ALLIED CAPITAL CORP
Form 497
March 26, 2003

Prospectus Supplement
(To Prospectus dated October 21, 2002)

Filed Pursuant to Rule 497
Registration Statement No. 333-87862

2,500,000 Shares

COMMON STOCK

We are offering for sale 2,500,000 shares of our common stock. Our common stock is traded on the New York Stock Exchange under the symbol ALD. The last reported sales price for our common stock on March 25, 2003 was $20.02 per share.

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

	Per Share	Total
Public offering price	$20.03	$50,075,000
Underwriting discount	$.80	$2,000,000
Proceeds to Allied Capital Corporation(1)	$19.23	$48,075,000

(1) Before deducting expenses payable by us estimated to be $50,000.

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 SEC maintains an Internet website (http://www.sec.gov) that contains other information about us.

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

The shares of common stock will be ready for delivery on or about March 26, 2003.

JEFFERIES & COMPANY, INC.

The date of this prospectus supplement is March 25, 2003.

You should rely only on the information contained in this prospectus supplement and the accompanying prospectus. We have not, and the underwriter has 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 underwriter is 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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Prospectus Supplement

Prospectus

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 n 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)	4.0%
Dividend reinvestment plan fees(2)	None
Annual Expenses (as a percentage of consolidated net assets attributable to common shares)(3)	
Operating expenses(4)	3.6%
Interest payments on borrowed funds(5)	4.9%
Total annual expenses(6)	8.5%

(1) The underwriting discounts and commissions with respect to the shares sold by Allied Capital in this offering are the only sales loads paid in connection with this offering.

(2) The expenses of our dividend reinvestment plan are included in Operating expenses. We have no cash 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) at September 30, 2002.

(4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2002 excluding interest on indebtedness. This percentage for the year ended December 31, 2001 was 3.8%.

(5) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2002. We had outstanding borrowings of $990.7 million at September 30, 2002. This percentage for the year ended December 31, 2001 was 5.5%. 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 4.9% of consolidated total assets.

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	$123	$291	$459	$881

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 $48.0 million. We intend to use the net proceeds from selling our common stock for investment in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities and other general corporate purposes. We may also repay a portion of our revolving line of credit. At March 25, 2003, the interest rate on our revolving line of credit was 2.74% and there was approximately $61.0 million outstanding. This revolving line of credit terminates in August 2003 and may be extended under substantially similar terms for one additional year.

UNDERWRITING

Subject to the terms and conditions stated in the underwriting agreement with Jefferies & Company, Inc., the underwriter has agreed to purchase, and we have agreed to sell to the underwriter, all 2,500,000 of the shares offered by this prospectus supplement.

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

The underwriter proposes to offer the shares to the public initially at the public offering price set forth on the cover of this prospectus supplement. The public offering price is equal to the volume weighted average price per share of our common stock on the New York Stock Exchange for each of the ten trading days beginning on March 12, 2003 and ending on March 25, 2003. After the offering, the public offering price may be changed by the underwriter.

The following table shows the per share and total underwriting discounts and commissions to be paid to the underwriter by us.

Per share	$.80
Total	$2,000,000

We estimate that the total expenses of this offering, excluding the underwriting discounts and commissions, will be approximately $50,000, which will be paid by us.

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

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

We have been advised by the underwriter that, in accordance with Regulation M under the Securities Act, some persons participating in this offering may engage in transactions, including syndicate covering transactions or stabilizing bids, that may have the effect of stabilizing or maintaining the market price of the shares at a level above that which might otherwise prevail in the open market.

A syndicate covering transaction is a bid for or the purchase of shares on behalf of the underwriter to reduce a syndicate short position incurred by the underwriter in connection with this offering. The underwriter may create a syndicate short position by making short sales of our shares and must then purchase our shares in the open market to cover the syndicate short positions created by these short sales. Short sales involve the sale by the underwriter of a greater number of shares than it is required to purchase in this offering. A short position is more likely to be created if the underwriter is concerned that there may be downward pressure in the price of the shares in the open market after pricing that could adversely affect investors who purchase in this offering.

A stabilizing bid is a bid for or the purchase of shares on behalf of the underwriter for the purpose of fixing or maintaining the price of our shares.

We have been advised by the representatives of the underwriter that these transactions may be effected on the New York Stock Exchange 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 or regarding 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.

The underwriter expects to deliver the shares through the facilities of The Depository Trust Company in New York, New York, on or about March 26, 2003. At that time, the underwriter will pay us for the shares in immediately available funds.

This offering is being conducted in compliance with Rule 2810 of the Conduct Rules of the National Association of Securities Dealers, Inc.

The address for Jefferies & Company, Inc. is 520 Madison Avenue, 12th Floor, New York, NY 10022.

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 underwriter by Morgan, Lewis & Bockius LLP, New York, New York.

RECENT DEVELOPMENTS

Operating Results for the Year Ended December 31, 2002

For the year ended December 31, 2002, we reported net income of $228.3 million, or $2.20 per share, a 1.9% increase on a per share basis as compared to net income of $200.7 million, or $2.16 per share, for 2001. For the three months ended December 31, 2002, we reported net income of $53.4 million, or $0.51 per share, as compared to net income of $42.9 million, or $0.43 per share, for the three months ended December 31, 2001. Net income varies substantially from quarter to quarter primarily due to the recognition of realized and unrealized gains or losses, which vary from quarter to quarter. As a result, quarterly comparisons of net income may not be meaningful.

Net investment income before net realized and unrealized gains or losses was $183.9 million, or $1.77 per share for 2002, as compared to net investment income of $179.5 million, or $1.93 per share, for 2001. For the fourth quarter of 2002, net investment income before net realized and unrealized gains or losses totaled $42.4 million, or $0.40 per share, as compared to fourth quarter 2001 net investment income of $53.4 million, or $0.53 per share. Employee and administrative expenses associated with the closing of our

German office decreased net income and net investment income for the three and twelve months ended December 31, 2002 by $3.0 million, or $0.03 per share.

Net realized and unrealized gains totaled $44.4 million, or $0.43 per share, for 2002 as compared to $21.3 million, or $0.23 per share, for 2001. For the year ended December 31, 2002, we recognized realized gains of $95.5 million and realized losses of $50.6 million.

During 2002, we invested a total of $506.4 million. After total repayments of $143.2 million, asset sales of $213.5 million and valuation changes during the year, total assets increased to $2.79 billion at December 31, 2002, a 13.6% increase over total assets of $2.46 billion at December 31, 2001. Shareholders equity increased 14.3% to $1.55 billion at December 31, 2002 from $1.35 billion at December 31, 2001. Net asset value per share at December 31, 2002 was $14.22, a 4.8% increase over the net asset value per share of $13.57 at December 31, 2001.

Cash flow provided by operating activities before new portfolio investments for the year ended December 31, 2002 was $571.7 million and dividends to shareholders for 2002 were $229.9 million. Cash flow provided by operating activities before new portfolio investments for the year ended December 31, 2001 was $330.8 million and dividends to shareholders for 2001 were $186.2 million.

For the year ended December 31, 2002, our annual return on average assets was 9.0% and the annual return on average equity was 16.0%.

Private Finance

The private finance portfolio totaled $1.74 billion at December 31, 2002. The debt portion of this portfolio, which totaled $1.15 billion at December 31, 2002, had a weighted average yield of 14.4%, as compared to 14.8% at December 31, 2001. During the fourth quarter of 2002, we invested a total of $78.7 million in our private finance business. Significant private finance investments during the fourth quarter of 2002 included:

$10.4 million of subordinated debt in Frozen Specialties, Inc., a leading manufacturer of budget, private-label frozen pizza and appetizers for convenience and grocery stores nationwide,

$15.0 million of subordinated debt and $4 million of equity to acquire Housecall Medical Resources, Inc., a leading home healthcare organization and

$29.7 million of senior debt in Powell Plant Farms, Inc., one of the largest suppliers of bedding and flowering plants in the United States.

During the first quarter of 2003, we announced that we had provided $50 million in financing to Business Loan Express in connection with its $128 million acquisition of a pool of performing small business loans and other assets from Amresco Independence Funding. Also during the first quarter of 2003, we announced that we had provided a $30 million senior secured loan to Resun Leasing, Inc., a provider of modular space solutions.

During the first quarter of 2003, we announced that we realized a capital gain of approximately $8.4 million from our investment in Morton Grove Pharmaceuticals, Inc. We also generated a capital gain of approximately $7.0 million from our investment in CyberRep in connection with the sale of the company.

CMBS Investing

At December 31, 2002, our CMBS portfolio totaled $608.3 million, and had a weighted average yield to maturity of 14.4%, as compared to 14.8% at December 31, 2001. We invested $64.7 million in two new CMBS transactions during the fourth quarter of 2002. Because we generally acquire our CMBS investments at significant discounts from the face amounts of the bonds, the unamortized discount on the CMBS portfolio totaled $649.5 million at December 31, 2002.

In January 2003, we sold BB+ through B CMBS bonds with a cost basis of $115.7 million, which generated $127.9 million in cash proceeds. This sale resulted in a realized capital gain of $12.2 million.

Liquidity and Capital Resources

During 2002, we raised a total of $86.4 million of new equity in three secondary offerings. We also raised $86.5 million in a non-transferable rights offering that was completed during the fourth quarter. We expanded our committed unsecured revolving credit facility to $527.5 million during 2002, of which $318.0 million was available at December 31, 2002. We repaid our auction rate reset note of $75.0 million in December 2002.

At December 31, 2002, we had a weighted average cost of debt of 6.9%. At December 31 2002, we had regulatory asset coverage of 270% and the ratio of debt to equity was 0.65 to 1. We are required to maintain regulatory asset coverage of at least 200%. In early March 2003, we raised $34.4 million of new equity in a secondary offering.

