ALLIED CAPITAL CORP
Form 497
September 30, 2004

Prospectus Supplement
(To Prospectus dated September 14, 2004)

Filed Pursuant to Rule 497
Registration Statement No. 333-113671

3,000,000 Shares

Common Stock

We are offering for sale 3,000,000 shares of our common stock. Our common stock is traded on the New York Stock Exchange (the NYSE) under the symbol ALD. The last reported sales price of our common stock on the NYSE on September 29, 2004, was $25.11 per share.

You should review the information, including the risk of leverage, set forth under Risk Factors on page 10 of the accompanying prospectus before investing in our common stock.

	Per Share	Total
Public offering price	$25.00	$75,000,000
Underwriting discount	$ 1.25	$ 3,750,000
Proceeds to Allied Capital Corporation(1)	$23.75	$71,250,000

(1) Before deducting expenses payable by us estimated to be $470,000.

Please read this prospectus supplement, and the accompanying prospectus, before investing, and keep it for future reference. The prospectus supplement and the accompanying prospectus contain important information about us. The Securities and Exchange Commission (the SEC) maintains an Internet website (http://www.sec.gov) that contains other information about us.

We have granted the underwriters a 30-day option to purchase up to 450,000 additional shares of common stock to cover over-allotments. If the underwriters exercise the option in full, the public offering price, the underwriting discount and proceeds to us would be $86,250,000, $4,312,500 and $81,937,500, respectively.

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

The shares of common stock will be ready for delivery on or about October 5, 2004.

Joint Book-Running Managers

Banc of America Securities LLC **Deutsche Bank Securities**

JMP Securities

The date of this prospectus supplement is September 29, 2004.

You should rely only on the information contained in this prospectus supplement and the accompanying prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus supplement and the accompanying prospectus is accurate only as of their respective dates. Our business, financial condition, results of operations and prospects may have changed since those dates.

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

Information contained in this prospectus supplement and the accompanying prospectus may contain forward-looking statements, which can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negat thereof or other variations thereon or comparable terminology. The matters described in Risk Factors in the accompanying prospectus and certain other factors noted throughout this prospectus supplement and the accompanying prospectus constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

FEES AND EXPENSES

This table describes the various costs and expenses that an investor of our common stock will bear directly or indirectly.

Shareholders Transaction Expenses	
Sales load (as a percentage of offering price)[1]	5.0%
Dividend reinvestment plan fees[2]	None
Annual Expenses (as a percentage of consolidated net assets attributable to common shares)(3)	
Operating expenses[4]	4.6%
Interest payments on borrowed funds[5]	4.0%
Total annual expenses[6][7]	8.6%

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(1) Represents the underwriting discounts and commissions with respect to the shares sold by Allied Capital in this offering.

(2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases, if any. See Dividend Reinvestment Plan in the accompanying prospectus.

(3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities and preferred stock), which at June 30, 2004 was $1.9 billion.

(4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2004, excluding interest on indebtedness. This percentage for the year ended December 31, 2003, was 3.1%.

(5) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2004. We had outstanding borrowings of $1,058.8 million at June 30, 2004. This percentage for the year ended December 31, 2003, was 4.0%. See Risk Factors in the accompanying prospectus.

(6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that the Total annual expenses percentage be calculated as a percentage of net assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 5.2% of consolidated total assets.

(7) The holders of shares of our common stock (and not the holders of our debt securities or preferred stock, if any) indirectly bear the cost associated with our annual expenses.

Example

The following example, required by the SEC, demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in us. In calculating the following expense amounts, we assumed we would have no additional leverage and that our operating expenses would remain at the levels set forth in the table above.

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$ 86	$258	$429	$854

Although the example assumes (as required by the SEC) a 5.0% annual return, our performance will vary and may result in a return of greater or less than 5.0%. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants

in the dividend reinvestment plan may receive shares of common stock that we issue at or above net asset value or purchased by the administrator of the dividend reinvestment plan, at the market price in effect at the time, which may be higher than, at, or below net asset value. See Dividend Reinvestment Plan in the accompanying prospectus.

The example should not be considered a representation of future expenses, and the actual expenses may be greater or less than those shown.

USE OF PROCEEDS

The net proceeds from the sale of the shares of our common stock, after deducting estimated expenses of this offering, are estimated to be $70.8 million. We intend to use the net proceeds from selling our common stock to reduce borrowings under our revolving line of credit. Amounts repaid under our revolving line of credit will remain available for future borrowing. At September 29, 2004, the interest rate on our revolving line of credit was 3.3% and there was approximately $353.0 million outstanding. This revolving line of credit terminates in April 2005 and may be extended on substantially similar terms for one additional year at our option.

UNDERWRITING

We are offering the shares of our common stock described in this prospectus through the underwriters named below. Banc of America Securities LLC and Deutsche Bank Securities Inc. are acting as joint book-running managers of the offering and representatives of the underwriters. We have entered into an underwriting agreement with the underwriters. Subject to the terms and conditions of the underwriting agreement, each of the underwriters has severally agreed to purchase the number of shares of common stock listed next to its name in the following table:

Underwriters	Number of shares
Banc of America Securities LLC	1,350,000
Deutsche Bank Securities Inc.	1,350,000
JMP Securities LLC	300,000
Total	3,000,000

The underwriting agreement provides that the obligation of the underwriters to purchase the shares offered by us is subject to some conditions. The underwriters are obligated to purchase all of the shares offered by us, if any of the shares are purchased.

This offering of the shares is made for delivery when, as and if accepted by the underwriters and subject to prior sale and to withdrawal, cancellation or modification of this offering without notice. The underwriters reserve the right to reject an order for the purchase of shares in whole or in part.

We have agreed to indemnify the underwriters against certain liabilities, including liabilities under the Securities Act, and to contribute to payments the underwriters may be required to make in respect of these liabilities.

Commissions and Discounts

The underwriters propose to offer the shares to the public initially at the public offering price set forth on the cover of this prospectus supplement and to dealers at that price, less a selling concession of $0.75 per share. After the offering, the public price may be changed by the underwriters.

The following table shows the per share and total underwriting discounts and commissions to be paid to the underwriters by us assuming both no exercise and full exercise of the underwriters option to purchase additional shares.

	No Exercise of Option	Full Exercise of Option
Per share	$ 1.25	$ 1.25
Total	$3,750,000	$4,312,500

We estimate that the total expenses of this offering, which will be paid by us, excluding the underwriting discounts and commissions, will be approximately $470,000.

Overallotment Option

The underwriters have the option to purchase up to 450,000 additional shares of common stock from us at the same price they are paying for the 3,000,000 shares offered hereby. The underwriters may purchase additional shares only to cover overallotments made in connection with this offering and only within 30 days after the date of this prospectus supplement. The underwriters will offer any additional shares that they purchase on the terms described in the preceding section.

No Sale of Similar Securities

We and certain of our executive officers have agreed not to offer, sell, transfer or otherwise dispose of, or to engage in certain hedging and derivative transactions with respect to, the common stock or any securities convertible into or exchangeable for shares of common stock for a period of 60 days after the date of this prospectus supplement without first obtaining the written consent of Banc of America Securities LLC and Deutsche Bank Securities Inc., as representatives of the underwriters, except in certain limited circumstances, including (i) our additional issuance of equity securities through privately negotiated transactions that may or may not involve an underwriter, whether or not registered with the SEC, aggregating not more than $50 million and (ii) our additional issuance of securities as all or part of the consideration paid for by us in connection with the acquisition of assets or securities of a third-party entity.

Price Stabilization and Short Positions

In connection with this offering, the underwriters may purchase and sell shares of our common stock in the open market. These transactions may include stabilizing transactions, short sales and purchases to cover positions created by short sales. Stabilizing transactions consist of bids or purchases made for the purpose of preventing or retarding a decline in the market price of our common stock while this offering is in progress. Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in this offering. Short sales may be either covered short sales or naked short sales. Covered short sales are sales made in an amount not greater than the underwriters over-allotment option to purchase additional shares in this offering. The underwriters may close out any covered short position by either exercising their over-allotment option or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option. Naked short sales are sales in excess of the over-allotment option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned there may be downward pressure on the price of shares in the open market after pricing that could adversely affect investors who purchase in this offering.

We have been advised by the representatives of the underwriters that these transactions may be effected on the NYSE or otherwise and, if commenced, may be discontinued at any time. Similar to other purchase activities, these activities may have the effect of raising or maintaining the market price of our shares or preventing a decline in the market price of our shares. As a result, the price of our shares may be higher than the price that might otherwise exist in the open market.

