,948 | 43% |
| | ----- | ----- | ----- | ----- |
| EXPENSES | | | | |
| Interest..... | 31,881 | 26,591 | 5,290 | 20% |
| Employee..... | 13,965 | 9,760 | 4,205 | 43% |
| Administrative..... | 6,027 | 6,835 | (808) | (12)% |
| | ----- | ----- | ----- | ----- |
| Total operating expenses..... | 51,873 | 43,186 | 8,687 | 20% |
| | ----- | ----- | ----- | ----- |
| Formula and cut-off awards..... | 91 | 3,403 | (3,312) | (97)% |
| | ----- | ----- | ----- | ----- |

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| | | | | |
|--|-----------|----------|-----------|-------|
| Net operating income before net realized and unrealized gains..... | 81,846 | 47,273 | 34,573 | 73% |
| | ----- | ----- | ----- | --- |
| NET REALIZED AND UNREALIZED GAINS | | | | |
| Net realized gains..... | 4,991 | 15,041 | (10,050) | (67)% |
| Net unrealized gains..... | 11,297 | 2,057 | 9,240 | 449% |
| | ----- | ----- | ----- | --- |
| Total net realized and unrealized gains..... | 16,288 | 17,098 | (810) | (5)% |
| | ----- | ----- | ----- | --- |
| Net increase in net assets resulting from operations..... | \$ 98,134 | \$64,371 | \$ 33,763 | 52% |
| | ===== | ===== | ===== | === |
| Diluted net operating income per share..... | \$ 0.92 | \$ 0.69 | \$ 0.23 | 33% |
| | ===== | ===== | ===== | === |
| Diluted earnings per share..... | \$ 1.10 | \$ 0.94 | \$ 0.16 | 17% |
| | ===== | ===== | ===== | === |
| Weighted average shares outstanding -- diluted..... | 88,966 | 68,175 | 20,791 | 30% |

Net increase in net assets resulting from operations (NIA) results from total interest and related portfolio income earned, less total expenses incurred in the operations of the Company, plus net realized and unrealized gains or losses.

Total interest and related portfolio income is primarily a function of the level of interest income earned and the balance of portfolio assets. In addition, total interest and related portfolio income

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includes dividend income, premiums from loan dispositions, prepayment premiums, and fees and other income.

| | | |
|--|---|--------|
| | FOR THE SIX MONTHS ENDED JUNE 30, | |
| | ----- | ----- |
| | 2001 | 2000 |
| | ----- | ----- |
| (\$ IN MILLIONS, EXCEPT PER SHARE AMOUNTS) | | |
| Total Interest and Related Portfolio Income..... | \$133.8 | \$93.9 |
| Per share..... | \$ 1.50 | \$1.38 |

The increase in interest income earned results primarily from continued growth of the Company's investment portfolio and the Company's focus on increasing its overall portfolio yield. The Company's investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 20% to \$1,639.7 million at June 30, 2001 from \$1,361.1 million at June 30, 2000. The weighted average yield on the interest bearing investments in the portfolio at June 30, 2001 and 2000 was as follows:

| | | |
|--|----------|-------|
| | JUNE 30, | |
| | ----- | ----- |
| | 2001 | 2000 |
| | ----- | ----- |

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| | | |
|-------------------------------------|-------|-------|
| Private Finance..... | 14.6% | 14.5% |
| Commercial Real Estate Finance..... | 13.6% | 13.0% |
| Small Business Finance..... | --% | 12.3% |
| Total Portfolio..... | 14.2% | 13.6% |

Included in net premiums from loan dispositions are premiums from loan sales and premiums received on the early repayment of loans. Premiums from loan sales were \$0.7 million and \$5.8 million for the six months ended June 30, 2001 and 2000, respectively. Premium income results from the premium paid by purchasers on loans sold less the origination commissions associated with the loans sold. For the six months ended June 30, 2000, premiums from loan sales resulted primarily from the sale of loans originated through Allied Capital Express. Upon the merger of the Allied Capital Express operations into BLX, the premium from loan sales earned historically is intended to be replaced with interest income earned by the Company from its subordinated debt investment in BLX as well as fees earned from its guaranty of the BLX Credit Facility and its management contract with BLX.

Prepayment premiums were \$1.0 million and \$2.0 million for the six months ended June 30, 2001 and 2000, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for the Company's borrowers to refinance or pay off their debts to the Company ahead of schedule. Because the Company seeks to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, the Company generally structures its loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income include diligence, financial structuring, management and guaranty fees of \$15.8 million for the six months ended June 30, 2001. The Company continues to emphasize new financial structuring, diligence and portfolio management activity that generates additional fee income. Because individual fees for any one activity can vary in size, fee income may vary from quarter to quarter.

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Operating expenses include interest, employee and administrative expenses. The Company's single largest expense is interest on indebtedness. The fluctuations in interest expense during the six months ended June 30, 2001 and 2000 are attributable to changes in the level of borrowings by the Company and its subsidiaries under various notes payable and debentures and revolving credit facilities. The Company's borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

| | AT AND FOR THE SIX MONTHS ENDED JUNE 30, | |
|-------------------------------|---|---------------|
| | ----- 2001 | 2000 ----- |
| (\$ IN MILLIONS) | ----- | ----- |
| Total Outstanding Debt..... | \$881.1 | \$726.4 |
| Average Outstanding Debt..... | \$801.3 | \$659.0 |
| Weighted Average Cost..... | 7.4% | 8.1% |

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BDC Asset Coverage*..... 247% 225%

 * As a BDC, the Company is generally required to maintain a ratio of 200% of total assets to total borrowings.