Portfolio Quality

We employ a grading system to monitor the quality of our portfolio. Grade 1 is for those investments from which a capital gain is expected. Grade 2 is for investments performing in accordance with plan. Grade 3 is for investments that require closer monitoring; however, no loss of interest or principal is expected. Grade 4 is for investments that are in workout and for which some loss of current interest is expected, but no loss of principal is expected. Grade 5 is for investments that are in workout and for which some loss of principal is expected and the investment is written down to net realizable value.

At December 31, 2002, the portfolio of Grade 1 investments totaled $801.0 million, or 32.1% of the total portfolio at value; Grade 2 investments totaled $1.40 billion, or 56.3% of the total portfolio; Grade 3 investments totaled $166.0 million, or 6.7% of the total portfolio; Grade 4 investments totaled $23.6 million, or 1.0% of the total portfolio; and Grade 5 investments totaled $96.8 million, or 3.9% of the total portfolio. Included in Grade 4 and 5 investments are assets totaling $24.1 million that are secured by commercial real estate.

For the total investment portfolio, workout loans and debt securities not accruing interest that were classified in Grade 4 and 5 were $89.1 million at value at December 31, 2002, or 3.6% of the total portfolio. Included in this category at December 31, 2002, were loans of $13.0 million that were secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled $63.6 million at value, and loans and debt securities to companies that are less than 50% owned by us that were not in workout but were not accruing interest totaled $7.2 million at value at December 31, 2002.

For the total investment portfolio, loans and debt securities greater than 90 days past due were $103.1 million at value at December 31, 2002, or 4.1% of the total portfolio. Included in this category are loans and debt securities valued at $26.0 million that are secured by commercial real estate. At December 31, 2002, greater than 30-day delinquencies in the underlying collateral pool related to the CMBS portfolio were 1.0%.

Quarterly Dividend

On February 7, 2003, we increased our regular quarterly dividend to $0.57 per share for the first quarter of 2003. The dividend is payable on March 28, 2003 to shareholders of record on March 14, 2003.

For 2002, we paid regular quarterly dividends of $2.20 per share, a 9.5% increase over total dividends of $2.01 per share in 2001. An extra cash dividend of $0.03 was paid for 2002. Our dividend is paid from taxable income. Our board of directors determines the dividend based on annual estimates of taxable income, which differs from book income due to both temporary and permanent differences in income and expense recognition. Changes in unrealized appreciation and depreciation have no impact on the company s taxable income.

Other Matters

On December 31, 2002, Warren K. Montouri retired as a member of our board of directors. Also, on January 19, 2003, T. Murray Toomey, a member of our board of directors, passed away. On March 13, 2003, our board of directors appointed Alex J. Pollock and Ann Torre Grant to fill these two vacancies.

SUMMARY FINANCIAL INFORMATION

(In thousands, except per share amounts)	At December 31, (unaudited) 2002	2001
Assets		
Portfolio at Value:		
Private finance	$1,743,215	$1,595,072
Commercial real estate finance	744,952	734,518
Total Portfolio at Value	2,488,167	2,329,590
Other assets	294,966	130,234
Cash and cash equivalents	11,186	889
Total Assets	$2,794,319	$2,460,713
Liabilities and Shareholders Equity		
Liabilities:		
Debt	$998,450	$1,020,806
Accounts payable and other liabilities	242,798	80,784
Total Liabilities	1,241,248	1,101,590
Preferred stock	7,000	7,000
Shareholders Equity:		
Common stock		

	11	10
Additional paid-in capital	1,547,183	1,352,688
Notes receivable from sale of common stock	(24,704)	(26,028)
Net unrealized appreciation	39,411	39,981
Distributions in excess of earnings	(15,830)	(14,528)
Total Shareholders Equity	1,546,071	1,352,123
Total Liabilities and Shareholders Equity	$2,794,319	$2,460,713
Net asset value per common share	$14.22	$13.57
Actual shares outstanding at end of period	108,698	99,607

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(In thousands, except per share amounts)	3 Months Ended December 31 (unaudited) 2002	2001	12 Months Ended December 31 (unaudited) 2002	2001
Interest and Related Portfolio Income:				
Interest and dividends	$68,753	$66,742	$264,042	$240,464
Premiums from loan dispositions	725	434	2,776	2,504
Fees and other income	8,537	15,490	43,110	46,142
Total Interest and Related Portfolio Income	78,015	82,666	309,928	289,110
Expenses:				
Interest	18,029	17,130	70,443	65,104
Employee(1)	8,664	7,387	33,126	29,656
Administrative(1)	8,591	5,133	21,504	15,299
Total Operating Expenses	35,284	29,650	125,073	110,059

Net Investment Income Before Income Tax Expense and Net Realized and Unrealized Gains (Losses)
42,731 53,016 184,855 179,051
Income Tax Expense (Benefit)
330 (412) 930 (412)

Net Investment Income Before Net Realized and Unrealized Gains (Losses)
42,401 53,428 183,925 179,463
Net Realized and Unrealized Gains (Losses):

Net realized gains (losses)
(12,135) (7,678) 44,937 661
Net unrealized gains (losses)
23,090 (2,860) (571) 20,603

Total Net Realized and Unrealized Gains (Losses)
10,955 (10,538) 44,366 21,264

Net Income
$53,356 $42,890 $228,291 $200,727

Net Investment Income per share diluted

	$0.40	$0.53	$1.77	$1.93
Earnings per share diluted				
	$0.51	$0.43	$2.20	$2.16
Weighted average shares outstanding diluted				
	105,077	100,052	103,574	93,003

(1) Employee and administrative expenses for the three and twelve months ended December 31, 2002 include costs associated with the closing of our German office of $3.0 million, or $0.03 per share.

INTERIM MANAGEMENT S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company s Consolidated Financial Statements and the Notes thereto included herein and in the accompanying prospectus.

Financial or other information presented for private finance portfolio companies has been obtained from the portfolio company, 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 provides long-term debt and equity investment capital to support the expansion of companies in a variety of industries. Our lending and investment activity is generally focused in private finance and commercial real estate finance, primarily in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS. 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, buyouts, acquisitions, recapitalizations, note purchases, and bridge financings. We generally invest in private companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable.

Our portfolio composition at September 30, 2002, and December 31, 2001, was as follows:

	At September 30, 2002	At December 31, 2001
Private Finance	71%	68%
Commercial Real Estate Finance	29%	32%

Our earnings depend primarily on the level of interest and related portfolio income, fee income and net realized and unrealized gains or losses earned on our investment portfolio after deducting interest paid on borrowed capital and operating expenses. Interest income results from the stated interest rate earned on a loan and the amortization of loan origination points and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory and competitive factors that influence new investment activity, the amount of loans for which interest is not accruing and our ability to secure debt and equity capital for our investment activities.

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the three and nine months ended September 30, 2002 and 2001, and at and for the year ended December 31, 2001, were as follows:

($ in millions)	At and for the Three Months Ended September 30, 2002 (unaudited)	At and for the Three Months Ended September 30, 2001 (unaudited)	At and for the Nine Months Ended September 30, 2002 (unaudited)	At and for the Nine Months Ended September 30, 2001 (unaudited)	At and for the Year Ended December 31, 2001
Portfolio at value	$2,343.6	$2,174.4	$2,343.6	$2,174.4	$2,329.6
Investments funded	$157.6	$213.7	$353.0	$513.5	$680.3
Change in accrued or reinvested interest and dividends	$13.5	$14.9	$33.0	$40.4	$51.6
Principal repayments	$44.7	$7.9	$111.7	$50.4	$74.5
CMBS and commercial real estate loan sales	$87.2	$55.4	$213.5	$130.0	$130.0
Yield*	14.1%	14.1%	14.1%	14.1%	14.3%

* The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned 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, investment activity and yields at and for the three and nine months ended September 30, 2002 and 2001, and at and for the year ended December 31, 2001, were as follows:

($ in millions)	At and for the Three Months Ended September 30, 2002 (unaudited)	At and for the Three Months Ended September 30, 2001 (unaudited)	At and for the Nine Months Ended September 30, 2002 (unaudited)	At and for the Nine Months Ended September 30, 2001 (unaudited)	At and for the Year Ended December 31, 2001
Portfolio at value:					
Loans and debt securities	$1,122.6	$1,095.6	$1,122.6	$1,095.6	$1,107.9
Equity interests	540.0	443.7	540.0	443.7	487.2

Total portfolio	$1,662.6	$1,539.3	$1,662.6	$1,539.3	$1,595.1
Investments funded	$148.7	$116.9	$218.4	$230.7	$287.7
Change in accrued or reinvested interest and dividends	$13.5	$14.8	$32.6	$39.2	$48.9
Principal repayments	$44.2	$6.0	$100.2	$29.1	$43.8
Yield*	14.4%	14.5%	14.4%	14.5%	14.8%

* The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned 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 during the three and nine month periods ended September 30, 2002, and the year ended December 31, 2001, consisted of the following:

($ in thousands)	Loans and Debt Securities	Equity Interests	Total
For the three months ended September 30, 2002(1)			
Companies more than 25% owned	$15,775	$300	$16,075
Companies 5% to 25% owned	17,314	386	17,700
Companies less than 5% owned	106,995	7,886	114,881
Total	$140,084	$8,572	$148,656
For the nine months ended September 30, 2002(1)			
Companies more than 25% owned	$31,737	$4,059	$35,796
Companies 5% to 25% owned	24,808	7,432	32,240
Companies less than 5% owned	141,018	9,392	150,410
Total	$197,563	$20,883	$218,446
For the year ended December 31, 2001(1)			

Companies more than 25% owned	$47,860	$78,260	$126,120
Companies 5% to 25% owned	8,203	3,721	11,924
Companies less than 5% owned	142,144	7,548	149,692
Total	$198,207	$89,529	$287,736

(1) The private finance portfolio is presented in three categories companies more than 25% owned, which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and therefore are deemed controlled by us under the 1940 Act; companies owned 5% to 25%, which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company s board of directors and, therefore are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned, which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company.

At September 30, 2002, we had outstanding funding commitments of $92.8 million to portfolio companies, including $28.1 million committed to private venture capital funds. At September 30, 2002, we also had total commitments to private finance portfolio companies in the form of standby letters of credit and guarantees of $61.7 million.