Settlement

The underwriters expect to deliver the shares through the facilities of The Depository Trust Company in New York, New York, on or about October 5, 2004. At that time, the underwriters will pay us for the shares in immediately available funds. For the third quarter of 2004, our Board of Directors declared a dividend of $0.57 per common share. The third quarter dividend is payable on September 30, 2004, with a record date of September 10, 2004. Accordingly, the shares offered by this prospectus supplement will not be entitled to the third quarter dividend.

Other Relationships

In the ordinary course of business, the underwriters and/or their affiliates have in the past performed, and may continue to perform, commercial banking, financial advisory and investment banking services for us for which they have received, or may receive, customary compensation. Affiliates of Banc of America Securities LLC and Deutsche Bank Securities Inc. are members of the lending syndicate for our unsecured revolving line of credit. JMP Securities LLC provides portfolio valuation services to us.

Other Information

This offering is being conducted in compliance with Rule 2810 of the Conduct Rules of the National Association of Securities Dealers, Inc. Because 10% or more of the net offering proceeds may be paid to affiliates of Banc of America Securities LLC and Deutsche Bank Securities Inc., the offering will also be conducted in compliance with NASD Rule 2710(h).

The address for Banc of America Securities LLC, 9 West 57th Street, 21st Floor, New York, NY 10019. The address for Deutsche Bank Securities Inc. is 60 Wall Street, 4th Floor, New York, NY 10005. The address for JMP Securities LLC is 600 Montgomery Street, Suite 1100, San Francisco, CA 94111.

LEGAL MATTERS

Certain legal matters with respect to the validity of the shares of common stock we are offering will be passed upon for us by Sutherland Asbill & Brennan LLP, Washington, D.C. Certain legal matters related to the offering will be passed upon for the underwriters by Davis Polk & Wardwell, New York, New York.

PROSPECTUS

20,000,000 Shares

Common Stock

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

Our investment objective is to achieve current income and capital gains. We seek to achieve our investment objective by investing in companies in a variety of industries, non-investment grade commercial mortgage-backed securities, and collateralized debt obligation bonds and preferred shares. No assurances can be given that we will continue to achieve our objective.

Please read this prospectus, and the accompanying prospectus supplement, if any, before investing, and keep it for future reference. It contains important information about us. The SEC maintains an Internet website (http://www.sec.gov) that contains other information about us.

We may offer, from time to time, up to 20,000,000 shares of our common stock in one or more offerings.

The shares of common stock may be offered at prices and on terms to be described in one or more supplements to this prospectus. The offering price per share of our common stock less any underwriting commissions or discounts will not be less than the net asset value per share of our common stock at the time we make the offering.

Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of September 13, 2004, the last reported sale price on the New York Stock Exchange for the common stock was $25.48.

You should review the information, including the risk of leverage, set forth under Risk Factors on page 10 of this prospectus before investing in our common stock.

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

This prospectus may not be used to consummate sales of shares of common stock unless accompanied by a prospectus supplement.

September 14, 2004

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

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, we may offer, from time to time, up to 20,000,000 shares of our common stock on the terms to be determined at the time of the offering. Shares of our common stock may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the shares of our common stock that we may offer. Each time we use this prospectus to offer shares of our common stock, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any prospectus supplement together with the additional information described under Where You Can Find Additional Information in the Prospectus Summary and Risk Factors sections before you make an investment decision.

PROSPECTUS SUMMARY

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

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

BUSINESS *(Page 64)*

As a business development company, we are in the private equity business. We provide long-term debt and equity capital. We have participated in the private equity business for over 40 years and have financed thousands of companies nationwide. Our investment objective is to achieve current income and capital gains.

We believe the private equity capital markets are important to the growth of small and middle market companies because such companies often have difficulty accessing the public debt and equity capital markets because their capital needs are too small to be attractive to the public markets, or because they are in need of long-term growth capital, which banks do not generally provide. We believe that we are well positioned to be a source of capital for such companies.

Our investment activity is primarily focused in three areas:

- Lending subordinated debt with or without equity features to middle market companies (mezzanine investing),
- Buying controlling equity stakes in middle market companies (buyout investing), and
- Investing in non-investment grade classes of commercial mortgage-backed securities (CMBS) and collateralized debt obligations (CDOs).

Our investments are long-term in nature, privately negotiated, and no readily available market exists for them. This makes our investments highly illiquid.

As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, valuing and ultimately exiting our investments. Each investment is subject to an extensive due diligence process. It is not uncommon for a single investment to take from two months to a year to complete, depending on the complexity of the transaction.

Our private finance portfolio is primarily composed of mezzanine loans and equity securities. This capital is used by portfolio companies to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, or other types of financings. We generally target companies in less cyclical industries with, among other things, high return on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and that have the ability to generate free cash flow.

Our primary commercial real estate investments are in the non-investment grade classes of CMBS bonds. We generally invest at the initial issuance of the CMBS, and are able to review the underlying collateral of mortgage loans as if we were making an initial decision to fund such loans and to determine if we want to exclude any loans that do not meet our credit, collateral, structural or other standards. We are also able to negotiate to acquire the securities at significant discounts from their face value. In addition to our CMBS investments, we have invested in the bonds and preferred shares of CDOs.

Our investments are typically structured to provide recurring cash flow in the form of interest income to us as the investor. In addition to earning interest income, we may structure our investments

to generate income from management, diligence, structuring, or other fees. Our total return may be enhanced through capital gains.

As a private equity investor, we believe that we have certain competitive advantages including:

- Access to public equity markets generally gives us a lower cost of capital than that of other private equity funds, and
- Our capital structure is perpetual in nature and may enable us to be a better long-term partner for our portfolio companies than other private equity funds that may have a limited life.

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

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

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

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 and our telephone number is (202) 331-1112. In addition, we have regional offices in New York, Chicago and Los Angeles.

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

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

DETERMINATION OF

NET ASSET VALUE *(Page 86)*

Our portfolio investments are generally recorded at fair value as determined in good faith by our Board of Directors in the absence of readily available public market values. At June 30, 2004, portfolio investments recorded at fair value were approximately 87% of our total assets.

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

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general

reserve for anticipated loan losses. Instead we are required to specifically value each individual investment and record unrealized depreciation for an investment that we believe has become impaired including where collection of a loan or realization of an equity security is doubtful or when the enterprise value of the company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer including the sum of the values of all debt and equity securities used to capitalize the enterprise at a point in time. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

PLAN OF DISTRIBUTION *(Page 120)*

We may offer, from time to time, up to 20,000,000 shares of our common stock, on terms to be determined at the time of the offering.

Shares of our common stock may be offered at prices and on terms described in one or more supplements to this prospectus. The offering price per share of our common stock less any underwriting commission or discount will not be less than the net asset value per share of our common stock at the time we make the offering.

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

We may not sell shares of common stock pursuant to this prospectus without delivering a prospectus supplement describing the method and terms of the offering of such shares.

USE OF PROCEEDS *(Page 18)*

We intend to use the net proceeds from selling shares of common stock for general corporate purposes, which includes investments in the debt or equity securities of primarily private companies, non-investment grade commercial mortgage-backed securities or the bonds and preferred shares of collateralized debt obligations, repayment of indebtedness, acquisitions and other general corporate purposes. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS *(Page 19)*

We intend to pay quarterly dividends to holders of our common stock. The amount of our quarterly dividends is determined by our Board of Directors on a quarterly basis.

DIVIDEND REINVESTMENT PLAN *(Page 113)*

We maintain an opt in dividend reinvestment plan for our common shareholders. As a result, if our Board of Directors declares a dividend, then our shareholders that have not opted in to our dividend reinvestment plan will receive cash dividends. New shareholders must notify our transfer agent in writing if they wish to enroll in the dividend reinvestment plan.

RISK FACTORS *(Page 10)*

Investment in our shares of common stock involves a number of significant risks relating to our business and our investment objective that you should consider before purchasing our shares of common stock.

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

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

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

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

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

Our business of making private equity investments and positioning them for liquidity events also may be affected by current and future market conditions. The absence of an active senior lending environment may slow the amount of private equity investment activity generally. As a result, the pace of our investment activity may slow.

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

We may not be able to pay dividends and failure to qualify as a regulated investment company for tax purposes could have a material adverse effect on our total return, if any.

Also, we are subject to certain risks associated with valuing our portfolio, investing in non-investment grade commercial mortgage-backed securities and collateralized debt obligations, changing interest rates, accessing additional capital, fluctuating financial results, and operating in a regulated environment.

Our common stock price may be volatile due to market factors that may be beyond our control.

CERTAIN ANTI-TAKEOVER

PROVISIONS *(Page 116)*

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

FEES AND EXPENSES

This table describes the various costs and expenses that an investor in our shares of common stock will bear directly or indirectly.