Employee expenses include salaries and employee benefits. The increase in salaries and employee benefits for the periods presented reflects wage increases and the experience level of employees hired. Total employees were 101 and 129 at June 30, 2001 and 2000, respectively. As part of the recapitalization of Allied Capital Express discussed above, employees of the Company were transferred to the portfolio company at the end of 2000. Expenses related to employees dedicated to Allied Capital Express are reflected in employee expense for the six months ended June 30, 2000.

Administrative expenses include the leases for the Company's headquarters in Washington, DC, and its regional offices, travel costs, stock record expenses, directors' fees, legal and accounting fees and various other expenses. Administrative expenses for the six months ended June 30, 2000 included expenses related to Allied Capital Express regional offices. The cost of these regional offices was transferred to BLX at the beginning of 2001. For the six months ended June 30, 2001 and 2000, employee and administrative costs as a percentage of total interest and related portfolio income less interest expense plus net realized and unrealized gains was 17% and 20%, respectively.

The formula and cut-off awards totaled \$3.4 million, or \$0.05 per share, for the six months ended June 30, 2000. The formula award vested over a three-year period which ended on December 31, 2000.

Net realized gains resulted from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early

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repayment of private finance loans, commercial mortgage loans and Purchased CMBS bonds, offset by losses on investments. Realized gains and losses were as follows:

| | FOR THE SIX MONTHS ENDED JUNE 30, | |
|---------------------------|---|---------------|
| | ----- 2001 | 2000 ----- |
| (\$ IN MILLIONS) | ----- | ----- |
| Realized Gains..... | \$ 6.6 | \$15.9 |
| Realized Losses..... | (1.6) | (0.9) |
| | ----- | ----- |
| Net Realized Gains..... | \$ 5.0 | \$15.0 |
| | ===== | ===== |
| Net Unrealized Gains..... | \$11.3 | \$ 2.1 |
| | ===== | ===== |

Realized gains for the six months ended June 30, 2001 primarily resulted from transactions involving two portfolio companies, Southwest PCS, LLC (\$0.8 million) and FTI Consulting, Inc. (\$4.6 million), and the sale of Purchased CMBS

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BB bonds (\$0.9 million). Realized gains for the six months ended June 30, 2000 resulted primarily from transactions involving five portfolio companies. The Company reversed previously recorded unrealized appreciation totaling \$4.0 million and \$3.7 million when these gains were realized for the six months ended June 30, 2001 and 2000, respectively.

Realized losses for the six months ended June 30, 2001 and 2000 resulted from the continued liquidation of the Company's whole loan commercial real estate portfolio, as well as other small losses in the private finance portfolio. The Company reversed previously recorded unrealized depreciation totaling \$2.2 million and \$0.7 million when the related losses were realized in the six months ended June 30, 2001 and 2000, respectively.

Net unrealized gains for the three months ended June 30, 2001 and 2000 consisted of valuation changes resulting from the Board of Directors' valuation of the Company's assets and the effect of reversals of unrealized appreciation or depreciation resulting from realized gains or losses.

The Company increased the value of its equity investment in BLX by \$15.5 million at March 31, 2001. During the first quarter, BLX secured a 3-year \$117.5 million revolving credit facility and completed a \$65 million securitization of unguaranteed SBA 7(a) loans. As a result of the elimination of the refinancing risk that existed at the time of the merger, and BLX's progress in merger integration, the Company increased the value of its equity investment. The Company also increased the value of its investment in Wyo-Tech Acquisition Corporation by \$8.8 million at March 31, 2001, due to its continued growth and positive performance. In addition to BLX and Wyo-Tech, the Company increased the value of other portfolio companies by \$9.9 million in total for the six months ended June 30, 2001. These companies increased in value because of continued positive performance, and valuation data that would indicate that a valuation increase was necessary.

The Company decreased the value of its common equity investment in Startec Global Communications Corporation by \$3.0 million and the value of its debt investment in NETtel Communications, Inc. by \$5.0 million at March 31, 2001. In addition, the Company decreased the value of other portfolio companies by a total of \$13.1 million for the six months ended June 30, 2001.

At June 30, 2001, net unrealized appreciation in the portfolio totaled \$30.7 million and was composed of unrealized appreciation of \$78.6 million, resulting primarily from appreciated equity interests in portfolio companies, and unrealized depreciation of \$47.9 million, resulting primarily from underperforming loan and equity interests in the portfolio. Net realized and unrealized gains can vary substantially on a quarterly basis.

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

At June 30, 2001, the Company's portfolio was graded as follows:

| PORTFOLIO | PERCENTAGE OF |
|-----------|---------------|
|-----------|---------------|

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| GRADE ----- | AT VALUE ----- (IN MILLIONS) | TOTAL PORTFOLIO ----- |
|----------------|------------------------------------|--------------------------|
| 1..... | \$ 449.7 | 22.5% |
| 2..... | 1,430.0 | 71.5% |
| 3..... | 43.1 | 2.2% |
| 4..... | 45.1 | 2.2% |
| 5..... | 32.7 | 1.6% |
| | ----- | ----- |
| | \$2,000.6 | 100.0% |
| | ===== | ===== |

Grade 5 private finance investments at June 30, 2001, totaled \$31.7 million, at value, or 1.6%, of the Company's total portfolio. Total Grade 4 and 5 assets as a percentage of the total portfolio at value at June 30, 2001 and December 31, 2000 and 1999 were 3.8%, 5.7% and 3.8%, respectively. The Company expects that a certain number of portfolio companies will be in the Grade 4 or 5 category from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect the Company's investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate significantly from quarter to quarter as the Company helps these companies work through their problems. The Company continues to follow its historical practices of working with a troubled portfolio company in order to recover the maximum amount of the Company's investment, but records unrealized depreciation for the expected full amount of the potential loss when such exposure is identified.