We fund new investments using cash, through the issuance of our common equity, 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 providing a subsequent growth investment.

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional capital and, therefore, we may defer current debt service. Our most significant investments acquired through control buyout transactions at September 30, 2002, were The Hillman Companies, Inc., (formerly SunSource, Inc.), acquired in 2001 and Business Loan Express, Inc., acquired in 2000.

The Hillman Companies, Inc. During 2001, we acquired 93.2% of the common equity of SunSource, Inc. for $71.5 million in cash. Subsequently, SunSource completed the sale of its STS business unit and distributed $16.5 million in cash to us, reducing our common stock cost basis to $57.2 million at December 31, 2001. As part of the STS sale, we invested $3.2 million in the new STS. During the third quarter of 2001, we received fees from SunSource of $2.8 million related to transaction assistance for the SunSource sale and STS sale, and $1.6 million for the syndication of SunSource s senior credit facilities. In addition, we realized a gain of $2.5 million from the sale of warrants prior to the buyout transaction. During the first quarter of 2002, SunSource changed its name to The Hillman Companies, Inc., also referred to as Hillman.

Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers and mass merchants. Hillman has certain patent-protected products including key duplication technology that is important to its business. Hillman s primary operations are located in Cincinnati, Ohio.

During the second quarter of 2002, we recorded unrealized appreciation on this investment of $32.8 million. At September 30, 2002, our investment in Hillman totaled $131.5 million at value, or 5.2% of total assets. We did not change the unrealized appreciation on our investment in Hillman during the third quarter of 2002, as the fair value of our investment was still within our range of estimations of enterprise value for the company. Hillman remains on plan with respect to achieving its estimated 2002 earnings before interest, taxes, depreciation, amortization and management fees, of approximately $50 million.

Business Loan Express, Inc. On December 31, 2000, we acquired 94.9% of BLC Financial Services, Inc. in a going private buyout transaction for $95.2 million. We issued approximately 4.1 million shares of our common stock, or $86.1 million of new equity, and paid $9.1 million in cash to acquire BLC, which thereafter changed its name to Business Loan Express, Inc., also referred to as BLX.

As part of the transaction, we recapitalized Allied Capital Express, our small business lending operation, as an independently managed private portfolio company and merged it into Business Loan Express. We contributed certain assets, including our online rules-based underwriting technology and fixed assets, and transferred 37 employees to the private portfolio company. Upon completion of the transaction, our investment in Business Loan Express as of December 31, 2000 totaled $204.1 million and consisted of $74.5 million of subordinated debt, $25.1 million of preferred stock, and $104.5 million of common stock.

At September 30, 2002, our investment in Business Loan Express totaled $254.3 million at value, or 10.1% of our total assets, which includes unrealized appreciation of $35.4 million. We did not change the unrealized appreciation on our investment in BLX during the third quarter of 2002, as the fair value of our investment was still within our range of estimations of enterprise value. In determining the equity value included in the estimated enterprise value, we assumed that BLX s equity securities would be valued at a multiple of approximately 8 times trailing 2002 pro-forma net income of $23 million, which results from BLX s actual fiscal 2002 earnings adjusted for management fees and a pro-forma capital structure that assumes the sale of the company.

To view another measure of the fair value of our investment in BLX, we compared our investment at fair value in BLX of $254.3 million to our share of the book value of BLX s junior capital. Our share of BLX s junior capital totals $145.7 million and includes subordinated debt due to us of $89.4 million, preferred equity of $25.1 million and our share of common equity, including paid-in capital and retained earnings of $31.2 million. This comparison shows that the fair value of our $254.3 million investment is 1.7 times the cost or book basis of our share of BLX s junior capital in total.

Summary financial data for Business Loan Express at and for the quarter ended September 30, 2002, and the year ended June 30, 2002, was as follows:

($ in millions)	At and for the Quarter Ended September 30, 2002(1)	At and for the Year Ended June 30, 2002
Operating Data		
Total revenue	$25.7	$84.6
Profits before taxes	$1.5	$3.6
Earnings before interest, taxes and management fees (EBITM)	$12.9	$43.0
Balance Sheet Data		
Total assets(2)	$279.7	$277.1
Total debt	$186.1	$183.0
Total shareholders equity	$60.7	$59.9
Cash Flow Data		
Cash provided by operating activities	$10.7	$18.7
Cash used in investing activities	$(8.6)	$(37.1)
Cash provided by financing activities	$0.7	$3.0
Other Data		
Total loan originations	$153.7	$565.1
Serviced loan portfolio	$1,501.6	$1,372.6
Number of loans	2,251	2,083
Loan delinquencies(3)	8.5%	9.4%

(1)

Financial data at and for the quarter ended September 30, 2002, is unaudited. The results of operations, changes in cash flows and loan originations for the three months ended September 30, 2002 are not necessarily indicative of the operating results to be expected for the full year.

(2) Included in total assets is $6 million of goodwill. There is no other goodwill on BLX s balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. Push-down accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.

(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 7.9% at September 30, 2002. Delinquencies for the types of small business loans made by BLX typically range between 8% and 12%.

The loans originated by BLX are generally secured by commercial real estate. Loans originated under the 7(a) Guaranteed Loan Program also require the personal guarantee of the borrower and, in many cases, the loans are also secured by additional real estate collateral. Because the loans are secured by collateral, BLX s annual loan losses for its serviced SBA 7(a) loans, computed using the unguaranteed balance of the SBA 7(a) loan portfolio, were less than 1% on average for the last five fiscal years.

Business Loan Express sells or securitizes substantially all of the loans it originates. BLX currently 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% and 2.0% of the guaranteed loan amount. Alternatively, BLX may sell the guaranteed piece of SBA 7(a) guaranteed loans at par and retain an annual servicing spread, at current prices, of generally between 4.0% and 4.8%. BLX securitizes the unguaranteed piece of the SBA 7(a) loans and conventional loans it originates. Typically, BLX retains up to 2.7% of the loan securitization pools and receives a spread from the excess of loan interest received on the loans sold over the interest cost on the securities issued in the securitization generally between 4.7% and 4.8%.

As a result of BLX s guaranteed loan sales and as a result of securitization transactions, BLX had assets at September 30, 2002, totaling approximately $116.1 million representing the residual interests in and servicing assets for loans sold or securitized, together referred to as Residual Interests. These Residual Interests represent the discounted present value of future cash flow streams to be received from loans sold or securitized after making allowances for estimated prepayments, losses and loan delinquencies.

If loan payments on all loans were to be received as stated in the loan agreements, estimated future cash flows to BLX from loans sold or securitized would total approximately $469 million in the aggregate over the remaining term of these loans. Of the approximate $469 million, estimated cash flows for the 12 months ended September 30, 2003, 2004, 2005, and 2006 would be approximately $36 million, $35 million, $34 million and $33 million, respectively.

BLX s cash flow from operations for the quarter ended September 30, 2002 was $10.7 million. Sources of cash flow from operations include net income, cash proceeds from loan sales net of cash used for loans originated, and changes in working capital. BLX s cash used in investing activities for the quarter ended September 30, 2002 was $8.6 million. Cash used in investing activities includes the origination of residual interests from loans sold, net of collections of residual interests and cash used to purchase fixed assets. BLX s external cash funding requirements to finance its operations and loan portfolio for the quarter were $0.7 million which was funded by the senior revolving line of credit.

Business Loan Express has a three-year $124 million revolving credit facility that matures in March 2004. As the controlling shareholder of Business Loan Express, 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, accrued interest and other fees) of Business Loan Express under the revolving credit facility. The amount guaranteed by us at September 30, 2002 was $48.5 million. This guaranty can be called by the lenders only in the event of a default by Business Loan Express. Business Loan Express was in compliance with the terms of the revolving credit facility at September 30, 2002. We have also provided two standby letters of credit in connection with two term securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling $10.6 million.

Business Loan Express is currently contemplating a corporate restructure and recapitalization whereby the company would convert from a corporation to a limited liability company. This restructure would enable the company to have greater flexibility as it grows. Upon such restructure and recapitalization, our equity interests would be converted to membership units and the earnings of Business Loan Express would pass through to its members as dividends. There can be no assurance when or if the corporate restructure and recapitalization will occur. BLX expects to incur certain reorganization expenses related to the corporate restructure and recapitalization.

Business Loan Express is the nation s second largest non-bank government guaranteed lender utilizing the SBA s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). Therefore, changes in the laws or regulations that govern SBLCs or the SBA s 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material impact on Business Loan Express or its operations. As of October 1, 2002, the SBA implemented a maximum loan size of $500,000 for loans originated through the SBA 7(a) Guaranteed Loan Program. Pending revision of the government s funding of this program, this limitation may be revisited. BLX does not anticipate that the change will have a material effect on its business. The company plans to emphasize its conventional loan program should the $500,000 SBA 7(a) loan size cap remain in place. Business Loan Express is a preferred lender as designated by the SBA in 68 markets across the United States, and originates, sells and services small business loans. In addition to the 7(a) Guaranteed Loan Program, Business Loan Express originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. Business Loan Express has 37 offices across the United States and is headquartered in New York, New York.

WyoTech Acquisition Corporation. On July 1, 2002, WyoTech Acquisition Corporation was sold for $84.4 million. We acquired WyoTech in December of 1998 and owned 91% of the common equity of WyoTech. At June 30, 2002, our investment had a cost basis of $16.4 million, which represented all of the debt ($12.6 million), preferred stock ($3.7 million) and 91% of the common equity capital ($0.1 million) of WyoTech. Our total proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our 91% common equity ownership, were $77.2 million. We recognized a realized gain of $60.8 million on the transaction. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions.