Shareholder Transaction Expenses	
Sales load (as a percentage of offering price)[1]	%
Dividend reinvestment plan fees[2]	None
Annual Expenses (as a percentage of consolidated net assets attributable to common stock)(3)	
Operating expenses[4]	4.4%
Interest payments on borrowed funds[5]	4.0%
Total annual expenses[6][7]	8.4%

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(1) In the event that the shares of common stock to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will disclose the applicable sales load.

(2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases or sales, if any. See Dividend Reinvestment Plan.

(3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities), which at June 30, 2004, was $1.9 billion.

(4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2004, excluding interest on indebtedness. This percentage of consolidated net assets for the year ended December 31, 2003, was 3.1%.

(5) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2004. We had outstanding borrowings of $1,058.8 million at June 30, 2004. This percentage for the year ended December 31, 2003, was 4.0%. See Risk Factors.

(6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that Total annual expenses percentage be calculated as a percentage of *net* assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 5.0% of consolidated total assets.

(7) The holders of shares of our common stock (and not the holders of our debt securities or preferred stock, if any) indirectly bear the cost associated with our annual expenses.

Example

The following example, required by the SEC, demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in us. In calculating the following expense amounts, we assumed we would have no additional leverage and that our operating expenses would remain at the levels set forth in the table above. In the event that shares to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will restate this example to reflect the applicable sales load.

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$ 84	$252	$420	$840

Although the example assumes (as required by the SEC) a 5.0% annual return, our performance will vary and may result in a return of greater or less than 5.0%. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in the dividend reinvestment plan may receive shares of common stock that we issue at or above net asset value or are purchased by the administrator of the dividend reinvestment plan, at the market price in effect at the time, which may be higher than, at, or below net asset value.

The example should not be considered a representation of future expenses, and the actual expenses

may be greater or less than those shown.

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included in this prospectus. Financial information at and for the years ended December 31, 2003 and 2002, has been derived from our financial statements that were audited by KPMG LLP. Financial information at and for the years ended December 31, 2001, 2000, and 1999, has been derived from our financial statements that were audited by Arthur Andersen LLP. For important information about Arthur Andersen LLP, see the section entitled Notice Regarding Arthur Andersen LLP. Quarterly financial information is derived from unaudited financial data, but in the opinion of management, reflects all adjustments (consisting only of normal recurring adjustments) that are necessary to present fairly the results of such interim periods. Interim results at and for the six months ended June 30, 2004, are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. **See Management s Discussion and Analysis of Financial Condition and Results of Operations on page 20 for more information.**

(in thousands, except per share data)	Six Months Ended June 30, (unaudited) 2004	2003	Year Ended December 31, 2003	2002	2001	2000	1999
Operating Data:							
Interest and related portfolio income:							
Interest and dividends	$ 147,712	$132,658	$290,719	$264,042	$240,464	$182,307	$121,112
Loan prepayment premiums and premiums from loan dispositions	4,017	2,758	8,172	2,776	2,504	16,138	14,284
Fees and other income	17,536	14,928	30,338	43,110	46,142	13,144	5,744
Total interest and related portfolio income	169,265	150,344	329,229	309,928	289,110	211,589	141,140
Expenses:							
Interest	37,096	37,280	77,233	70,443	65,104	57,412	34,860
Employee	17,893	17,379	36,945	33,126	29,656	26,025	22,889
Individual performance award	6,382						
Administrative	14,903	9,498	22,387	21,504	15,299	15,435	12,350
Total operating expenses	76,274	64,157	136,565	125,073	110,059	98,872	70,099
Net investment income before income taxes	92,991	86,187	192,664	184,855	179,051	112,717	71,041
Income tax expense (benefit)	(544)	(1,081)	(2,466)	930	(412)		
Net investment income	93,535	87,268	195,130	183,925	179,463	112,717	71,041
Net realized and unrealized gains (losses):							
Net realized gains	174,453	56,879	75,347	44,937	661	15,523	25,391
Net change in unrealized appreciation or depreciation	(152,338)	(64,334)	(78,466)	(571)	20,603	14,861	2,138
Total net gains (losses)	22,115	(7,455)	(3,119)	44,366	21,264	30,384	27,529
Net increase in net assets resulting from operations	$ 115,650	$ 79,813	$192,011	$228,291	$200,727	$143,101	$ 98,570
Per Share:							
Diluted earnings per common share	$ 0.88	$ 0.71	$ 1.62	$ 2.20	$ 2.16	$ 1.94	$ 1.64

Dividends per common share[1]	$ 1.14	$ 1.14	$ 2.28	$ 2.23	$ 2.01	$ 1.82	$ 1.60
Weighted average common shares outstanding diluted[2]	131,620	112,291	118,351	103,574	93,003	73,472	60,044

(in thousands, except per share data)	At June 30, 2004	At December 31, 2003	2002	2001	2000	1999
	(unaudited)					
Balance Sheet Data:						
Portfolio at value	$2,784,814	$2,584,599	$2,488,167	$2,329,590	$1,788,001	$1,228,497
Total assets	3,180,387	3,019,870	2,794,319	2,460,713	1,853,817	1,290,038
Total debt outstanding[3]	1,058,780	954,200	998,450	1,020,806	786,648	592,850
Preferred stock issued to Small Business Administration[3]		6,000	7,000	7,000	7,000	7,000
Shareholders equity	1,904,711	1,914,577	1,546,071	1,352,123	1,029,692	667,513
Shareholders equity per common share (net asset value)[4]	$ 14.77	$ 14.94	$ 14.22	$ 13.57	$ 12.11	$ 10.20
Common shares outstanding at period end[2]	128,960	128,118	108,698	99,607	85,057	65,414

	Six Months Ended June 30,		Year Ended December 31,				
	2004	2003	2003	2002	2001	2000	1999
	(unaudited)						
Other Data:							
Investments funded	$795,080	$526,399	$931,450	$506,376	$680,329	$901,545	$751,871
Principal collections related to investment repayments or sales	430,861	426,985	783,967	356,641	204,441	391,275	337,929
Realized gains	204,003	61,311	94,305	95,562	10,107	28,604	31,536
Realized losses	(29,550)	(4,432)	(18,958)	(50,625)	(9,446)	(13,081)	(6,145)

(in thousands, except per share data)	2004 Qtr 2	2004 Qtr 1	2003 Qtr 4	2003 Qtr 3	2003 Qtr 2	2003 Qtr 1	2002 Qtr 4	2002 Qtr 3	2002 Qtr 2	2002 Qtr 1
Quarterly Data (unaudited):										
Total interest and related portfolio income	$87,500	$81,765	$90,015	$88,870	$77,214	$73,130	$78,015	$76,329	$73,193	$82,391
Net investment income	48,990	44,545	54,254	53,608	44,598	42,670	42,401	45,094	42,561	53,869
Net increase in net assets resulting from operations	95,342	20,308	78,454	33,744	59,940	19,873	53,356	45,520	73,454	55,961
Diluted earnings per common share	0.73	0.15	0.62	0.28	0.52	0.18	0.51	0.44	0.71	0.55
Dividends declared per common share[5]	0.57	0.57	0.57	0.57	0.57	0.57	0.59	0.56	0.55	0.53
Net asset value per common share[4]	14.77	14.60	14.94	14.46	14.23	14.05	14.22	13.95	14.02	13.71

(1) Dividends are based on taxable income, which differs from income for financial reporting purposes.

(2) Excludes 234,977 and 516,779 common shares held in the deferred compensation trust at and for the years ended December 31, 2000 and 1999, respectively.

(3) See Senior Securities on page 60 for more information regarding our level of indebtedness.

(4) We determine net asset value per common share as of the last day of the period. The net asset values shown are based on outstanding shares at the end of each period.

(5) Dividends declared per common share for the fourth quarter of 2002 included the regular quarterly dividend of $0.56 per common share and an extra dividend of $0.03 per common share.

WHERE YOU CAN FIND

ADDITIONAL INFORMATION

We have filed with the SEC a registration statement on Form N-2 together with all amendments and related exhibits under the Securities Act of 1933. The registration statement contains additional information about us and the securities being offered by this prospectus. You may inspect the registration statement and the exhibits without charge at the SEC at 450 Fifth Street, NW, Washington, DC 20549. You may obtain copies from the SEC at prescribed rates.

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You can inspect our SEC filings, without charge, at the SEC s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The SEC also maintains a web site at *http://www.sec.gov* that contains our SEC filings. You can also obtain copies of these materials from the SEC s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, at prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. Copies may also be obtained, after paying a duplicating fee, by electronic request to publicinfo@sec.gov or by written request to Public Reference Section, Washington, DC 20549. You can also inspect reports and other information we file at the offices of the New York Stock Exchange, and you are able to inspect those at 20 Broad Street, New York, NY 10005.