At June 30, 2001, delinquencies in the underlying collateral pool for the Company's CMBS portfolio were 0.35%. The yield used to accrue interest on this portfolio assumes a 1% loss rate on the entire underlying collateral mortgage pool, and as of June 30, 2001, no losses have been realized.

For the total investment portfolio, loans greater than 120 days delinquent were \$63.5 million at value at June 30, 2001, or 3.2% of the total portfolio. Included in this category are loans valued at \$10.9 million that are fully secured by real estate. Loans greater than 120 days delinquent generally do not accrue interest. Loans greater than 120 days delinquent at December 31, 2000 were \$56.4 million at value, or 3.2% of the total portfolio, which included \$13.3 million that were fully secured by real estate. As a provider of long-term privately negotiated investment capital, it is not atypical to defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 120 days delinquent may vary from quarter to quarter. The terms of the private finance agreements frequently provide an opportunity for portfolio companies to restructure their debt and equity capital. During such restructuring, the Company may not receive or accrue interest or dividend payments. The investment portfolio is priced to provide current returns for our shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. The Company also prices its investments for a total return including current interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans greater

than 120 days delinquent is not necessarily an indication of future principal loss or loss of anticipated investment return. The Company's portfolio grading system is used as a means to assess loss of investment return (Grade 4 assets) or loss of investment principal (Grade 5 assets).

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The Company has elected to be taxed as a regulated investment company ("RIC") under Subchapter M of the Internal Revenue Code of 1986, as amended ("Code"). As long as the Company qualifies as a RIC, the Company is not taxed on its investment company taxable income or realized capital gains, to the extent that such income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions may differ from NIA for the fiscal year due to timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

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

The weighted average common shares outstanding used to compute basic earnings per share were 87.4 million and 68.1 million for the six months ended June 30, 2001 and 2000, respectively. The increases in the weighted average shares reflect the issuance of new shares and the issuance of shares pursuant to a dividend reinvestment plan.

All per share amounts included in management's discussion and analysis have been computed using the weighted average shares used to compute diluted earnings per share, which were 89.0 million and 68.2 million for the six months ended June 30, 2001 and 2000, respectively.

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COMPARISON OF THREE MONTHS ENDED JUNE 30, 2001 AND 2000

The following table summarizes Allied Capital's operating results for the three months ended June 30, 2001 and 2000.

| | FOR THE THREE MONTHS ENDED JUNE 30, | | | |
|---|---|----------|----------|-------------------|
| (\$ IN THOUSANDS, EXCEPT PER SHARE AMOUNTS) | 2001 | 2000 | CHANGE | PERCENT CHANGE |
| INTEREST AND RELATED PORTFOLIO INCOME | | | | |
| Interest and dividends..... | \$58,824 | \$42,986 | \$15,838 | 37% |
| Premiums from loan dispositions..... | 910 | 4,554 | (3,644) | (80)% |
| Fees and other income..... | 9,005 | 2,425 | 6,580 | 271% |
| | ----- | ----- | ----- | --- |
| Total interest and related portfolio income..... | 68,739 | 49,965 | 18,774 | 38% |
| | ----- | ----- | ----- | --- |
| EXPENSES | | | | |
| Interest..... | 15,951 | 14,280 | 1,671 | 12% |
| Employee..... | 7,547 | 5,191 | 2,356 | 45% |
| Administrative..... | 3,060 | 4,082 | (1,022) | (25)% |
| | ----- | ----- | ----- | --- |
| Total operating expenses..... | 26,558 | 23,553 | 3,005 | 13% |

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| | | | | |
|---|----------|----------|----------|-------|
| Formula and cut-off awards..... | 63 | 1,712 | (1,649) | (96)% |
| Net operating income before net realized and unrealized gains..... | 42,118 | 24,700 | 17,418 | 71% |
| NET REALIZED AND UNREALIZED GAINS | | | | |
| Net realized gains..... | 3,837 | 12,865 | (9,028) | (70)% |
| Net unrealized gains..... | 151 | (2,775) | 2,926 | 105% |
| Total net realized and unrealized gains.... | 3,988 | 10,090 | (6,102) | (60)% |
| Net increase in net assets resulting from operations..... | \$46,106 | \$34,790 | \$11,316 | 33% |
| Diluted net operating income per share..... | \$ 0.46 | \$ 0.35 | \$ 0.11 | 24% |
| Diluted earnings per share..... | \$ 0.51 | \$ 0.50 | \$ 0.01 | 2% |
| Weighted average shares outstanding -- diluted..... | 90,848 | 70,035 | 20,813 | 30% |

Net increase in net assets resulting from operations (NIA) results from total interest and related portfolio income earned, less total expenses incurred in the operations of the Company, plus net realized and unrealized gains or losses. In addition to the discussion of the comparison of the three months ended June 30, 2001 to the three months ended June 30, 2000 that follows, refer to the "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Comparison of Six Months Ended June 30, 2001 and 2000" above for additional discussion regarding the nature of and reasons for fluctuation in income and expense items in the company's operating results.