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity and yields at and for the three and nine months ended September 30, 2002 and 2001, and at and for the year ended December 31, 2001, were as follows:

($ in millions)	At and for the Three Months Ended September 30, 2002	At and for the Three Months Ended September 30, 2001	At and for the Nine Months Ended September 30, 2002	At and for the Nine Months Ended September 30, 2001	At and for the Year Ended December 31, 2001
	(unaudited)		(unaudited)		
Portfolio at value:					
CMBS bonds	$496.4	$447.5	$496.4	$447.5	$558.3
Collateralized debt obligation preferred shares	53.0	24.6	53.0	24.6	24.2
Total CMBS	549.4	472.1	549.4	472.1	582.5
Commercial mortgage loans	59.7	86.2	59.7	86.2	79.6
Residual interest	69.0	74.4	69.0	74.4	69.9
Real estate owned	2.9	2.4	2.9	2.4	2.5
Total Portfolio	$681.0	$635.1	$681.0	$635.1	$734.5

Investments funded	$8.9	$96.8	$134.6	$282.8	$392.6
Change in accrued or reinvested interest	$	$0.1	$0.4	$1.2	$2.7
Principal repayments	$0.5	$1.9	$11.5	$21.3	$30.7
CMBS and commercial real estate loan sales	$87.2	$55.4	$213.5	$130.0	$130.0
Yield*	13.6%	13.5%	13.6%	13.5%	13.5%

* The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned 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.

Our primary commercial real estate investment activity is the investment in non-investment grade commercial mortgage-backed securities, or CMBS. In 1998, we began to take advantage of a unique market opportunity to acquire non-investment grade CMBS bonds at significant discounts from the face amount of the bonds. We believe that CMBS is an attractive asset class because of the yields that can be earned on securities that are secured by commercial mortgage loans, and ultimately commercial real estate properties. We did not make any new CMBS bond investments during the third quarter of 2002 as there was a limited supply of new CMBS bond issuances in the market. The supply of new CMBS bond issuances has increased in the fourth quarter and we are currently in the process of underwriting two transactions that may close during the fourth quarter of 2002. Our CMBS investment activity level will be dependent upon our ability to invest in CMBS at attractive yields. We plan to continue our CMBS investment activity, however, in order to maintain a balanced portfolio, we expect that CMBS will not exceed 25% of our total assets.

Our commercial real estate investment activity for the three and nine months ended September 30, 2002, and for the year ended December 31, 2001, was as follows:

	Amount Invested			
($ in millions)	**Face Amount**	**Discount**	**Amount Funded**	**Yield(1)(3)**
For the three months ended September 30, 2002				
CMBS bonds	$	$	$	
CDOs	1.0		1.0	17.4%
Commercial mortgage loans				
Real estate owned(2)	7.9		7.9	
Total	$8.9	$	$8.9	17.4%
For the nine months ended September 30, 2002				
CMBS bonds	$181.4	$(83.8)	$97.6	14.7%
CDOs	29.0		29.0	17.5%
Commercial mortgage loans	0.1		0.1	10.0%
Real estate owned(2)	7.9		7.9	
Total	$218.4	$(83.8)	$134.6	15.3%

For the year ended December 31, 2001				
CMBS bonds	$661.4	$(295.6)	$365.8	14.0%
CDOs	24.6		24.6	16.9%
Commercial mortgage loans	2.2		2.2	10.0%
Total	$688.2	$(295.6)	$392.6	14.2%

(1) The yield on new CMBS bond investments will vary from period to period depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds purchased in that period to the total amount invested.
(2) During the quarter ended September 30, 2002, we acquired real estate property in connection with a foreclosed asset in order to facilitate the disposition of the property. A current yield was therefore not calculated for this investment.
(3) Total yield calculation for the three and nine months ended September 30, 2002 excludes new investments in real estate owned.

CMBS Bonds. The 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 generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At September 30, 2002, our CMBS bonds were subordinate to 91% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest, 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 nine months ended September 30, 2002, and the year ended December 31, 2001, the average discount for the CMBS bonds in which we invested was 46% and 45%, respectively.

The underlying pools of mortgage loans that are collateral for our new CMBS bond investments for the nine months ended September 30, 2002, and for the year ended

December 31, 2001, had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

Loan to Value Ranges ($ in millions)	For the Nine Months Ended September 30, 2002		For the Year Ended December 31, 2001	
	Amount	Percentage	Amount	Percentage
Less than 60%	$401.9	16%	$1,259.7	15%
60-65%	178.7	7	941.6	11
65-70%	264.1	11	1,140.6	14
70-75%	799.5	32	2,400.4	29
75-80%	812.7	33	2,466.4	30
Greater than 80%	12.0	1	119.6	1
Total	$2,468.9	100%	$8,328.3	100%
Weighted average loan to value	70.4%		69.7%	

Debt Service Coverage Ratio(1) Ranges ($ in millions)	For the Nine Months Ended September 30, 2002		For the Year Ended December 31, 2001	
	Amount	Percentage	Amount	Percentage
Greater than 2.00	$103.3	4%	$484.8	6%
1.76-2.00	84.2	3	158.2	2
1.51-1.75	240.3	10	855.0	10
1.26-1.50	1,631.8	66	5,008.3	60
1.00-1.25				

	409.3	17	1,822.0	22
Total	$2,468.9	100%	$8,328.3	100%
Weighted average debt service coverage ratio	1.41		1.48	

(1) Defined as annual net cash flow before debt service divided by annual debt service payments.

As a part of our strategy to maximize our return on equity capital, we sold CMBS bonds rated BB+ through B during the nine months ended September 30, 2002 with a cost basis of $205.9 million, and bonds rated BB+ through BB- during the year ended December 31, 2001 with a cost basis of $124.5 million. These bonds had a weighted average effective yield of 11.5% and 10.3%, and were sold for $225.6 million and $126.8 million, respectively, resulting in realized gains on the sales. The sales of these primarily lower-yielding bonds increased our overall liquidity. Included in the CMBS bond sales during the third quarter of 2002 were $129.8 million of face amount of CMBS bonds with a cost basis of $82.7 million. We recognized a gain on this sale of $12.0 million, net of a realized loss of $2.1 million from a hedge related to the CMBS bonds sold. The CMBS bonds sold represented a strip of BB+ through B from our portfolio and had a weighted average yield to maturity of 12.0%. The CMBS bonds were sold to institutional investors.

The effective yield on our CMBS bond portfolio at September 30, 2002 and December 31, 2001 was 14.5% and 14.7%, respectively. The yield on the CMBS portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds held in the portfolio. At September 30, 2002, and December 31, 2001, the unamortized discount related to the CMBS portfolio was $595.6 million and $611.9 million, respectively. At September 30, 2002, the CMBS bond portfolio had a fair value of $496.4 million, which included net unrealized appreciation on the CMBS bonds of $39.8 million.

At September 30, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 commercial mortgage loans with a total outstanding principal balance of $22.9 billion. At September 30, 2002, and December 31, 2001, 0.99% and 0.52%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

Collateralized Debt Obligation Preferred Shares. During the nine months ended September 30, 2002, and the year ended December 31, 2001, we invested in the preferred shares of three and one, respectively, collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of $1,017.6 million and was issued by 42 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of $479.0 million issued in 39 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of $463.4 million issued in 39 separate CMBS transactions. Included in the CMBS collateral for the CDOs are $397.9 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 23 separate CMBS transactions. The preferred shares are junior in priority for payment of 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 resulting in reduced cash flows, the preferred shares will bear this loss first. At September 30, 2002, our preferred shares in the CDOs were subordinate to approximately 96% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs was 17.2% and 16.9% at September 30, 2002, and December 31, 2001, respectively.

Commercial Mortgage Loans and Real Estate Owned. Since 1998, we have been liquidating much of our whole commercial mortgage loan portfolio so that we can redeploy the proceeds into higher yielding assets. For the nine months ended September 30, 2002, and for the year ended December 31, 2001, we sold $7.6 million and $5.5 million, respectively, of commercial mortgage loans and real estate owned. At September 30, 2002, our whole commercial mortgage loan portfolio had been reduced to $59.7 million from $79.6 million at December 31, 2001.

Residual Interests. The residual interest primarily consists of a retained interest totaling $68.9 million from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At September 30, 2002, one class of bonds rated AAA was outstanding totaling $21.7 million. We have the right to call the bonds upon a minimum of ten days notice to the bondholders. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to us calling the bonds, the remaining loans in the trust will be returned to us as payment on the residual interest. At September 30, 2002, the residual interest had a fair value of $69.0 million.

Portfolio Asset Quality

As a means to review portfolio quality, we are providing data using three separate measures 1) portfolio by grade, 2) loans and debt securities on non-accrual status, and 3) loans and debt securities over 90 days delinquent. These three separate categories should not be added together, but instead are three different measures to assist in evaluating the portfolio. Our primary measure for portfolio quality remains the grade of each investment in the portfolio.

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

At September 30, 2002, and December 31, 2001, our portfolio was graded as follows:

	2002		2001	
Grade	**Portfolio at Value**	**Percentage of Total Portfolio**	**Portfolio at Value**	**Percentage of Total Portfolio**
($ in millions)				
1	$720.3	30.7%	$603.3	25.9%
2	1,441.6	61.5	1,553.8	66.7
3	58.2	2.5	79.5	3.4
4	12.8	0.6	44.5	1.9
5	110.7	4.7	48.5	2.1
	$2,343.6	100.0%	$2,329.6	100.0%

Portfolio by Grade. Total Grades 4 and 5 assets as a percentage of the total portfolio at value at September 30, 2002 and December 31, 2001 were 5.3% and 4.0%, respectively. 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 significantly from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected full amount of the potential loss when such exposure is identified.

Loans and Debt Securities on Non-Accrual Status. Loans and debt securities on non-accrual status for which we have doubt about interest collection are classified as Grade 4 or 5 assets, which are investments in workout status. In addition to Grade 4 and 5 assets that are in workout, we may not accrue interest on loans to companies which are more than 50% owned by us from time to time if such companies are in need of additional capital and, therefore, we may defer current debt service. Loans and debt securities on non-accrual status may or may not be over 90 days delinquent, as it is not unusual for us to place a loan on non-accrual status before it is over 90 days past due, and there may be loans over 90 days delinquent for which we believe that the interest is fully collectible.