RISK FACTORS

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

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

Investing in private companies involves a high degree of risk. Our portfolio consists of primarily 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 our 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, loss of key personnel, or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses.

Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments. At June 30, 2004, portfolio investments recorded at fair value were approximately 87% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security

has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

Our borrowers may default on their payments, which may have an effect on our financial performance. We make long-term unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources 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 related collateral.

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

Our financial results could be negatively affected if Business Loan Express fails to perform as expected. Business Loan Express, LLC (BLX) is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At June 30, 2004, the investment totaled $352.8 million at value, or 11.1% of total assets.

In addition, as controlling equity owner of BLX, we have provided an unconditional guaranty to BLX s senior credit facility lenders in an amount equal to 50% of BLX s total obligations on its $275.0 million revolving credit facility. The amount we have guaranteed at June 30, 2004, was $86.6 million. This guaranty can only be called in the event of a default by BLX. At June 30, 2004, we had also provided four standby letters of credit totaling $35.6 million in connection with four term securitization transactions completed by BLX.

Our financial results could be negatively affected if a significant portfolio investment fails to perform as expected. We purchase controlling equity stakes in companies and our total debt and equity investment in controlled companies may be significant individually or in the aggregate. Investments in controlled portfolio companies are generally larger and in fewer companies than our investments in companies that we do not control. As a result, if a significant investment in one or more controlled companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies.

Investments in non-investment grade commercial mortgage-backed securities and collateralized debt obligations may be illiquid, may have a higher risk of default, and may not produce current returns. The commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares in which we invest are not 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. Non-investment grade commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares 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 securities, but with the higher return comes greater risk of default. In addition, the fair value of these securities may change as interest rates change over time. Economic recessions or downturns may cause defaults or losses on collateral securing these securities to increase. 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.

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders 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, 2004, our asset coverage for senior indebtedness was 296%.

We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us. Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders. Lenders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our

consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

At June 30, 2004, we had $1,058.8 million of outstanding indebtedness bearing a weighted average annual interest cost of 6.8%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.3%.

Illustration. The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) $3,180.4 million in total assets, (ii) an average cost of funds of 6.8%, (iii) $1,058.8 million in debt outstanding and (iv) $1,904.7 million of shareholders equity.

Assumed Return on Our Portfolio

(net of expenses)

	-20%	**-10%**	**-5%**	**0%**	**5%**	**10%**	**20%**
Corresponding return to shareholder	-37.4%	-20.7%	-12.3%	-4.0%	4.4%	12.7%	29.4%

Changes in interest rates may affect our cost of capital and net investment income. Because we borrow money to make investments, our net investment income is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our revolving line of credit as a means to bridge to long-term financing. Our long-term fixed-rate investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act. We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected our net income by less than 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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

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

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

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

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

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

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

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

Until the question raised by the staff of the SEC pertaining to the Federal Reserve s 1998 change to its margin rules has been addressed by legislative, administrative or judicial action, we intend to treat as qualifying assets only those debt and equity securities that are issued by a private company that has no marginable securities outstanding at the time we purchase such securities. As a result, we will not invest in a private company with outstanding debt securities unless at the time of and after giving effect to such investment, at least 70% of our total assets are qualifying assets.

Results may fluctuate and may not be indicative of future performance. Our operating results may fluctuate and, therefore, you should not rely on current or historical period results to be indicative of our performance in future reporting periods. Factors that could cause operating results to fluctuate include, 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 net realized gains or losses and changes in unrealized appreciation or depreciation, the degree to which we encounter competition in our markets, and general economic conditions.

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

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

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

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

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

Disclosure Regarding Forward-Looking Statements

Information contained or incorporated by reference in this prospectus, and the accompanying prospectus supplement, if any, may contain forward-looking statements which can be identified by the use of forward-looking terminology such as may, will, expect, inter anticipate, estimate or continue or the negative thereof or other variations or similar words or phrases. The matters described in Risk Factors and certain other factors noted throughout this prospectus, and the accompanying prospectus supplement, if any, and in any exhibits to the registration statement of which this prospectus, and the accompanying prospectus supplement, if any, is a part, constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

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

USE OF PROCEEDS

We intend to use the net proceeds from selling shares of our common stock for general corporate purposes, which may include investment in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares, repayment of indebtedness, acquisitions and other general corporate purposes. Because our primary business is to provide long-term debt and equity capital to small and middle-market companies, we are constantly identifying, reviewing and, to the extent consistent with our investment objective, funding new investments. As a result, we typically raise equity capital as we deem appropriate to fund such new investments. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

We anticipate that substantially all of the net proceeds of any offering of shares of our common stock will be used, as described above, within six months, but in no event longer than two years. Pending investment, we intend to invest the net proceeds of any offering of shares of our common stock in time deposits, income-producing securities with maturities of three months or less that are issued or guaranteed by the federal government or an agency of the federal government, and high quality debt securities maturing in one year or less from the time of investment. Our ability to achieve our investment objective may be limited to the extent that the net proceeds of any offering, pending full investment, are held in time deposits and other short-term instruments.

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On September 13, 2004, the last reported closing sale price of our common stock was $25.48 per share.

		Closing Sales Price		Premium of High Sales Price	Premium of Low Sales Price	
	NAV(1)	High	Low	to NAV(2)	to NAV(2)	Declared Dividends
Year ended December 31, 2002						
First Quarter	$13.71	$28.93	$25.84	211%	188%	$0.53
Second Quarter	$14.02	$27.66	$20.88	197%	149%	$0.55
Third Quarter	$13.95	$24.49	$18.90	176%	135%	$0.56
Fourth Quarter	$14.22	$22.87	$18.90	161%	133%	$0.56
Extra Dividend						$0.03
Year ended December 31, 2003						
First Quarter	$14.05	$23.85	$19.82	170%	141%	$0.57
Second Quarter	$14.23	$25.16	$19.85	177%	139%	$0.57
Third Quarter	$14.46	$26.60	$22.97	184%	159%	$0.57
Fourth Quarter	$14.94	$28.16	$24.63	188%	165%	$0.57
Year ending December 31, 2004						
First Quarter	$14.60	$30.85	$27.15	211%	186%	$0.57
Second Quarter	$14.77	$30.25	$23.06	205%	156%	$0.57
Third Quarter (through September 13, 2004)	*	$25.67	$22.22	*	*	$0.57

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

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

* Net asset value has not yet been calculated for this period.

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

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

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

MANAGEMENT S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The information contained in this section should be read in conjunction with our 2003 Consolidated Financial Statements and the Notes thereto. In addition, this prospectus contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or other variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth above in the Risk Factors section. Other factors that could cause actual results to differ materially include:

changes in the economy;

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

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

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

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

OVERVIEW

We are a business development company that is in the private equity business and provides long-term debt and equity capital. Our lending and investment activity is generally focused on private finance and commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS, and collateralized debt obligation bonds and preferred shares, which we refer to as CDOs. Our private finance activity principally involves providing financing through privately negotiated long-term debt and equity investment capital. Our private financing is generally used to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital or whose securities may not be marginable.

Our portfolio composition at June 30, 2004, and December 31, 2003, 2002, and 2001, was as follows:

	At June 30, 2004	At December 31, 2003	2002	2001
Private finance	69%	74%	70%	68%
Commercial real estate finance	31%	26%	30%	32%

Our earnings depend primarily on the level of interest and dividend income, fee and other income, and net gains or losses earned on our investment portfolio after deducting interest expense on borrowed capital and operating expenses. Interest income results from the interest 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 outstanding during the period multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory, and competitive factors that influence new investment activity, the amount of loans and debt securities for which interest is not accruing and our ability to secure debt and equity capital for our investment activities.

Because we are a regulated investment company for tax purposes, we distribute substantially all of our taxable income as dividends to our shareholders.

PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, were as follows:

($ in millions)	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,		
	2004	2003	2003	2002	2001
	(unaudited)				
Portfolio at value	$2,784.8	$2,546.1	$2,584.6	$2,488.2	$2,329.6
Investments funded	$ 795.1	$ 526.4	$ 931.5	$ 506.4	$ 680.3
Change in accrued or reinvested interest and dividends	$ 26.1	$ 20.4	$ 45.0	$ 44.7	$ 51.6
Principal collections related to investment repayments or sales	$ 430.9	$ 427.0	$ 784.0	$ 356.6	$ 204.4
Yield[(1)]	14.0%	14.1%	14.7%	14.0%	14.3%

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

Private Finance

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, were as follows:

($ in millions)	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,		
	2004	2003	2003	2002	2001
	(unaudited)				
Portfolio at value:					
Loans and debt securities	$1,278.1	$1,192.4	$1,214.9	$1,151.2	$1,107.9
Equity interests	634.4	646.8	687.8	592.0	487.2
Total portfolio	$1,912.5	$1,839.2	$1,902.7	$1,743.2	$1,595.1
Investments funded[1]	$ 562.5	$ 273.9	$ 498.0	$ 297.2	$ 287.7
Change in accrued or reinvested interest and dividends	$ 21.4	$ 19.4	$ 41.8	$ 42.6	$ 48.9
Principal collections related to investment repayments or sales	$ 394.5	$ 146.0	$ 314.3	$ 129.3	$ 43.8
Yield[2]	14.6%	14.4%	15.0%	14.4%	14.8%

(1) Investments funded for the six months ended June 30, 2004, include a $47.5 million subordinated debt investment in The Hillman Companies, Inc. received in conjunction with the sale of Hillman as discussed below.

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

Investments funded for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, consisted of the following:

($ in millions)	Loans and Debt Securities	Equity Interests	Total
For the Six Months Ended June 30, 2004			
Companies more than 25% owned	$189.4	$106.2	$295.6
Companies 5% to 25% owned	24.8	16.4	41.2
Companies less than 5% owned	213.5	12.2	225.7
Total	$427.7	$134.8	$562.5
For the Six Months Ended June 30, 2003			
Companies more than 25% owned	$ 42.2	$ 25.2	$ 67.4
Companies 5% to 25% owned	9.5	1.0	10.5
Companies less than 5% owned	190.6	5.4	196.0
Total	$242.3	$ 31.6	$273.9

($ in millions)	Loans and Debt Securities	Equity Interests	Total
For the Year Ended December 31, 2003			
Companies more than 25% owned	$ 53.0	$34.0	$ 87.0
Companies 5% to 25% owned	23.8	1.9	25.7
Companies less than 5% owned	377.4	7.9	385.3
Total	$454.2	$43.8	$498.0
For the Year Ended December 31, 2002			
Companies more than 25% owned	$ 86.1	$18.7	$104.8
Companies 5% to 25% owned	22.3	0.4	22.7
Companies less than 5% owned	154.6	15.1	169.7
Total	$263.0	$34.2	$297.2
For the Year Ended December 31, 2001			
Companies more than 25% owned	$ 47.8	$78.3	$126.1
Companies 5% to 25% owned	13.5	4.5	18.0
Companies less than 5% owned	136.9	6.7	143.6
Total	$198.2	$89.5	$287.7

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. Over the last three years, we believe that there was a decline in the availability of senior debt capital from banks for middle market companies and there were fewer merger and acquisition transactions for these companies. In mid-2003, we began to see an increase in merger and acquisition activity and debt capital became more available. As a result, investments funded and principal repayments were higher for 2003 than for 2002 and 2001. Merger and acquisition activity in the middle market has been strong in the first half of 2004, which has resulted in an increase in private finance investments funded, as well as increased repayments.

On June 30, 2004, we completed the purchase of a majority ownership stake in the business of Advantage Sales & Marketing, Inc. (Advantage), a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. At June 30, 2004, our investment in Advantage totaled $257.2 million at cost and value in debt and equity securities, including closing costs. At the closing of the transaction, we invested $90.2 million in loans and subordinated debt and $73.5 million in common stock. In addition, prior to completing the purchase, we had invested $93.7 million in subordinated debt in certain predecessor companies of Advantage, of which $45.5 million was invested during the second quarter of 2004. This existing debt was exchanged for new subordinated debt in Advantage as part of the transaction.

Also during the second quarter, we completed the purchase of a majority ownership stake in Mercury Air Centers, Inc. (Mercury), an operator of fixed base operations, from Mercury Air Group, Inc. At June 30, 2004, our investment in Mercury totaled $82.7 million at cost and value, including closing costs. Our investment in Mercury consists of $53.2 million in debt and $29.5 million in common stock. We have an additional $8.5 million commitment to fund senior subordinated debt for future working capital and construction commitments. In connection with the transaction, Mercury Air Group, Inc. repaid its $24 million subordinated debt obligation to Allied Capital.

On March 31, 2004, we sold The Hillman Companies, Inc. (Hillman) for a total transaction value of $510 million, including the repayment of outstanding debt and adding the value of Hillman s outstanding trust preferred shares. We were repaid our existing $44.6 million in outstanding mezzanine debt. Total consideration to us from this sale at closing, including the repayment of debt, was $244.3 million, which included net cash proceeds of $196.8 million and the receipt of a new subordinated debt instrument of $47.5 million. During the second quarter of 2004, we sold a $5.0 million participation in our subordinated debt in Hillman to a third party, which reduced our investment, and no gain or loss resulted from the transaction. For the six months ended June 30, 2004, we realized a gain of $150.2 million on the transaction, including a gain of $1.2 million realized during the second quarter of 2004, resulting from post-closing adjustments, which provided additional cash consideration to us in the same amount. The sale of Hillman is subject to certain other post-closing adjustments.

In addition, investing activities in portfolio companies more than 25% owned during the six months ended June 30, 2004, included a $6.6 million debt and equity investment, including closing costs, to purchase Legacy Partners Group, LLC; an equity investment of $7.5 million and an exchange of existing subordinated debt with a cost basis of $7.3 million for equity interests in an affiliate of Impact Innovations Group, LLC; and an exchange of existing debt securities, along with accrued and unpaid interest thereon, with a total cost basis of $49.8 million for $12.5 million of new debt and a 68.5% common stock interest in Startec Global Communications Corporation (Startec) upon its emergence from bankruptcy in May 2004. We also provided a $2.2 million term loan to Startec for working capital.

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

At June 30, 2004, we had outstanding investment commitments to private finance portfolio companies totaling $321.2 million. In addition, we had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling $133.8 million.

Significant outstanding investment commitments at June 30, 2004, included the following:

$93.0 million of financing and purchase commitments to Callidus Capital Corporation (Callidus), an asset management company that structures and manages collateralized debt obligations (CDOs), senior loan collateralized loan obligations (CLOs), and other related investments. Our commitment consists of $50 million of subordinated debt to support Callidus warehouse facilities and warehousing activities, $41.8 million to purchase preferred equity securities in Callidus future CDO or CLO transactions, and $1.2 million for working capital needs. At June 30, 2004, we had an investment in Callidus totaling $6.3 million at value, which included equity ownership for 80% of the management company. We made our initial investment in Callidus in the fourth quarter of 2003.

During the first quarter of 2004, Callidus obtained a secured warehouse credit facility for up to $300 million to finance the acquisition of senior corporate loans pending securitization through a CDO or CLO. In conjunction with this warehouse

credit facility, we have agreed to designate $32.3 million of our $50 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

Subsequent to June 30, 2004, we made an additional investment commitment of $150 million in the form of a revolving line of credit facility to support Callidus middle-market underwriting and syndication activities. This commitment is not included in our outstanding investment commitments as of June 30, 2004.

Approximately $93.3 million in the form of subordinated debt and equity to purchase Financial Pacific Company, a specialized commercial finance company focused on providing leases for business-essential equipment to small businesses nationwide. The purchase was completed on August 2, 2004.

$55.1 million in the form of subordinated debt to CBA Mezzanine Capital Finance, LLC to support its loan origination activity. This commitment expires in April 2005 and there are currently no amounts outstanding under this facility.

$20 million in the form of a revolving credit facility to Business Loan Express, LLC (BLX) to provide working capital to the company. At June 30, 2004, BLX had outstanding borrowings of $10 million on the facility. This $10 million was repaid by BLX after the end of the second quarter, and there are currently no amounts outstanding under this facility.

$25.4 million in the form of equity to eight private venture capital funds.

Our most significant investments at June 30, 2004, were in Business Loan Express, LLC (BLX), which was acquired in 2000, and Advantage Sales & Marketing, Inc. (Advantage), which was acquired on June 30, 2004.

Business Loan Express, LLC. At June 30, 2004, our investment in BLX totaled $275.0 million at cost and $352.8 million at value, or 11.1% of our total assets, which includes unrealized appreciation of $77.8 million.

BLX is a national, non-bank lender utilizing the SBA s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a nationwide preferred lender, as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans, originates loans under the USDA Business and Industry Guaranteed Loan Program (B&I) and during the quarter ended March 31, 2004, BLX began originating small investment real estate loans. BLX has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, could negatively affect our financial results.