Total interest and related portfolio income is primarily a function of the level of interest income earned and the balance of portfolio assets. In addition, total interest and related portfolio income

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includes dividend income, premiums from loan dispositions, prepayment premiums, and fees and other income.

| | FOR THE THREE MONTHS ENDED JUNE 30, | |
|--|---|--------|
| | 2001 | 2000 |
| (\$ IN MILLIONS, EXCEPT PER SHARE AMOUNTS) | ----- | ----- |
| Total Interest and Related Portfolio Income..... | \$68.7 | \$50.0 |
| Per share..... | \$0.76 | \$0.71 |

The increase in interest income earned results primarily from continued growth of the Company's investment portfolio and the Company's focus on increasing its overall portfolio yield. The Company's investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 20% to \$1,639.7 million at June 30, 2001 from \$1,361.1 million at June 30, 2000.

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Included in net premiums from loan dispositions are premiums from loan sales and premiums received on the early repayment of loans. Premiums from loan sales were \$0.7 million and \$3.6 million for the three months ended June 30, 2001 and 2000, respectively. Premium income results from the premium paid by purchasers on loans sold less the origination commissions associated with the loans sold. For the three months ended June 30, 2000, premiums from loan sales resulted primarily from the sale of loans originated through Allied Capital Express. Upon the merger of the Allied Capital Express operations into BLX, the premium from loan sales earned historically is intended to be replaced with interest income earned by the Company from its subordinated debt investment in BLX as well as fees earned from its guaranty of the BLX Credit Facility and its management contract with BLX. Prepayment premiums were \$0.2 million and \$0.9 million for the three months ended June 30, 2001 and 2000, respectively.

Fees and other income include diligence and financial structuring fees and management and guaranty fees of \$7.3 million for the three months ended June 30, 2001.

Operating expenses include interest, employee and administrative expenses. The Company's single largest expense is interest on indebtedness. The fluctuations in interest expense during the three months ended June 30, 2001 and 2000 are attributable to changes in the level of borrowings by the Company and its subsidiaries under various notes payable and debentures and revolving credit facilities. The Company's borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

| | AT AND FOR THE THREE MONTHS ENDED JUNE 30, | |
|-------------------------------|--|---------|
| (\$ IN MILLIONS) | 2001 | 2000 |
| Total Outstanding Debt..... | \$881.1 | \$726.4 |
| Average Outstanding Debt..... | \$812.5 | \$690.6 |
| Weighted Average Cost..... | 7.4% | 8.1% |
| BDC Asset Coverage*..... | 247% | 225% |

 * As a BDC, the Company is generally required to maintain a ratio of 200% of total assets to total borrowings.

Employee expenses include salaries and employee benefits. The increase in salaries and employee benefits for the periods presented reflects wage increases and the experience level of employees hired. Total employees were 101 and 129 at June 30, 2001 and 2000, respectively. As part of the

recapitalization of Allied Capital Express discussed above, employees of the Company were transferred to the portfolio company at the end of 2000. Expenses related to employees dedicated to Allied Capital Express are reflected in employee expense for the three months ended June 30, 2000.

Administrative expenses include the leases for the Company's headquarters in Washington, DC, and its regional offices, travel costs, stock record expenses, directors' fees, legal and accounting fees and various other expenses. Administrative expenses for the three months ended June 30, 2000 included

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expenses related to Allied Capital Express regional offices. The cost of these regional offices was transferred to BLX at the beginning of 2001. For the three months ended June 30, 2001 and 2000, employee and administrative costs as a percentage of total interest and related portfolio income less interest expense plus net realized and unrealized gains was 19% and 20%, respectively.

Net realized gains resulted from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans, commercial mortgage loans and Purchased CMBS bonds, offset by losses on investments. Realized gains and losses were as follows:

| | FOR THE THREE MONTHS ENDED JUNE 30, | |
|---------------------------|---|---------|
| (\$ IN MILLIONS) | 2001 | 2000 |
| Realized Gains..... | \$ 4.7 | \$13.2 |
| Realized Losses..... | (0.9) | (0.3) |
| | ----- | ----- |
| Net Realized Gains..... | \$ 3.8 | \$12.9 |
| | ===== | ===== |
| Net Unrealized Gains..... | \$ 0.2 | \$(2.8) |
| | ===== | ===== |

For further discussion of net realized and unrealized gains and losses, refer to "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Comparison of Six Months Ended June 30, 2001 and 2000" above.

The weighted average common shares outstanding used to compute basic earnings per share were 89.4 million and 70.0 million for the three months ended June 30, 2001 and 2000, respectively. The increases in the weighted average shares reflect the issuance of new shares and the issuance of shares pursuant to a dividend reinvestment plan.

All per share amounts included in management's discussion and analysis have been computed using the weighted average shares used to compute diluted earnings per share, which were 90.8 million and 70.0 million for the three months ended June 30, 2001 and 2000, respectively.

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FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

CASH AND CASH EQUIVALENTS

At June 30, 2001, the Company had \$3.4 million in cash and cash equivalents. The Company invests otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. The Company's objective is to manage to a low cash balance and fund new originations with its credit facilities.

DEBT

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The Company had outstanding debt at June 30, 2001 as follows:

| (\$ IN MILLIONS) | FACILITY AMOUNT | AMOUNT OUTSTANDING | ANNUAL INTERES COST (1) |
|---|--------------------|-----------------------|-------------------------------|
| | ----- | ----- | ----- |
| Notes payable and debentures: | | | |
| Unsecured long-term notes payable..... | \$ 544.0 | \$544.0 | 7.9% |
| SBA debentures..... | 101.8 | 87.0 | 7.9% |
| Auction rate reset note..... | 79.6 | 79.6 | 5.9% |
| OPIC loan..... | 5.7 | 5.7 | 6.6% |
| | ----- | ----- | ----- |
| Total notes payable and debentures..... | \$ 731.1 | \$716.3 | 7.7% |
| | ----- | ----- | ----- |
| Revolving credit facilities: | | | |
| Revolving line of credit..... | 417.5 | 164.8 | 6.1% |
| | ----- | ----- | ----- |
| Total debt..... | \$1,148.6 | \$881.1 | 7.4% |
| | ===== | ===== | ===== |

 (1) The annual interest cost includes the cost of commitment fees and other facility fees.