For the total investment portfolio, workout loans not accruing interest, or those loans and debt securities in Grade 4 and 5, were $88.1 million at value at September 30, 2002, or 3.8% of the total portfolio. Included in this category at September 30, 2002, were loans of $14.3 million that were secured by commercial real estate. Workout loans not accruing interest were $109.0 million at value at December 31, 2001, or 4.7% of the total portfolio, of which $8.9 million were related to portfolio companies in liquidation, and $15.2 million represented loans secured by commercial real estate. As of September 30, 2002, $8.9 million representing receivables related to portfolio companies in liquidation were included in other assets. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies which are more than 50% owned by us that were not accruing interest totaled $63.8 million at value at September 30, 2002.

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities over 90 days delinquent are all loans and debt securities in the portfolio that are over 90 days past due, and these loans and debt securities may or may not be included in Grade 4 or 5 assets. If the loan pertains to an investment in workout, the loan or debt security will be included in the Grade 4 or 5 categories. A loan or debt security may be included in Grade 4 or 5 before it is over 90 days past due. If a loan is past due but does not pertain to an investment in workout, the loan or debt security would be included in Grades 1, 2 or 3.

Loans and debt securities greater than 90 days delinquent were $66.5 million at value at September 30, 2002, or 2.8% of the total portfolio. Included in this category are loans valued at $26.9 million that are secured by commercial real estate. Loans greater than 90 days delinquent were $39.1 million at value at December 31, 2001, or 1.7% of the total portfolio. Included in this category are loans valued at $14.1 million that were secured by commercial real estate.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from quarter to quarter. 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. 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 investments for a total return including interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans greater than 90 days delinquent or on non-accrual status 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 principal (Grade 5 assets).

At September 30, 2002 and December 31, 2001, 0.99% and 0.52%, respectively, of the loans in the underlying collateral pool for our CMBS bond portfolio were over 30 days delinquent or were classified as real estate owned. We closely monitor the performance of all of the loans in the underlying collateral pools securing our CMBS investments.

Other Assets and Other Liabilities

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of borrowed Treasury securities, with the obligations 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 the possible inability of counterparties to meet the terms of their contracts and from movements in the value of the borrowed Treasury securities and interest rates; we do not anticipate nonperformance by any counterparty.

The total obligations to replenish borrowed Treasury securities were $52.2 million and $47.3 million at September 30, 2002, and December 31, 2001, respectively, which included unrealized depreciation on the obligations of $5.6 million and unrealized appreciation on the obligations of $1.2 million, respectively, due to changes in the yield on the borrowed Treasury securities. The obligations have been recorded as an other liability. The proceeds related to the sales of the borrowed Treasury securities were $46.7 million and $48.5 million at September 30, 2002, and December 31, 2001, respectively, and have been recorded as an other asset. Under the terms of the transactions, we have provided additional cash collateral of $5.0 million at September 30, 2002 for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities on the weekly settlement date. The cash collateral has been recorded as an other asset in the accompanying consolidated financial statements.

RESULTS OF OPERATIONS

Comparison of Three Months Ended September 30, 2002 and 2001

The following table summarizes our condensed operating results for the three months ended September 30, 2002 and 2001.

($ in thousands, except per share amounts)	For the Three Months Ended September 30, 2002	2001	Change	Percent Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$67,624	$60,023	$7,601	13%
Premiums from loan dispositions	392	339	53	16%
Fees and other income	8,313	12,272	(3,959)	(32%)
Total interest and related portfolio income	76,329	72,634	3,695	5%
Expenses				
Interest	17,430	16,093	1,337	8%
Employee	8,153	8,213	(60)	(1%)
Administrative	5,052	4,139	913	22%

Total operating expenses	30,635	28,445	2,190	8%
Net investment income before income tax expense and net realized and unrealized gains	45,694	44,189	1,505	3%
Income tax expense	600		600	
Net investment income before net realized and unrealized gains	45,094	44,189	905	2%
Net Realized and Unrealized Gains				
Net realized gains	48,222	3,348	44,874	*
Net unrealized gains (losses)	(47,796)	12,166	(59,962)	*
Total net realized and unrealized gains	426	15,514	(15,088)	*

Net increase in net assets resulting from operations	$45,520	$59,703	$(14,183)	(24%)
Diluted earnings per share	$0.44	$0.63	$(0.19)	(30%)
Weighted average shares outstanding diluted	103,302	94,585	8,717	9%

* Net realized and net unrealized gains and losses can fluctuate significantly from quarter to quarter. As a result, quarterly comparisons of net realized and net unrealized gains and losses may not be meaningful.

Net increase in net assets resulting from operations, or net income, results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus net realized and unrealized gains or losses.

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

($ in millions, except per share amounts)	For the Three Months Ended September 30, 2002	2001
Total Interest and Related Portfolio Income	$76.3	$72.6
Per share	$0.74	$0.77

The increase in interest and dividend income earned resulted from the growth of our interest bearing investment portfolio and the dividends earned on certain preferred equity securities. Our investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 4% to $1,803.6 million at September 30, 2002, from $1,730.7 million at September 30, 2001. The weighted average yield on the interest-bearing investments in the portfolio at September 30, 2002 and 2001, was as follows:

	September 30, 2002	2001
Private Finance	14.4%	14.5%
Commercial Real Estate Finance	13.6%	13.5%
Total Portfolio	14.1%	14.1%

Included in premiums from loan dispositions are prepayment premiums of $0.4 million and $0.3 million for the three months ended September 30, 2002 and 2001, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management services to portfolio companies, guaranties and other advisory services. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance and risk management.

Fees and other income for the quarter ended September 30, 2002, included fees of $2.2 million related to structuring and diligence, fees of $0.4 million related to transaction services provided to portfolio companies, and fees of $5.7 million related to management services provided to portfolio companies, guaranty and other advisory services. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Business Loan Express and Hillman are our most significant portfolio investments and together represent 15.3% of our total assets at September 30, 2002. Total interest and related portfolio income earned from these investments for the three months ended September 30, 2002 and 2001, was $12.4 million and $11.0 million, respectively.

Operating Expenses. Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the three months ended September 30, 2002 and 2001, are attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

	At and for the Three Months Ended September 30,	
($ in millions)	**2002**	**2001**
Total Outstanding Debt	$990.7	$924.5
Average Outstanding Debt	$901.5	$862.4
Weighted Average Cost	7.1%	7.1%
BDC Asset Coverage*	259%	255%

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

Employee expenses include salaries and employee benefits. The change in employee expense reflects the effect of wage increases and the change in the mix of employees given their area of responsibility and relevant experience level. Total employees were 103 and 95 at September 30, 2002 and 2001, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums and various other expenses. The increase in administrative expenses as compared to the same period in 2001 includes approximately $0.2 million from legal, consulting and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately $0.3 million due to increased costs for corporate liability insurance and $0.2 million due to travel costs, including corporate aircraft depreciation.

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

($ in millions)	For the Three Months Ended September 30, 2002	2001
Realized Gains	$77.9	$3.3
Realized Losses	(29.7)	
Net Realized Gains	$48.2	$3.3

Realized gains and losses for the three months ended September 30, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the three months ended September 30, 2002, primarily resulted from transactions involving three private finance portfolio companies, Wyoming Technical Institute ($60.8 million), Oriental Trading Company, Inc. ($2.5 million) and Kirkland s, Inc. ($2.2 million), and the sale of CMBS bonds ($12.0 million, net of a realized loss of $2.1 million from a hedge related to the CMBS bonds sold). We reversed previously recorded unrealized appreciation totaling $70.1 million and $2.5 million when gains were realized for the three months ended September 30, 2002 and 2001, respectively.

Realized losses for the three months ended September 30, 2002, primarily resulted from transactions involving two private finance portfolio companies, Velocita, Inc. ($16.0 million) and Schwinn Holdings Corporation ($7.9 million), and two commercial real estate investments ($2.1 million). We reversed previously recorded unrealized depreciation totaling $29.3 million and zero when losses were realized for the three months ended September 30, 2002 and 2001, respectively.

Unrealized Gains and Losses. We determine the fair value of each investment in our portfolio on a quarterly basis, and changes in fair value result in unrealized gains or losses being recognized. At September 30, 2002, approximately 93% of our total assets represented portfolio investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily ascertainable market value for the investments in our portfolio, we value substantially all of our investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily ascertainable market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we must determine the fair value of each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. The structure of each debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition and market changing events that impact valuation.

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

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based upon multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company s earnings power. Adjustments to EBITDA may include compensation to previous owners, or acquisition, recapitalization or restructuring related items.

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

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

Valuation Methodology CMBS Bonds. CMBS bonds are carried at fair value, which is based upon a discounted cash flow model which utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds. Our assumption with regard to discount rate is based upon the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS bonds, as comparable yields in the market change and/or whenever we determine that the value of our CMBS bonds is less than the cost basis due to changes in cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

Net Unrealized Gains and Losses Net unrealized gains (losses) for the three months ended September 30, 2002 and 2001 were as follows:

($ in millions)	For the Three Months Ended September 30, 2002	For the Three Months Ended September 30, 2001
Unrealized appreciation:		
Unrealized gains	$29.8	$28.3
Reversal of previously recorded depreciation	29.3	
Total unrealized appreciation	59.1	28.3
Unrealized depreciation:		
Unrealized losses	(36.8)	(13.6)
Reversal of previously recorded appreciation	(70.1)	(2.5)

Total unrealized depreciation	(106.9)	(16.1)
Net unrealized gains (losses)	$(47.8)	$12.2

During the third quarter of 2002, we increased the fair value of our investment in Blue Rhino by $1.8 million based on the public market valuations of the company stock. In addition, we recorded unrealized appreciation totaling $6.2 million on ten other investments in our portfolio based upon the performance of the respective companies and/or indicative valuation estimates received from third parties.