Summary financial data for BLX at and for the nine months ended June 30, 2004, and at and for its fiscal year ended September 30, 2003, is presented below. Summary financial data has been provided by BLX and is unaudited.

($ in millions)	At and for the Nine Months Ended June 30, 2004[1]	At and for the Fiscal Year Ended September 30, 2003
Operating Data		
Total revenue	$ 92.3	$ 108.3
Net income[2]	$ 13.0	$ 4.7
Earnings before interest, taxes and management fees (EBITM)[2]	$ 37.6	$ 37.5
Balance Sheet Data		
Total assets	$ 419.6	$ 353.0
Total debt	$ 208.1	$ 178.5
Total owners equity	$ 151.3	$ 136.1
Other Data		
Loan originations		
7(a) originations	$ 272.2	$ 502.4
Conventional originations	212.1	151.6
B&I originations	11.4	31.8
Total loan originations	$ 495.7	$ 685.8
Serviced loan portfolio	$2,507.1	$2,227.4
Number of loans	3,501	3,136
Loan delinquencies[3]	8.7%	8.3%
Serviced Loan Portfolio by Industry		
Hotels	24%	24%
Gas stations/convenience stores	20	19
Professional and retail services	12	12
Restaurants	9	9
Manufacturing and industrial	9	9
Car wash/auto repair services	7	7
Child care and health care services	6	6
Recreation	4	5
Shrimp/fishing vessels	4	5
Other	5	4
Total	100%	100%

(1) The results of operations for the nine months ended June 30, 2004, are not necessarily indicative of the operating results to be expected for the full fiscal year.

(2) For the fiscal year ended September 30, 2003, EBITM and net income were reduced by $2.3 million due to costs associated with its acquisition of Amresco Independence Funding, Inc. and its reorganization from a corporation to a limited liability company (LLC) and $2.3 million due to the increased value of issued and outstanding equity appreciation rights. In addition, net income for the fiscal year ended September 30, 2003, was increased by $3.4 million due to the reversal of certain net deferred tax liabilities upon the conversion of BLX from a corporation to a limited liability company. As an LLC, BLX is generally not subject to federal income tax; however, BLX is subject to certain state income and franchise taxes, and income taxes associated with a taxable subsidiary corporation.

(3) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan

portfolio, were 8.7% at June 30, 2004. SBA 7(a) loans greater than one year old at June 30, 2004, had a delinquency rate of 10.5%. BLX will from time to time grant a 90-day deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice. The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative economic conditions. Small businesses are also more vulnerable to customer preferences, competition, rising fuel prices and market conditions and, as a result, delinquencies in BLX s portfolio may increase. For instance, the shrimp and fishing industry has been affected by rising fuel costs and competition from imported shrimp. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and receives personal guarantees from the principal owners of the small business.

BLX s revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX s portfolio, and other income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. The total of cash loan sale premiums, cash interest income and cash received from residual interests and other cash income is equal to approximately 80% of BLX s revenue of $92.3 million for the nine months ended June 30, 2004, and approximately 83% of BLX s revenue of $108.3 million for the fiscal year ended September 30, 2003.

BLX s business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. Loans originated during the nine months ended June 30, 2004, totaled $495.7 million. Proceeds from loan sales during the nine months ended June 30, 2004, totaled approximately $477.6 million. Loans originated during the fiscal year ended September 30, 2003, totaled $685.8 million. Proceeds from loan sales during the fiscal year ended September 30, 2003, totaled approximately $664.2 million. From time to time, BLX funds the construction of commercial real estate projects and as a result is unable to sell a construction loan until the loan is fully funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore, until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.4% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the nine months ended June 30, 2004, were approximately $20.8 million in total. Cash premiums received from guaranteed loan sales during the fiscal year ended September 30, 2003, were approximately $31.3 million in total. Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 5.0%.

In addition, BLX sells the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates into a conduit facility. The conduit loans are securitized and BLX retains an interest of up to 5.0% of the loan pool. BLX then receives the excess of loan interest payments on the loans sold over the interest cost on the securities issued in the securitization over the life of the loan pool, which is generally between 4.3% and 5.0% annually on the loans sold into the securitization pools.

When BLX sells a guaranteed piece of an SBA 7(a) loan at par, or when BLX securitizes a loan, it will record a residual interest and servicing asset, together referred to as the Residual Interest, in order to account for the retained interest in the loans sold and the net present value of the future cash flows it expects to receive from the loans sold or securitized. In computing the Residual Interest, BLX discounts estimated future cash flows after making assumptions as to future loan losses and loan prepayments, which may reduce future cash flows. For the nine months ended June 30, 2004, BLX received cash payments from the Residual Interest of approximately $44.4 million. For the fiscal year ended September 30, 2003, BLX received cash payments from the Residual Interest of approximately $49.3 million.

At June 30, 2004, BLX s Residual Interest totaled $197.9 million, representing BLX s estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of $834.1 million over time, with approximately $70.2 million, $61.9 million, $60.0 million, and $58.2 million (or $250.3 million in the aggregate) scheduled to be received in the next four years ending on June 30, 2005, 2006, 2007, and 2008, respectively.

In February 2003, BLX completed a reorganization from a corporation to a limited liability company in order to simplify its corporate structure and provide certain income tax efficiencies. In connection with the reorganization, BLX s stated book equity increased by $43 million because we converted $43 million of our subordinated debt into preferred stock in BLX, Inc., which was exchanged for Class A equity interests in BLX, LLC. In addition, we exchanged our existing preferred stock and common equity investments in BLX, Inc. for similar classes of members equity in BLX, LLC represented by Class B and Class C equity interests, respectively. In connection with the reorganization, BLX changed its fiscal year end to September 30.

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

BLX paid dividends to us in cash or in kind on the Class A interests totaling $6.1 million and $4.6 million, respectively, for the six months ended June 30, 2004 and 2003, and totaling $10.4 million for the year ended December 31, 2003. The guaranteed dividend yield on these equity interests is included in interest income. In addition, BLX paid dividends to us on the Class B interests totaling $4.8 million and $2.0 million, respectively, for the six months ended June 30, 2004 and 2003, and totaling $7.8 million for the year ended December 31, 2003, and these dividends were paid to us through the issuance of additional Class B equity interests.

In the last week of the second quarter of 2004, BLX had a high volume of loan closings and funded approximately $49 million of new loans. In order to facilitate this high volume of loan originations, we provided BLX a $10 million draw on a new $20 million revolving credit facility to provide temporary working capital. This draw was repaid by BLX after the end of the second quarter, and there are currently no outstanding borrowings under this facility.

At June 30, 2004, BLX had a three-year $275.0 million revolving credit facility that matures in January 2007. The facility provides for a sub-facility for the issuance of letters of credit for up to a total of $50.0 million. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. The principal amount outstanding on the revolving credit facility at June 30, 2004, was $155.8 million and the amount guaranteed by us was $86.6 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 revolving credit facility at June 30, 2004. At June 30, 2004, we had also provided four standby letters of credit totaling $35.6 million in connection with four term securitization transactions completed by BLX.

Advantage Sales & Marketing, Inc. At June 30, 2004, our investment in Advantage Sales & Marketing, Inc. totaled $257.2 million at cost and value, or 8.1% of our total assets. As discussed above, we completed the purchase of a majority ownership stake in Advantage on June 30, 2004. Given that this investment was completed on June 30, 2004, the fair value of our investment in Advantage is equal to our cost. Advantage is a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the country and is headquartered in Irvine, CA.

The Hillman Companies, Inc. At December 31, 2003, our investment in Hillman totaled $94.6 million at cost and $234.5 million at value, or 7.8% of total assets, which included unrealized appreciation of $139.9 million. On March 31, 2004, we sold The Hillman Companies, Inc. (Hillman) for a total transaction value of $510 million, including the repayment of outstanding debt and adding the value of Hillman s outstanding trust preferred shares. We were repaid our existing $44.6 million in outstanding mezzanine debt. Total consideration to us from this sale at closing, including the repayment of debt, was $244.3 million, which included net cash proceeds of $196.8 million and the receipt of a new subordinated debt instrument of $47.5 million. During the second quarter of 2004, we sold a $5.0 million participation in our subordinated debt in Hillman to a third party, which reduced our investment, and no gain or loss resulted from the transaction. For the six months ended June 30, 2004, we realized a gain of $150.2 million on the transaction, including a gain of $1.2 million realized during the second quarter of 2004, resulting from post-closing adjustments, which provided additional cash consideration to us in the same amount. The sale of Hillman is subject to certain other post-closing adjustments.