UNSECURED LONG-TERM NOTES PAYABLE. The Company has issued long-term debt to institutional lenders, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2003. The notes require payment of interest only semi-annually, and all principal is due upon maturity.

SBA DEBENTURES. The Company, through its SBIC subsidiary, has debentures payable to the SBA with terms of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. The Company may currently borrow up to \$101.8 million from the SBA under the SBIC program. At June 30, 2001, the Company has a commitment to borrow up to an additional \$14.8 million above the amount outstanding from the SBA. The commitment expires on September 30, 2005.

AUCTION RATE RESET NOTE. The Company has a \$79.6 million Auction Rate Reset Senior Note Series A that matures on December 2, 2002 and bears interest at the three-month London Inter-Bank Offer Rate ("LIBOR") plus 1.75% which adjusts quarterly. Interest is due quarterly and the Company, at its option, may pay or defer and capitalize such interest payments. The amount outstanding on the note will increase as interest due is deferred and capitalized. As a means to repay the note, the Company has entered into an agreement to issue \$79.6 million of debt, equity or other securities in one or more public or private transactions, or prepay the Auction Rate Reset Note, on or before August 31, 2002. If the note is prepaid, the Company will pay a fee equal to 0.5% of the aggregate amount of the note outstanding.

REVOLVING LINE OF CREDIT. As of June 30, 2001, the Company has a two-year, \$417.5 million unsecured revolving line of credit that expires in May 2002. This facility may be expanded up to \$500 million. At the Company's option, the credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal

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Funds rate plus 0.50%. The credit facility requires monthly payments of interest, and all principal is due upon maturity. On August 3, 2001, the Company amended this credit facility to have borrowing capacity of \$467.5 million, which can be expanded up to \$600 million, and extended the maturity to August 2003, with the right to extend the maturity for an additional one year at the Company's sole option, under substantially the same terms.

EQUITY CAPITAL AND DIVIDENDS

The Company raises debt and equity capital for continued investment in its portfolio. Because the Company is a RIC, it distributes its income and requires external capital for growth. Because the Company is a BDC, it is limited in the amount of debt capital it may use to fund its growth, since it is generally required to maintain a ratio of 200% of total assets to total borrowings, or approximately 1 to 1 debt to equity capital ratio.

To support its growth during the six months ended June 30, 2001, the Company raised \$123.3 million in new equity capital primarily through the sale of shares from its shelf registration statement. The Company issues equity from time to time when it has a clear use of proceeds for attractive investment opportunities. Historically, this process has enabled the Company to raise equity on an accretive basis for existing shareholders. At June 30, 2001, total shareholders' equity had increased to \$1.17 billion.

The Company's Board reviews the dividend rate quarterly, and adjusts the quarterly dividend rate throughout the year as the Company's earnings momentum builds. For the first and second quarter of 2001, the Board declared a \$0.49 and \$0.50 per common share dividend, respectively. For the third quarter of 2001, the Board has declared a dividend of \$0.51 per common share. Dividends are paid from the Company's taxable income.

As a result of growth in ordinary taxable income combined with the increased size and diversity of the Company's portfolio and its projected future capital gains, the Company's Board of Directors will continue to evaluate whether to retain or distribute capital gains as they occur. The Company's dividend policy allows the Company to continue to distribute some capital gains, but will also allow the Company to retain gains that exceed a normal capital gains distribution level, and therefore avoid any unusual spike in dividends in any one year. The dividend policy also enables the Board to selectively retain gains to support future growth.

The Company plans to maintain a strategy of financing its operations, dividend requirements and future investments with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. The Company maintains a matched-funding philosophy that focuses on matching the estimated maturities of its loan and investment portfolio to the estimated maturities of its borrowings. The Company will utilize its short-term credit facilities only as a means to bridge to long-term financing, which may result in temporary differences in the matching of estimated maturities. The Company evaluates its interest rate exposure on an ongoing basis. To the extent deemed necessary, the Company may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques. At June 30, 2001, the Company's debt to equity ratio was 0.75 to 1 and weighted average cost of funds was 7.4%. There are no significant maturities of long-term debt until 2003. The Company believes that it has access to capital sufficient to fund its ongoing investment and operating activities, and from which to pay dividends.

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Investing in the Company involves a number of significant risks and other factors relating to the structure and investment objective of the Company. As a result, there can be no assurance that the Company will achieve its investment objective.

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

OUR FINANCIAL RESULTS COULD BE NEGATIVELY AFFECTED IF BLX FAILS TO PERFORM AS EXPECTED. Business Loan Express, Inc. ("BLX") is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected. At June 30, 2001, the investment totaled \$213.7 million, or 10% of total assets. In addition, as controlling shareholder of BLX, the Company has provided an unconditional guaranty to BLX's credit facility lenders in an amount equal to 50% of BLX's total obligations on its \$117.5 million unsecured revolving credit facility. The amount guaranteed by the Company at June 30, 2001 was \$51.7 million. This guaranty can only be called in the event of a default by BLX.

OUR BORROWERS MAY DEFAULT ON THEIR PAYMENTS. We make unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in and lend to companies that may have limited financial resources and that may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry or negative economic conditions. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in any collateral for the loan.