We recorded unrealized losses of $32.5 million on 30 portfolio investments during the three months ended September 30, 2002, largely due to conditions in the manufacturing, media and technology sectors, and due to company specific matters in certain companies. Portfolio companies for which unrealized depreciation was recorded this quarter include four companies in the portfolio that continue to be affected by weakness in the manufacturing sector for which we decreased fair value by $6.4 million; four companies in the media sector that have declined in fair value due to declining values in this sector for which we have decreased fair value by $10.5 million; and the three companies that have been affected by lower levels of technology spending for which we have decreased fair value by $1.8 million. In general, our portfolio companies in the consumer-driven sectors, such as retail and consumer products, continue to perform well. However, we decreased the fair value of three investments in this sector by $8.6 million. We also recorded depreciation of $2.0 million on five commercial mortgage loans and $0.7 million on one real estate owned property. As the economy improves, the financial performance of these portfolio companies may also improve. However, there can be no assurance when or if these companies performance may improve.

CMBS Bonds. We recorded a net unrealized gain on our CMBS bond portfolio of $17.5 million in the third quarter of 2002. We determined the fair value of our CMBS bond portfolio using a discounted cash flow model based upon (i) the current performance of the underlying collateral loans, which utilizes prepayment and loss assumptions based upon historical and projected experience, economic factors and the characteristics of the underlying cash flow, and (ii) current market yields for comparable CMBS bonds, based upon Treasury rates and market spreads.

Cash flow assumptions. With respect to the cash flows of the underlying collateral loans securing the CMBS bonds, the performance of the collateral loans to date is generally consistent with our original assumptions. We generally assume no prepayments on the collateral loans prior to maturity, as prepayments on the loans prior to maturity are generally prohibited or there are significant penalties, such as prepayment premiums, yield maintenance and/or defeasance requirements. Our credit loss assumptions for the underlying collateral loans at the time of investment in the CMBS bonds were generally estimated to assume that approximately 1% of the underlying collateral loan principal would be lost, and that one-third of the losses would be realized in year three, one-third in year six, and one-third in year nine. We believe that this is an appropriate approach to setting loss assumptions, as losses are expected to occur throughout the life of the CMBS bonds.

As of September 30, 2002, total estimated losses in the underlying collateral pools over the life of the CMBS bonds were assumed to total approximately $217 million. Through September 30, 2002, $2.3 million in actual losses have been realized. While the actual realized losses as of September 30, 2002 are less than our originally estimated losses, we have not reduced the original estimates of the total expected losses over the life of the CMBS bonds. Loss assumptions affecting future cash flows are updated quarterly to reflect the estimated current and expected performance of the collateral loans on a loan-by-loan basis.

Yield assumptions. During the third quarter of 2002, the overall yields on newly-issued CMBS bonds rated BB+ through B continued to decline due to the decline in Treasury yields combined with the narrowing of spreads, resulting in market yields for these bond classes being lower than the yields-to-maturity on our CMBS bonds for the same classes. More buyers of CMBS bonds have recently entered the market, particularly buyers for BB+ through BB rated CMBS bonds, which has contributed to the decline in spreads for these bond classes beginning in the second quarter of 2002. Historically, we have found yields on new issuances to be in the same range as the CMBS bonds we own. We confirmed our CMBS bond portfolio pricing estimates at September 30, 2002 with respect to spreads for our BB+ through B rated bonds with other CMBS bond market participants. Lower yields imply an increase in the value of our BB+ through B rated CMBS bond portfolio. The yields on B- through the non-rated classes have generally remained relatively consistent with the yields on our CMBS bonds in these classes. Pricing for these deeply subordinated classes of bonds are generally much more a function of the credit quality of a single issuance rather than market conditions.

Fair Value. We have determined the fair value of our CMBS bonds based upon a discounted cash flow model using expected future cash flows and current market yields, as discussed above, to be approximately $496.4 million, and as a result have recorded a net unrealized gain on the CMBS bonds of $21.8 million for the quarter ended September 30, 2002. The net unrealized gain includes an unrealized loss of $0.7 million related to changes in estimated prepayment or loss assumptions.

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the 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. The net proceeds related to the sales of the borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities totaled $46.7 million and $52.2 million, respectively, and have been included in other assets and other liabilities, respectively, at September 30, 2002. As of September 30, 2002, the total obligations on the hedge had increased to $52.2 million due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligation of $5.6 million. The decrease in the value of the hedge during the three months ended September 30, 2002, was $4.3 million and was recorded as an unrealized loss.

The net unrealized gain on the CMBS bonds of $21.8 million, net of the unrealized loss on the hedge of $4.3 million, resulted in a net unrealized gain from the CMBS bond portfolio of $17.5 million for the three months ended September 30, 2002.

Given that Treasury yields fluctuate, it is possible that there may be future adjustments to the fair value of the CMBS bonds. As a result, we have not classified the appreciated CMBS bonds as Grade 1 assets at September 30, 2002, since they may not result in any future capital gain. Therefore, CMBS bonds remain in Grade 2.

Other Matters. All per share amounts included in the Management s Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 103.3 million and 94.6 million for the three months ended September 30, 2002 and 2001, respectively.

We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net increase in net assets resulting from operations for the fiscal year due to timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

In order to maintain our status as a regulated investment company, we must, in general, (1) continue to qualify as a business development company; (2) derive at least

90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet investment diversification requirements as defined in the Internal Revenue Code; and (4) distribute annually to shareholders at least 90% of our investment company taxable income as defined in the Internal Revenue Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

RESULTS OF OPERATIONS

Comparison of Nine Months Ended September 30, 2002 and 2001

The following table summarizes our condensed operating results for the nine months ended September 30, 2002, and 2001.

($ in thousands, except per share amounts)	For the Nine Months Ended September 30, 2002	2001	Change	Percent Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$195,289	$173,722	$21,567	12%
Premiums from loan dispositions	2,051	2,070	(19)	(1%)
Fees and other income	34,573	30,652	3,921	13%
Total interest and related portfolio income	231,913	206,444	25,469	12%
Expenses				
Interest	52,414	47,974	4,440	9%
Employee	24,462	22,269	2,193	10%
Administrative	12,913	10,166	2,747	27%

Total operating expenses	89,789	80,409	9,380	12%
Net investment income before income tax expense and net realized and unrealized gains	142,124	126,035	16,089	13%
Income tax expense	600		600	
Net investment income before net realized and unrealized gains	141,524	126,035	15,489	12%
Net Realized and Unrealized Gains				
Net realized gains	57,072	8,339	48,733	*
Net unrealized gains (losses)	(23,661)	23,463	(47,124)	*
Total net realized and unrealized gains	33,411	31,802	1,609	*

Net increase in net assets resulting from operations	$174,935	$157,837	$17,098	11%
Diluted earnings per share	$1.70	$1.74	$(0.04)	(2%)
Weighted average shares outstanding diluted	103,040	90,864	12,176	13%

* Net realized and net unrealized gains and losses can fluctuate significantly from period to period. As a result, year-to-date comparisons of net realized and net unrealized gains and losses may not be meaningful.

Net increase in net assets resulting from operations, or net income, results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus net realized and unrealized gains or losses.

Total interest and related portfolio income. Total interest and related portfolio income includes interest and dividend income, premiums from loan dispositions and fees and other income.

($ in millions, except per share amounts)	For the Nine Months Ended September 30, 2002	2001
Total Interest and Related Portfolio Income	$231.9	$206.4
Per share	$2.25	$2.27

The increase in interest and dividend income earned resulted primarily from the growth of our investment portfolio and the dividends earned on certain preferred equity securities. Our investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 4% to $1,803.6 million at September 30, 2002, from $1,730.7 million at September 30, 2001. The weighted average yield on the interest-bearing investments in the portfolio at September 30, 2002 and 2001 was as follows:

	September 30, 2002	2001
Private Finance	14.4%	14.5%
Commercial Real Estate Finance	13.6%	13.5%
Total Portfolio	14.1%	14.1%

Included in premiums from loan dispositions are prepayment premiums of $2.0 million and $1.6 million for the nine months ended September 30, 2002 and 2001, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management services to portfolio companies, guaranty and other advisory services. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance and risk management.

Fees and other income for the nine months ended September 30, 2002, included fees of $12.8 million related to structuring and diligence, fees of $4.1 million related to transaction services provided to portfolio companies, and fees of $17.4 million related to management services provided to portfolio companies, other advisory services and guaranty fees. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Fees and other income for the nine months ended September 30, 2002 include investment advisory fees of $1.6 million related to our investment advisory contract to provide services to the Allied Capital Germany Fund, LLC. During the fourth quarter of 2002, we have decided to discontinue our German operations due to difficulty in finding attractive investment opportunities for the Germany Fund. In conjunction with this, we will incur some costs of discontinued operations, which we estimate will reduce our net income during the fourth quarter of 2002 and for the full year of 2002 by approximately 2.5 cents to 3.5 cents per share.

Business Loan Express and Hillman are our most significant portfolio investments and together represent 15.3% of our total assets at September 30, 2002. Total interest and related portfolio income earned from these investments for the nine months ended September 30, 2002 and 2001 was $36.9 million and $27.4 million, respectively.

Operating Expenses. Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the nine months ended September 30, 2002 and 2001 are attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

	At and for the Nine Months Ended September 30,	
($ in millions)	**2002**	**2001**
Total Outstanding Debt	$990.7	$924.5
Average Outstanding Debt	$927.3	$821.9
Weighted Average Cost	7.1%	7.1%
BDC Asset Coverage*	259%	255%

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

Employee expenses include salaries and employee benefits. The change in employee expense reflects the effect of wage increases and the change in the mix of employees given their area of responsibility and relevant experience level. Total employees were 103 and 95 at September 30, 2002 and 2001, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums and various other expenses. The increase in administrative expenses as compared to the same period in 2001 includes approximately $1.5 million from legal, consulting and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately $0.5 million due to increased costs for corporate liability insurance, $0.5 million due to outsourced technology assistance, and $0.2 million due to travel costs, including corporate aircraft depreciation.