Commercial Real Estate Finance

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, were as follows:

	At and for Six Months Ended June 30,				At and for the Years Ended December 31,					
	2004		2003		2003		2002		2001	
	(unaudited)									
($ in millions)	Value	Yield[(1)]	Value	Yield[(1)]	Value	Yield[(1)]	Value	Yield[(1)]	Value	Yield[(1)]
Portfolio at value:										
CMBS bonds	$530.8	13.0%	$423.6	13.9%	$394.0	14.1%	$555.5	14.2%	$558.3	14.7%
CDO bonds and preferred shares	175.6	17.3%	167.4	16.6%	186.6	16.7%	52.8	17.2%	24.2	16.9%
Commercial mortgage loans	147.0	8.5%	105.4	7.8%	83.6	8.6%	63.7	7.5%	79.6	7.7%
Residual interest							69.0	9.4%	69.9	9.4%
Real estate owned	14.4		10.5		12.8		4.0		2.5	
Equity interests	4.5				4.9					
Total portfolio	$872.3		$706.9		$681.9		$745.0		$734.5	
Investments funded	$232.6		$252.5		$433.5		$209.2		$392.6	
Change in accrued or reinvested interest	$ 4.7		$ 1.0		$ 3.2		$ 2.1		$ 2.7	
Principal collections related to investment repayments or sales	$ 36.4		$281.0		$469.7		$227.3		$160.6	

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

Our commercial real estate investment activity for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, was as follows:

($ in millions)	Face Amount	Discount	Amount Funded
For the Six Months Ended June 30, 2004			
CMBS bonds (8 issuances)	$262.3	$(110.0)	$152.3
CDO bonds and preferred shares (1 issuance)	4.0	(0.3)	3.7
Commercial mortgage loans	84.8	(8.3)	76.5
Equity interests	0.1		0.1
Total	$351.2	$(118.6)	$232.6
For the Six Months Ended June 30, 2003			
CMBS bonds (7 issuances)	$250.1	$(115.7)	$134.4
CDO bonds and preferred shares (1 issuance)	118.4	(0.3)	118.1
Total	$368.5	$(116.0)	$252.5

For the Year Ended December 31, 2003			
CMBS bonds (18 issuances)	$508.5	$(225.9)	$282.6
CDO bonds and preferred shares (3 issuances)	145.8	(0.4)	145.4
Commercial mortgage loans	3.0		3.0
Equity interests	2.5		2.5
Total	$659.8	$(226.3)	$433.5

($ in millions)	Face Amount	Discount	Amount Funded
For the Year Ended December 31, 2002			
CMBS bonds (5 issuances)	$302.5	$(140.2)	$162.3
CDO preferred shares (3 issuances)	29.0		29.0
Commercial mortgage loans	11.7	(1.7)	10.0
Real estate owned	7.9		7.9
Total	$351.1	$(141.9)	$209.2
For the Year Ended December 31, 2001			
CMBS bonds (8 issuances)	$661.4	$(295.6)	$365.8
CDO preferred shares (1 issuance)	24.6		24.6
Commercial mortgage loans	2.2		2.2
Total	$688.2	$(295.6)	$392.6

At June 30, 2004, we had outstanding funding commitments related to commercial mortgage loans and equity interests of $4.6 million and commitments in the form of standby letters of credit and guarantees related to equity interests of $2.7 million.

CMBS Bonds. The underlying pools of mortgage loans that are collateral for our investments in new CMBS bond issuances for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, had respective original underwritten loan to value and underwritten debt service coverage ratios as follows:

	For the Six Months Ended June 30,				For the Years Ended December 31,					
	2004		2003		2003		2002		2001	
Loan to Value Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**
Less than 60%	$2,396.9	26%	$1,971.8	28%	$ 4,114.3	22%	$ 909.3	20%	$1,259.7	15%
60-65%	702.0	8	527.2	8	1,582.8	9	287.3	6	941.6	11
65-70%	862.1	9	776.5	11	1,768.0	10	587.9	13	1,140.6	14
70-75%	1,837.6	20	1,217.3	18	4,024.3	22	1,214.5	27	2,400.4	29
75-80%	3,160.0	34	2,364.9	34	6,560.5	36	1,477.5	33	2,466.4	30
Greater than 80%	335.8	3	25.2	1	138.6	1	47.8	1	119.6	1
Total	$9,294.4	100%	$6,882.9	100%	$18,188.5	100%	$4,524.3	100%	$8,328.3	100%
Weighted average loan to value	67.6%		67.1%		68.5%		68.5%		69.7%	

	For the Six Months Ended June 30,				For the Years Ended December 31,					
	2004		2003		2003		2002		2001	
Debt Service Coverage Ratio Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**
Greater than 2.00	$1,570.8	16%	$2,042.6	30%	$ 4,208.7	23%	$ 366.9	8%	$ 484.8	6%

1.76 2.00	894.9	10	697.1	10	2,094.6	12	229.6	5	158.2	2
1.51 1.75	1,094.8	12	1,264.4	18	3,132.8	17	477.4	11	855.0	10
1.26 1.50	4,375.3	47	2,478.3	36	7,362.9	40	2,739.6	60	5,008.3	60
Less than 1.25	1,358.6	15	400.5	6	1,389.5	8	710.8	16	1,822.0	22
Total	$9,294.4	100%	$6,882.9	100%	$18,188.5	100%	$4,524.3	100%	$8,328.3	100%
Weighted average debt service coverage ratio	1.62		1.75		1.73		1.41		1.48	

From time to time, we may sell lower yielding CMBS bonds rated BB+ through BB-, and to a lesser extent CMBS bonds rated B+ and B, in order to maximize the return on our CMBS bond portfolio. The cost basis of and the gross sales proceeds from CMBS bonds sold, the related net realized gains from these sales, and the weighted average yield on the CMBS bonds sold for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, were as follows:

($ in millions)	For the Six Months Ended June 30,		For the Years Ended December 31,		
	2004	**2003**	**2003**	**2002**	**2001**
Cost basis	$6.3	$253.5	$412.3	$205.9	$124.5
Gross sales proceeds[1]	$6.4	$284.8	$446.8	$225.6	$126.8
Net realized gains (net of related hedge gains or losses)	$0.1	$ 24.6	$ 31.6	$ 19.1	$ 1.7
Weighted average yield	7.7%	11.8%	10.1%	11.5%	10.3%

(1) Gross sales proceeds represent the total cash consideration received, including the repayment of the cost basis of the bonds and proceeds related to the net realized gains on the bonds.

The BBB- rated, non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages is generally allocated first to the senior tranches in order of priority, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages or properties securing those mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At June 30, 2004, the face value of the CMBS bonds we held were subordinate to 80% to 99% of the face value of the bonds issued in these various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of interest and principal, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, the average discount for the CMBS bonds in which we invested was 42%, 46%, 44%, 46% and 45%, respectively.

At June 30, 2004, the unamortized discount related to the CMBS bond portfolio was $725.9 million, of which $356.1 million has been set aside to absorb potential future losses. The yield on the CMBS bonds of 13.0% assumes that this amount that has been set aside will not be amortized. As the amount of future losses and the expected timing of recognition of such losses is difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yield will be achieved. At June 30, 2004, the CMBS bond portfolio had a fair value of $530.8 million, which included net unrealized depreciation on the CMBS bonds of $13.1 million.

The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB- and above rated CMBS bonds held in the portfolio. Consistent with our historical practice, we may sell some of the higher rated

bonds later in 2004. Our CMBS bond portfolio and the related yields at June 30, 2004, and December 31, 2003 and 2002, were as follows:

	June 30, 2004		December 31, 2003		December 31, 2002	
($ in millions)	Value	Yield	Value	Yield	Value	Yield
CMBS bonds rated BB- and above	$176.8	7.8%	$ 88.4	8.2%	$110.9	8.8%
CMBS bonds rated below BB-	354.0	15.6%	305.6	15.8%	444.6	15.5%
Total	$530.8	13.0%	$394.0	14.1%	$555.5	14.2%

At June 30, 2004, and December 31, 2003 and 2002, the age of our bonds rated below BB- was as follows:

	June 30, 2004		December 31, 2003		December 31, 2002	
($ in millions)	Value	Percentage	Value	Percentage	Value	Percentage
Less than one year old	$102.9	29.1%	$ 83.9	27.5%	$ 66.6	15.0%
One to two years old	54.6	15.4	41.0	13.4	125.1	28.1
Two to three years old	52.8	14.9	43.8	14.3	73.2	16.5
Three years old or older	143.7	40.6	136.9	44.8	179.7	40.4
Total	$354.0	100.0%	$305.6	100.0%	$444.6	100.0%

At June 30, 2004, and December 31, 2003 and 2002, we held CMBS bonds in 47, 38 and 27 separate CMBS issuances, respectively. The underlying collateral pool, consisting of commercial mortgage loans and real estate owned (REO) properties, for these CMBS bonds consisted of the following at June 30, 2004, and December 31, 2003 and 2002:

($ in millions)	June 30, 2004	December 31, 2003	December 31, 2002
Approximate number of loans and REO properties(1)	6,400	5,600	4,500
Total outstanding principal balance	$46,336	$38,437	$24,974
Loans over 30 days delinquent or classified as REO properties(2)	1.2%(3)	1.5% (3)	1.0% (3)

(1) Includes approximately 35, 22 and 12 REO properties obtained through the foreclosure of commercial mortgage loans at June 30, 2004, and December 31, 2003 and 2002, respectively.