OUR PORTFOLIO OF INVESTMENTS IS ILLIQUID. We acquire most of our investments directly from private companies. The majority of the investments in our portfolio will be subject to restrictions on resale or otherwise have no established trading market. The illiquidity of most of our portfolio may adversely affect our ability to dispose of loans and securities at times when it may be advantageous for us to liquidate such investments.

INVESTMENTS IN NON-INVESTMENT GRADE COMMERCIAL MORTGAGE-BACKED SECURITIES MAY BE ILLIQUID AND MAY HAVE A HIGHER RISK OF DEFAULT. The commercial mortgage-backed securities ("CMBS") in which we invest are non-investment grade, which means that nationally recognized statistical rating organizations rate them below the top four investment-grade rating categories (i.e., "AAA" through "BBB"), and are sometimes referred to as "junk bonds." The non-investment grade CMBS tend to be less liquid, may have a higher risk of default and may be more difficult to value. Non-investment grade securities usually provide a higher yield than do investment-grade bonds, but with the higher return comes greater risk. Non-investment grade securities are considered speculative, and their capacity to pay principal and interest in accordance with the terms of their issue is not ensured.

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OUR PORTFOLIO INVESTMENTS ARE RECORDED AT FAIR VALUE AS DETERMINED BY THE BOARD OF DIRECTORS IN ABSENCE OF READILY ASCERTAINABLE PUBLIC MARKET VALUES. Pursuant to the requirements of the Investment Company Act of 1940 ("1940 Act"), the Board of Directors is required to value each asset quarterly, and we are required to carry our portfolio at fair value as determined by the Board of Directors. Since there is typically no public market for the loans and equity securities of the companies in which we make investments, our Board of Directors estimates the fair value of these loans and equity securities pursuant to a written valuation policy and a consistently applied valuation process. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment and record an unrealized loss for an asset that we believe has become impaired. Without a readily ascertainable market value, the estimated value of our portfolio of loans and equity securities may differ significantly from the values that would be placed on the portfolio if there existed a ready market for the loans and equity securities. We adjust quarterly the valuation of our portfolio to reflect the Board of Directors' estimate of the current fair value of each investment in our portfolio. Any changes in estimated value are recorded in the Company's statement of operations as "Net unrealized gains (losses)."

WE BORROW MONEY WHICH MAGNIFIES THE POTENTIAL FOR GAIN OR LOSS ON AMOUNTS INVESTED AND MAY INCREASE THE RISK OF INVESTING IN OUR COMPANY. We borrow from, and issue senior debt securities to, banks, insurance companies and other lenders. Lenders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. 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. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to the Company's common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

At June 30, 2001, the Company had \$881.1 million of outstanding indebtedness, bearing a weighted annual interest cost of 7.4%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our portfolio of at least 3.1%.

WE MAY NOT BORROW MONEY UNLESS WE MAINTAIN ASSET COVERAGE FOR INDEBTEDNESS OF AT LEAST 200% WHICH MAY AFFECT RETURNS TO SHAREHOLDERS. We must maintain asset coverage for a class of senior security representing indebtedness of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of June 30, 2001, our asset coverage for senior indebtedness was 247%.

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INCOME. Because we borrow money to make investments, our net operating 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 portfolio income. In periods of sharply rising interest rates, our cost of funds would increase, which would reduce our net operating income before net realized and unrealized gains. However, there would be no effect on the return, if any, that could be generated from our equity interests. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. The Company utilizes its short-term credit facilities only 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.

BECAUSE WE MUST DISTRIBUTE INCOME, WE WILL CONTINUE TO NEED ADDITIONAL CAPITAL TO GROW. We will continue to need capital to fund incremental growth in our investments. Historically, we have borrowed from financial institutions and have issued equity securities. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our taxable net operating income excluding net realized long-term capital gains to our stockholders to maintain our regulated investment company ("RIC") status. As a result such earnings will not be available to fund investment originations. We expect to continue to borrow from financial institutions and sell additional equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which could have a material adverse effect on the value of the Company's common stock. In addition, as a business development company ("BDC"), we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances.

OUR PRIVATE FINANCE INVESTMENTS MAY NOT PRODUCE CAPITAL GAINS. Private finance investments are typically structured as debt securities with a relatively high fixed rate of interest and with an equity feature such as conversion rights, warrants or options. As a result, private finance investments generate interest income from the time they are made, and may also produce a realized gain from an accompanying equity feature. We cannot be sure that our portfolio will generate a current return or capital gains.

LOSS OF PASS-THROUGH TAX TREATMENT WOULD SUBSTANTIALLY REDUCE NET ASSETS AND INCOME AVAILABLE FOR DIVIDENDS. We have operated the Company so as to qualify to be taxed as a RIC under Subchapter M of the Internal Revenue Code of 1986, as amended ("Code"). If we meet source of income, diversification and distribution requirements, the Company qualifies for effective pass-through tax treatment. The Company would cease to qualify for such pass-through tax treatment if it were unable to comply with these requirements, or if it ceased to qualify as a BDC under the 1940 Act. We also could be subject to a 4% excise tax and/or corporate level income tax if we fail to make required distributions as a RIC. If the Company ceased to qualify as a RIC, the Company would become subject to federal income tax as if it were an ordinary corporation, which would substantially reduce our net assets and the amount of income available for distribution to our shareholders.

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WE OPERATE IN A COMPETITIVE MARKET FOR INVESTMENT OPPORTUNITIES. We compete for investments with many other companies and individuals, some of whom 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

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attractive investments.