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

($ in millions)	For the Nine Months Ended September 30, 2002	2001
Realized Gains	$93.4	$9.9
Realized Losses	(36.3)	(1.6)
Net Realized Gains	$57.1	$8.3

Realized gains and losses for the nine months ended September 30, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the nine months ended September 30, 2002, primarily resulted from transactions involving six private finance portfolio companies, Wyoming Technical Institute ($60.8 million), Aurora Communications, LLC ($4.9 million), Oriental Trading ($2.5 million), Kirkland s, Inc. ($2.2 million), Cumulus Media, Inc. ($0.5 million), and Alderwoods Group, Inc. ($0.1 million), the sale of CMBS bonds ($19.1 million, net of a realized loss of $0.5 million from a hedge related to the CMBS bonds sold) and one commercial real estate investment ($1.3 million). For the nine months ended September 30, 2002 and 2001, we reversed previously recorded unrealized appreciation totaling $77.4 million and $6.5 million, respectively, when gains were realized.

Realized losses for the nine months ended September 30, 2002, primarily resulted from transactions involving six private finance portfolio companies, Velocita, Inc. ($16.0 million), Schwinn Holdings Corporation ($7.9 million), The Loewen Group, Inc. ($2.7 million), iSolve Incorporated ($0.9 million), Sure-Tel, Inc. ($0.5 million), Soff-Cut Holdings, Inc. ($0.5 million), and six commercial real estate investments ($3.8 million). In January 2002, The Loewen Group, Inc. emerged from bankruptcy and as a result, we exchanged our debt securities for cash, new debt securities and publicly traded common stock in the reorganized company, which resulted in a realized loss. The Loewen Group, Inc. changed its name to Alderwoods Group, Inc. For the nine months ended September 30, 2002, and 2001, we reversed previously recorded unrealized depreciation totaling $34.5 million and $2.2 million, respectively, when losses were realized.

Unrealized Gains and Losses. For a discussion of our fair value methodology and how it affects unrealized gains and losses, see Unrealized Gains and Losses included in the Comparison of Three Months Ended September 30, 2002 and 2001.

Net unrealized gains (losses) for the nine months ended September 31, 2002 and 2001 were as follows:

($ in millions)	For the Nine Months Ended September 30, 2002	2001
Unrealized appreciation:		
Unrealized gains	$166.3	$64.6
Reversal of previously recorded depreciation	34.5	2.2
Total unrealized appreciation	200.8	66.8
Unrealized depreciation:		
Unrealized losses	(147.1)	(36.8)
Reversal of previously recorded appreciation	(77.4)	(6.5)
Total unrealized depreciation	(224.5)	(43.3)
Net unrealized gains (losses)	$(23.7)	$23.5

Unrealized gains and losses recognized for the nine months ended September 30, 2002 are summarized below.

During the nine months ended September 30, 2002, we increased the fair value of The Hillman Companies by $32.8 million and Business Loan Express, Inc. by $19.9 million based upon the performance of the companies; WyoTech Acquisition Corporation by $16.6 million based on the estimated proceeds expected to be received from the sale of this investment in July 2002; Blue Rhino and Kirkland s by $13.3 million and $5.7 million, respectively, based on the public market valuations of each company s stock; CorrFlex Graphics LLC and Morton Grove Pharmaceuticals, Inc. by $11.8 million, and $5.0 million, respectively, based on strong earnings growth and upon indicative valuation estimates received from third parties. In addition, we recorded unrealized gains totaling $15.5 million on 18 other investments in our portfolio.

During the nine months ended September 30, 2002, we decreased the fair value of our investment in Startec Global Communications Corporation by $10.2 million to reflect the current plan of reorganization filed with the bankruptcy court in the second quarter of 2002. We decreased the value of Alderwoods Group, Inc. by $2.7 million to reflect the change in the Company s public stock value.

We also recorded $111.6 million in unrealized losses during the nine months ended September 30, 2002, largely due to conditions in the manufacturing, technology and media sectors, and the continuing effects of the events of September 11th, 2001. Portfolio companies for which unrealized depreciation was recorded included five companies that have been affected by weakness in the manufacturing sector for which we decreased fair value by $25.2 million; five companies that have been affected by lower levels of technology spending for which we decreased fair value by $18.5 million; seven companies in the media sector that have declined in fair value due to declining values in this sector for which we decreased fair value by $18.4 million; and two companies that continued to endure difficulties during 2002 as a result of the attacks of September 11th that have declined in fair value by $11.3 million. In general, our portfolio companies in the consumer-driven sectors, such as retail and consumer products, continue to perform well. However, we did decrease the fair value of six investments in this sector by $16.7 million during the nine months ended September 30, 2002. As the economy improves, the financial performance of these portfolio companies may also improve. However, there can be no assurance when or if these companies performance may improve. We also recorded depreciation of $3.3 million on six commercial mortgage loans and $4.2 million on two real estate owned properties.

We also recorded $16.0 million of depreciation on our investment in Velocita, Inc. during the six months ended June 30, 2002, including accrued interest reserves, and we reversed the previously recorded depreciation during the third quarter of 2002 and recorded a realized loss of $16.0 million.

CMBS Bonds. Unrealized appreciation on the CMBS bond portfolio was $39.1 million for the nine months ended September 30, 2002, which consisted of a net unrealized gain on the CMBS bonds of $45.7 million less the net unrealized loss on the hedge of $6.6 million. See Unrealized Gains and Losses CMBS Bonds included in the Comparison of Three Months Ended September 30, 2002 and 2001.

Given that Treasury yields fluctuate, it is possible that there may be future adjustments to the fair value of the CMBS bonds. As a result, we have not classified the appreciated CMBS bonds as Grade 1 assets at September 30, 2002, since they may not result in any future capital gain. Therefore, CMBS bonds remain in Grade 2.

Other Matters. All per share amounts included in the Management s Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 103.0 million and 90.9 million for the nine months ended September 30, 2002 and 2001, respectively.

We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net increase in net assets resulting from operations for the fiscal year due to timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

At September 30, 2002, and December 31, 2001, we had $23.6 million and $0.9 million, respectively, in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit.

Debt and Other Commitments

We had outstanding debt at September 30, 2002, and December 31, 2001, as follows:

($ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost(1)
At September 30, 2002			
Notes payable and debentures:			
Unsecured long-term notes	$694.0	$694.0	7.8%
Small Business Administration debentures	101.8	94.5	8.2%
Auction rate reset note	75.0	75.0	3.6%
Overseas Private Investment Corporation loan	5.7	5.7	6.6%
Total notes payable and debentures	$876.5	$869.2	7.4%
Revolving line of credit	527.5	121.5	3.3%(2)
Total debt	$1,404.0	$990.7	7.1%
At December 31, 2001			
Notes payable and debentures:			

Unsecured long-term notes	$694.0	$694.0	7.8%
Small Business Administration debentures	101.8	94.5	7.7%
Auction rate reset note	81.9	81.9	3.9%
Overseas Private Investment Corporation loan	5.7	5.7	6.6%
Total notes payable and debentures	$883.4	$876.1	7.4%
Revolving line of credit	497.5	144.7	3.2%(2)
Total debt	$1,380.9	$1,020.8	7.0%

(1) The annual interest cost on notes payable and debentures includes the cost of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings.

(2) The current interest rate payable on the revolving line of credit was 3.3% and 3.2% at September 30, 2002 and December 31, 2001, respectively, which excludes the annual cost of commitment fees and other facility fees of $2.0 million.

Unsecured Long-Term Notes. We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2003. The notes require payment of interest only semi-annually, and all principal is due upon maturity.

Small Business Administration Debentures. We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with terms of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to $111.7 million from the Small Business Administration. At September 30, 2002, the Small Business Administration has a commitment to lend up to an additional $7.3 million above the amount outstanding. The commitment expires on September 30, 2005.

Auction Rate Reset Note. We have an Auction Rate Reset Senior Note Series A that bears interest at the three-month London Inter-Bank Offered Rate (LIBOR) plus 1.75%, which adjusts quarterly. Interest is due quarterly and the note matures on December 27, 2002, as amended. As a means to repay the note, we have entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of $75.0 million of debt, equity or other securities in one or more public or private transactions. Alternatively, we may repay the note in cash without conducting a capital raise. If we choose to repay the note in cash without conducting a capital raise, we will incur additional expense of approximately $3.2 million.

Revolving Line of Credit. As of September 30, 2002, we have a $527.5 million unsecured revolving line of credit that expires in August 2003, with the right to extend the maturity for one additional year at our sole option under substantially similar terms. This facility was increased by $30.0 million during the first quarter of 2002 from $497.5 million at December 31, 2001, and may be further expanded up to $600 million. As of September 30, 2002, $400.7 million remains unused and available, net of amounts committed for standby letters of credit of $5.3 million issued under the credit facility. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The credit facility requires monthly payments of interest, and all principal is due upon maturity.

We have various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of September 30, 2002, we were in compliance with these covenants.

The following table shows our significant contractual obligations as of September 30, 2002.

($ in millions) Contractual Obligations	Total	Payments Due By Year 2002	2003	2004	2005	2006	After 2006
Notes payable and debentures:							
Unsecured long-term notes	$694.0	$	$140.0	$214.0	$165.0	$175.0	$
Small Business Administration debentures	94.5			7.0	14.0		73.5
Auction rate reset note	75.0	75.0					
Overseas Private Investment Corporation loan	5.7					5.7	
Revolving line of credit(1)	121.5			121.5			
Operating leases	21.6	0.6	2.6	2.7	2.7	2.6	10.4
Total contractual cash obligations	$1,012.3	$75.6	$142.6	$345.2	$181.7	$183.3	$83.9

(1) The revolving line of credit expires in August 2003, and may be extended under substantially similar terms for one additional year at our sole option. We assume that we would exercise our option to extend the revolving line of credit, resulting in an assumed maturity of August 2004.