(2) As a percentage of total outstanding principal balance.

(3) At June 30, 2004, and December 31, 2003 and 2002, our investments included bonds in the first loss, unrated bond class in 40, 34 and 27 separate CMBS issuances, respectively. For these issuances, loans over 30 days delinquent or classified as REO properties were 1.5%, 1.7% and 1.0% of the total outstanding principal balance at June 30, 2004, and December 31, 2003 and 2002, respectively.

Collateralized Debt Obligation Bonds and Preferred Shares. During the six months ended June 30, 2004, we sold CDO bonds with a cost basis of $16.3 million for a net realized gain of $0.1 million, net of the related hedge gain. During the six months ended June 30, 2003, and the year ended December 31, 2003, we sold CDO bonds and preferred shares with a cost basis of $6.4 million and $13.9 million, respectively, for net realized losses of $0.1 million for both periods, net of the related hedge gains. The yield on the

CDO bonds and preferred shares sold was 7.6%, 8.4%, and 8.0% for the six months ended June 30, 2004 and 2003, and for the year ended December 31, 2003, respectively.

The BB rated bonds and the preferred shares of the CDOs in which we have invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral that result in reduced cash flows, the preferred shares will bear this loss first and then the bonds would bear any loss after the preferred shares. At June 30, 2004, our bonds and preferred shares in the CDO were subordinate to 70% to 98% of the more senior tranches of debt issued in the various CDO transactions. In addition, included in the CMBS collateral for the CDOs at June 30, 2004, were certain CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held directly by us.

The yield on our CDO bonds and preferred shares at June 30, 2004, and December 31, 2003, 2002, and 2001, was 17.3%, 16.7%, 17.2%, and 16.9%, respectively. The yield on the CDO portfolio at any point in time will generally vary depending on the amount of lower yielding CDO bonds held in the portfolio.

At June 30, 2004, and December 31, 2003 and 2002, the underlying collateral for our investments in the outstanding CDO issuances had balances as follows:

		December 31,	
($ in millions)	**June 30, 2004**	**2003**	**2002**
Investment grade REIT debt[1]	$1,404.1	$1,338.0	$1,016.9
Investment grade CMBS bonds[2]	805.6	662.3	494.2
Non-investment grade CMBS bonds[3]	1,185.3	1,133.7	438.3
Other collateral	120.2	32.4	8.2
Total collateral	$3,515.2	$3,166.4	$1,957.6

(1) Issued by 44, 44 and 40 REITs, respectively, for the respective periods presented.
(2) Issued in 97, 78 and 43 transactions, respectively, for the respective periods presented.
(3) Issued in 77, 68 and 33 transactions, respectively, for the respective periods presented.

Portfolio Asset Quality

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

At June 30, 2004, and December 31, 2003 and 2002, our portfolio was graded as follows:

			December 31,			
	At June 30, 2004		2003		2002	
Grade	**Portfolio at Value**	**Percentage of Total Portfolio**	**Portfolio at Value**	**Percentage of Total Portfolio**	**Portfolio at Value**	**Percentage of Total Portfolio**
($ in millions)						
1	$ 748.4	26.9%	$ 985.1	38.1%	$ 801.0	32.1%
2	1,809.2	65.0	1,271.4	49.2	1,400.8	56.3
3	82.4	2.9	212.4	8.2	166.0	6.7
4	36.4	1.3	34.7	1.4	23.6	1.0
5	108.4	3.9	81.0	3.1	96.8	3.9
	$2,784.8	100.0%	$2,584.6	100.0%	$2,488.2	100.0%

The decrease in Grade 1 assets at June 30, 2004, as compared to December 31, 2003, is primarily due to the sale of Hillman on March 31, 2004. The value of Hillman at December 31, 2003, was $234.5 million, and this value was included in Grade 1 assets. We received $47.5 million of new subordinated debt in Hillman in conjunction with the sale. During the second quarter of 2004, we sold a participation in this debt of $5.0 million to a third party, which reduced our investment. The remaining balance of this new debt was included in Grade 2 assets at June 30, 2004. We continue to include our CMBS portfolio in Grade 2 assets, as we are uncertain as to whether the unrealized appreciation or depreciation on our CMBS portfolio at June 30, 2004, will necessarily result in a realized gain or loss.

Total Grade 3, 4 and 5 portfolio assets as a percentage of the total portfolio at value at June 30, 2004, and December 31, 2003 and 2002, were 8.2%, 12.7% and 11.6%, respectively. Included in Grade 3, 4 and 5 assets at June 30, 2004 and December 31, 2003 and 2002, were assets totaling $35.4 million, $31.1 million and $25.8 million, respectively, that are secured by commercial real estate.

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

Loans and Debt Securities on Non-Accrual Status. At June 30, 2004, and December 31, 2003 and 2002, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

($ in millions)	June 30, 2004	December 31, 2003	December 31, 2002
Loans and debt securities in workout status (classified as Grade 4 or 5)[1]			
Private finance			
Companies more than 25% owned	$ 32.7	$ 31.9	$ 9.7
Companies 5% to 25% owned	16.0	2.7	0.4
Companies less than 5% owned	42.3	28.0	66.0
Commercial real estate finance	11.2	6.8	13.0
Loans and debt securities not in workout status			
Private finance			
Companies more than 25% owned	22.2	31.9	63.6
Companies 5% to 25% owned			7.2
Companies less than 5% owned	40.3	16.5	
Commercial real estate finance	5.8	0.2	
Total	$170.5	$118.0	$159.9
Percentage of total portfolio	6.1%	4.6%	6.4%

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

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent at value at June 30, 2004, and December 31, 2003 and 2002, were as follows:

($ in millions)	June 30, 2004	December 31, 2003	December 31, 2002
Private finance	$ 61.0	$ 85.6	$ 77.1
Commercial real estate finance			
CMBS bonds	49.1	40.3	15.5
Commercial mortgage loans	6.3	3.7	10.5
Total	$116.4	$129.6	$103.1
Percentage of total portfolio	4.2%	5.0%	4.1%

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to amend the terms of payment to us or to restructure their debt and equity capital. During such restructuring, we may not receive or accrue interest or dividend payments. As a result, the amount of the private finance portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. The investment portfolio is priced to provide current returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our private finance investments for a total return including interest or dividends plus capital gains from the sale of equity securities.

For CMBS bonds, interest payments are made to bondholders from the cash flow on the underlying collateral. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the lower rated tranches of the CMBS bonds in which we invest may not receive current interest payments and, therefore, may become delinquent. However, if the reduced cash flows resulting from defaults or losses in the underlying collateral pool have been factored into our yield on the bonds, we may continue to accrue interest on the bonds to the extent that we expect to collect such interest over time.

Given these factors, the amount of loans, debt securities, or CMBS bonds on non-accrual status or greater than 90 days delinquent is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment return or investment principal.

Hedging Activities

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were $164.8 million, $98.5 million and $197.0 million at June 30, 2004, and December 31, 2003 and 2002, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were $164.8 million, $98.5 million and $194.7 million at June 30, 2004, and December 31, 2003 and 2002, respectively. The amount of the hedge will vary from period to period depending upon the amount of higher rated CMBS and CDO bonds that we own and have hedged on the balance sheet date.

RESULTS OF OPERATIONS

Comparison of Six Months Ended June 30, 2004 and 2003

The following table summarizes our condensed operating results for the six months ended June 30, 2004 and 2003.

($ in thousands, except per share amounts)	For the Six Months Ended June 30, 2004	For the Six Months Ended June 30, 2003	Change	Percentage Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$147,712	$132,658	$15,054	11%
Loan prepayment premiums	4,017	2,758	1,259	46%
Fees and other income	17,536	14,928	2,608	17%
Total interest and related portfolio income	169,265	150,344	18,921	13%
Expenses				
Interest	37,096	37,280	(184)	(1)%
Employee	17,893	17,379	514	3%
Individual performance award	6,382		6,382	**
Administrative	14,903	9,498	5,405	