CHANGES IN THE LAW OR REGULATIONS THAT GOVERN THE COMPANY COULD HAVE A MATERIAL IMPACT ON THE COMPANY OR OUR OPERATIONS. We are regulated by the Securities and Exchange Commission and the SBA. In addition, changes in the laws or regulations that govern BDCs, RICs, real estate investment trusts ("REITs") and SBICs may significantly affect our business. Any change in the law or regulations that govern our business could have a material impact on the Company or its 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.

QUARTERLY RESULTS MAY FLUCTUATE AND MAY NOT BE INDICATIVE OF FUTURE QUARTERLY PERFORMANCE. The Company's quarterly operating results could fluctuate and therefore, you should not rely on quarterly results to be indicative of the Company's performance in future quarters. Factors that could cause quarterly operating results to fluctuate include, among others, variations in the investment origination volume and fee income earned, variation in timing of prepayments, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets and general economic conditions.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has been no material change in the quantitative or qualitative disclosures about market risk since December 31, 2000.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is party to certain lawsuits in the normal course of business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that these proceedings will have a material effect upon the Company's financial condition or results of operations.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

During the three months ended June 30, 2001 ACC issued a total of 69,381 shares pursuant to a dividend reinvestment plan. This plan is not registered and relies on an exemption from registration in the Securities Act of 1933.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On May 8, 2001, the Company held its Annual Meeting of Shareholders in Washington, DC. Shareholders voted on two matters; the substance of these matters and the results of the voting of each such matter are described below. There were no broker non-votes for these matters.

1. Election of Directors: Shareholders elected four directors of the Company, who will serve for three years, or until their successors are elected and qualified. Votes were cast as follows:

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| | FOR ----- | WITHHELD ----- |
|-----------------------------|--------------|-------------------|
| William L. Walton..... | 70,274,662 | 6,881,794 |
| George C. Williams, Jr..... | 76,122,498 | 1,033,956 |
| Brooks H. Browne..... | 75,878,768 | 1,277,686 |
| Robert E. Long..... | 76,089,506 | 1,066,949 |

The following directors are continuing as directors of the Company for their respective terms -- John D. Firestone, Anthony T. Garcia, Lawrence I. Hebert, Laura W. van Roijen, John I. Leahy, Warren K. Montouri, Guy T. Steuart II, and T. Murray Toomey, Esq.

2. Ratification of the selection of Arthur Andersen LLP to serve as independent public accountants for the year ending December 31, 2001. Votes were cast as follows:

| FOR ----- | AGAINST ----- | ABSTAIN ----- |
|--------------|------------------|------------------|
| 76,436,597 | 479,444 | 240,405 |

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) List of Exhibits

| EXHIBIT NUMBER ----- | DESCRIPTION ----- |
|----------------------------|---|
| 3(i) (a) (21) | Articles of Amendment and Restatement of the Articles of Incorporation. |
| 3(i) (b) (16) | Articles of Merger. |
| 56 | 53 |

| EXHIBIT NUMBER ----- | DESCRIPTION ----- |
|----------------------------|--|
| 3(i) (c) (17) | Amendment to the Amended and Restated Articles of Incorporation. |
| 3(ii)10 | Bylaws. |
| 4.1(4) | Specimen certificate of the Company's Common stock, par value \$0.0001 per share. See exhibits 3(i), 3(ii) and 3(iii) for other instruments defining the rights of security holders. |
| 4.2(2) | Form of debenture between certain subsidiaries of the |

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| | |
|------------|--|
| 5 | Company and the U.S. Small Business Administration. |
| 9 | Not applicable. |
| 10.1(15) | Not applicable. |
| 10.2(5) | Second Amended and Restated Credit Agreement, dated August 3, 2001. |
| 10.3(3) | Note Agreement dated as of April 30, 1998. |
| 10.4(8) | Loan Agreement between Allied I and Overseas Private Investment Corporation, dated April 10, 1995. Letter dated December 11, 1997 evidencing assignment of Loan Agreement from Allied I to the Company. |
| 10.4a(10) | Note Agreement dated as of May 1, 1999. |
| 10.4b(13) | Note Agreement dated as of November 15, 1999. |
| 10.4c(18) | Note Agreement dated as of October 15, 2000. |
| 10.5(17) | Auction Rate Reset Note Agreement, dated as of August 31, 2000 between the Company and Intrepid Funding Master Trust, a Delaware business trust administered by Banc of America Securities LLC; Forward Issuance Agreement, dated as of August 31, 2000, between the Company and Banc of America Securities LLC; Remarketing and Contingency Purchase Agreement, dated as of August 31, 2000 between the Company and Banc of America Securities LLC. |
| 10.6(4) | Amendment and Consent Agreement to the Amended and Restated Credit Agreement dated December 11, 2000. |
| 10.7(4) | Sale and Servicing Agreement dated as of January 1, 1998 among Allied Capital CMT, Inc., Allied Capital Commercial Mortgage Trust 1998-1 and the Company and LaSalle National Bank Inc. and ABN AMRO Bank N.V. |
| 10.8(4) | Indenture dated as of January 1, 1998 between Allied Capital Commercial Mortgage Trust 1998-1 and LaSalle National Bank. |
| 10.9(4) | Amended and Restated Trust Agreement dated January 1, 1998 between Allied Capital CMT, Inc., LaSalle National Bank Inc. and Wilmington Trust Company. |
| 10.10a(14) | Guaranty dated as of January 1, 1998 by the Company. |
| 10.10b(14) | Employment agreement dated June 15, 2000 between the Company and William L. Walton. |
| 10.10c(17) | Employment agreement dated June 15, 2000 between the Company and Joan M. Sweeney. |
| 10.11(7) | Employment agreement dated June 15, 2000 between the Company and John M. Scheurer. |
| 10.11a(19) | Amended and Restated Deferred Compensation Plan dated December 30, 1998. |
| 10.12(6) | Amendment to Deferred Compensation Plan dated October 18, 2000. |
| 10.12a(9) | Amended Stock Option Plan. |
| 10.12b(19) | Allied Capital 401(k) Plan dated September 1, 1999. |
| 10.13a(4) | Amendment to 401(k) Plan dated December 31, 2000. |
| 10.13b(4) | Form of Custody Agreement with Riggs Bank N.A. with respect to safekeeping. |
| | Form of Custody Agreement with LaSalle National Bank. |

| EXHIBIT NUMBER ----- | DESCRIPTION ----- |
|----------------------------|---|
| 10.13(15) | Custodian agreement with LaSalle Bank National Association, dated July 9, 2001. |

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- 10.14a(15) Agreement and Plan of Merger dated June 18, 2001 by and among the Company, Allied Capital Lock Acquisition Corporation, and SunSource Inc.
- 10.15(20) Control Investor Guaranty Agreement, dated as of March 28, 2001, between the Company and Fleet National Bank, in its capacity as Administrative Agent for the Lenders and Business Loan Express, Inc.
- 10.18(1) Dividend Reinvestment Plan.
- 11 Statement regarding computation of per share earnings is incorporated by reference to Note 8 to the Company's Notes to the Consolidated Financial Statements contained in the Company's 2000 Annual Report on Form 10-K for the year ended December 31, 2000.
- 21 Subsidiaries of the Company and jurisdiction of incorporation/organization:
- | | |
|--|----------|
| Allied Investment Corporation | Maryland |
| Allied Capital REIT, Inc. | Maryland |
| Allied Capital Holdings LLC | Delaware |
| Allied Capital Beteiligungsberatung GmbH | Germany |
| A.C. Corporation | Delaware |

- (1) Incorporated by reference to the exhibit of the same name filed with the Company's Annual Report on Form 10-K for the year ended December 31, 1997.
- (2) Incorporated by reference to the exhibit of the same name filed with Allied I's Annual Report on Form 10-K for the year ended December 31, 1996.
- (3) Incorporated by reference to Exhibit f.7 of Allied I's Pre-Effective Amendment No. 2 filed with the registration statement on Form N-2 on January 24, 1996 (File No. 33-64629). Assignment to Company is incorporated by reference to Exhibit 10.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 1997.
- (4) Incorporated by reference to the exhibit of the same name to the Company's registration statement on Form N-2 filed on the Company's behalf with the Commission on May 5, 1998 (File No. 333-51899).
- (5) Incorporated by reference to the exhibit of the same name filed with the Company's Quarterly Report on Form 10-Q for the period ended September 30, 1998.
- (6) Incorporated by reference to Exhibit A of the Company's definitive proxy materials for the Company's 2000 Annual Meeting of Stockholders filed with the Commission on March 29, 2000.
- (7) Incorporated by reference to the exhibit of the same name filed with the Company's Annual Report on Form 10-K for the year ended December 31, 1998.
- (8) Incorporated by reference to the exhibit of the same name filed with the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1999.
- (9) Incorporated by reference to Exhibit 4.4 of the Allied Capital 401(k) Plan registration statement on Form S-8, filed on behalf of such Plan on October 8, 1999 (File No. 333-88681).

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- (10) Incorporated by reference to the exhibit of the same name filed with the Company's Annual Report on Form 10-K for the year ended December 31, 1999.
- (11) Incorporated by reference to Appendix A to the Company's registration statement on Form N-14 filed on the Company's behalf with the Commission on November 6, 2000.
- (12) Incorporated by reference to the exhibit of the same name to the Company's registration statement on Form N-14 filed on the Company's behalf with the Commission on November 6, 2000.

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- (13) Incorporated by reference to the exhibit of the same name to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2000.
 - (14) Incorporated by reference to the exhibit of the same name to the Company's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000.
 - (15) Incorporated by reference to the exhibit of the same name to the Company's registration statement on Form N-2 filed on August 10, 2001.
 - (16) Incorporated by reference from Appendix B to the Company's registration statement on Form N-14 filed on September 26, 1997 (File No. 333-36459).
 - (17) Incorporated by reference to the exhibit of the same name filed with the Company's Post-Effective Amendment No. 2 to the registration statement on Form N-2 filed on March 21, 2001 (File No. 333-43534).
 - (18) Incorporated by reference to the exhibit of the same name filed with the Company's Pre-Effective Amendment No. 1 to the registration statement on Form N-2 filed on September 12, 2000 (File No. 333-43534).
 - (19) Incorporated by reference to the exhibit of the same name filed with the Company's Post-Effective Amendment No. 1 to the registration statement on Form N-2 filed on January 19, 2001 (File No. 333-43534).
 - (20) Incorporated by reference to the exhibit of the same name filed with the Company's Post-Effective Amendment No. 3 to the registration statement on Form N-2 filed on May 15, 2001 (File No. 333-43534).
 - (21) Incorporated by reference to exhibit 3(i) filed with Allied Lending's Annual Report on Form 10-K for the year ended December 31, 1996.
- (b) Reports on Form 8-K.

The Company filed no reports on Form 8-K during the quarter ended June 30, 2001.

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SIGNATURES

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

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undersigned thereunder duly authorized.

ALLIED CAPITAL CORPORATION
(Registrant)

Dated: August 9, 2001

/s/ PENNI F. ROLL

Executive Vice President and Chief Financial
Officer