The following table shows, as of September 30, 2002, our contractual commitments that may have the effect of creating, increasing or accelerating our liabilities.

($ in millions) Commitments	Total	Amount of Commitment Expiration Per Year 2002	2003	2004	2005	2006	After 2006
Standby letters of credit	$11.3	$	$	$5.3	$	$	$6.0
Guarantees	50.4		1.0	48.5	0.2		0.7
Total commitments	$61.7	$	$1.0	$53.8	$0.2	$	$6.7

Equity Capital and Dividends

Because we are a regulated investment company, we distribute income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity capital ratio.

To support our growth during the nine months ended September 30, 2002, and for the year ended December 31, 2001, we raised $49.9 million and $286.9 million, respectively, in new equity capital through the sale of shares from our shelf registration statement. We issue equity from time to time when we have attractive investment opportunities. In addition, during the nine months ended September 30, 2002 and for the year ended December 31, 2001, we raised $4.7 million and $6.3 million, respectively, in new equity capital through the issuance of shares through our dividend reinvestment plan. At September 30, 2002, total shareholders equity had increased to $1,429.0 million.

In order to raise new investment capital for portfolio growth, we are conducting a non-transferable rights offering. Each shareholder of record at the close of business on October 21, 2002, received one non-transferable right for each share held. For every 20 rights held, the shareholder will be able to purchase one share of Allied Capital s common stock. In addition, an over-subscription feature has been included, allowing shareholders to subscribe for additional shares not subscribed for by other shareholders on a pro rata basis.

The rights offering will expire on November 21, 2002, unless the offering is extended. The per share subscription price will be 93% of the average of the last reported sales price of a share of Allied Capital s common stock on the NYSE on November 21, 2002, and the four preceding business days. All shares of common stock acquired through the rights offering are expected to receive the fourth quarter dividend of $0.56 per share. Subscription certificates evidencing the non-transferable rights and a copy of the prospectus for this offering have been mailed to record date shareholders. The rights offering will be made only by means of the rights offering prospectus. See Recent Developments in the prospectus supplement.

Our board of directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first, second and third quarters of 2002, the board of directors declared a dividend of $0.53, $0.55 and $0.56 per common share, respectively. The board of directors has recently declared a dividend of $0.56 per common share for the fourth quarter of 2002, which will be paid on December 27, 2002 to shareholders of record on December 13, 2002. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our board of directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains that exceed a normal capital gains distribution level, and therefore avoid any unusual spike in dividends in any one year. The dividend policy also enables the board of directors to selectively retain gains to support future growth.

We plan to maintain a strategy of financing our business with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. Cash flow from operations before new investments was $504.8 million for the nine months ended September 30, 2002, and $330.8 million for the year ended December 31, 2001. Cash flow from operations before new investments has historically been sufficient to finance our operations.

We maintain a matched-funding philosophy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our short-term credit facilities as a means to bridge to long-term financing, which may or may not result in temporary differences in the matching of estimated maturities. We evaluate our interest rate exposure on an ongoing basis. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

At September 30, 2002, our debt to equity ratio was 0.69 to 1 and our weighted average cost of funds was 7.1%. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $400.7 million on September 30, 2002. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

CRITICAL ACCOUNTING POLICIES

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

Valuation of Portfolio Investments. As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. Our investments are generally subject to restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the board of directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for establishing the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and our equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale.

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned 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. Prepayment premiums are recorded on loans when received.

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

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

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

Commercial Mortgage-Backed Securities (CMBS). CMBS are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds. Our assumption with regard to discount rate is based upon the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS as comparable yields in the market change and/or whenever we determine that the value of our CMBS is less than the cost basis due to changes in cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

Residual Interest. We value our residual interest from a previous securitization and recognize income using the same accounting policies used for the CMBS. The residual interest is carried at fair value based on discounted estimated future cash flows. We recognize income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

Net Realized and Unrealized Gains or Losses. Realized gains or losses are measured by the difference between the net proceeds from the sale and the cost basis of the investment without regard to unrealized gains or losses previously recognized, and include investments charged off during the year, net of recoveries. Unrealized gains or losses reflect the change in portfolio investment values during the reporting period.

Fee Income. Fee income includes fees for diligence, structuring, transaction services, management services and investment advisory services rendered by us to portfolio companies and other third parties. Diligence, structuring and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management and investment advisory services fees are generally recognized as income as the services are rendered.

INTERIM FINANCIAL STATEMENTS

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	September 30, 2002	December 31, 2001
	(unaudited)	
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2002-$550,629; 2001-$451,705)	$589,613	$505,620
Companies 5% to 25% owned (cost: 2002-$235,006; 2001-$211,030)	266,131	232,399
Companies less than 5% owned (cost: 2002-$871,077; 2001-$891,231)	806,824	857,053
Total private finance	1,662,568	1,595,072
Commercial real estate finance (cost: 2002-$645,219; 2001-$732,636)	681,056	734,518
Total portfolio at value	2,343,624	2,329,590
Other assets	155,741	130,234
Cash and cash equivalents	23,630	889
Total assets	$2,522,995	$2,460,713

LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures	$869,200	$876,056
Revolving line of credit	121,500	144,750
Accounts payable and other liabilities	96,246	80,784
Total liabilities	1,086,946	1,101,590
Commitments and contingencies		
Preferred stock	7,000	7,000
Shareholders equity:		
Common stock, $0.0001 par value, 200,000,000 shares authorized; 102,467,934 and 99,607,396 shares issued and outstanding at September 30, 2002, and December 31, 2001, respectively	10	10
Additional paid-in capital	1,420,995	1,352,688
Notes receivable from sale of common stock	(25,356)	(26,028)
Net unrealized appreciation	16,320	39,981
Undistributed (distributions in excess of) earnings	17,080	(14,528)
Total shareholders equity	1,429,049	1,352,123
Total liabilities and shareholders equity	$2,522,995	$2,460,713

Net asset value per common share	$13.95	$13.57

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share amounts)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2002	2001	2002	2001
	(unaudited)		(unaudited)	
Interest and related portfolio income:				
Interest and dividends				
Companies more than 25% owned	$9,661	$5,776	$28,468	$16,664
Companies 5% to 25% owned	6,837	6,973	21,222	19,884
Companies less than 5% owned	51,126	47,274	145,599	137,174
Total interest and dividends	67,624	60,023	195,289	173,722
Premiums from loan dispositions				
Companies more than 25% owned		339		850
Companies less than 5% owned	392		2,051	1,220
Total premiums from loan dispositions	392	339	2,051	2,070
Fees and other income				
Companies more than 25% owned	5,250	9,059	19,115	15,136
Companies 5% to 25% owned	636	49	1,112	199
Companies less than 5% owned	2,427	3,164	14,346	15,317

Total fees and other income	8,313	12,272	34,573	30,652
Total interest and related portfolio income	76,329	72,634	231,913	206,444
Expenses:				
Interest	17,430	16,093	52,414	47,974
Employee	8,153	8,213	24,462	22,269
Administrative	5,052	4,139	12,913	10,166
Total operating expenses	30,635	28,445	89,789	80,409
Net investment income before income tax expense and net realized and unrealized gains	45,694	44,189	142,124	126,035
Income tax expense	600		600	

Net investment income before net realized and unrealized gains	45,094	44,189	141,524	126,035
Net realized and unrealized gains:				
Net realized gains (losses)				
Companies more than 25% owned	60,063	2,623	59,433	1,893
Companies 5% to 25% owned	(700)		18	4,571
Companies less than 5% owned	(11,141)	725	(2,379)	1,875
Total net realized gains	48,222	3,348	57,072	8,339
Net unrealized gains (losses)	(47,796)	12,166	(23,661)	23,463
Total net realized and unrealized gains	426	15,514	33,411	31,802
Net increase in net assets resulting from operations	$45,520	$59,703	$174,935	$157,837

Basic earnings per common share	$0.44	$0.64	$1.73	$1.77
Diluted earnings per common share	$0.44	$0.63	$1.70	$1.74
Weighted average common shares outstanding basic	102,327	92,903	101,329	89,282
Weighted average common shares outstanding diluted	103,302	94,585	103,040	90,864

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

(in thousands, except per share amounts)	For the Nine Months Ended September 30, 2002	2001
	(unaudited)	
Operations:		
Net investment income before income tax expense and net realized and unrealized gains	$142,124	$126,035
Income tax expense	600	
Net realized gains	57,072	8,339
Net unrealized gains (losses)	(23,661)	23,463
Net increase in net assets resulting from operations	174,935	157,837
Shareholder distributions:		
Common stock dividends	(166,823)	(135,702)
Preferred stock dividends	(165)	(165)
Net decrease in net assets resulting from shareholder distributions	(166,988)	(135,867)
Capital share transactions:		
Sale of common stock		

	49,920	237,037
Issuance of common stock upon the exercise of stock options	13,290	7,826
Issuance of common stock in lieu of cash distributions	4,696	4,879
Net decrease (increase) in notes receivable from sale of common stock	672	(1,167)
Other	401	
Net increase in net assets resulting from capital share transactions	68,979	248,575
Total increase in net assets	$76,926	$270,545
Net assets at beginning of period	$1,352,123	$1,029,692
Net assets at end of period	$1,429,049	$1,300,237
Net asset value per common share	$13.95	$13.42
Common shares outstanding at end of period	102,468	96,921

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)	For the Nine Months Ended September 30, 2002	2001
	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	$174,935	$157,837
Adjustments		
Portfolio investments	(353,026)	(513,489)
Repayments of investment principal	111,691	50,413
Proceeds from investment sales	213,474	129,980
Change in accrued or reinvested interest and dividends	(32,999)	(40,359)
Changes in other assets and liabilities	(7,845)	1,508
Amortization of loan discounts and fees	(15,479)	(11,793)
Depreciation and amortization	1,053	724
Realized losses	36,282	1,603
Net unrealized losses (gains)	23,661	(23,463)
Net cash provided by (used in) operating activities	151,747	(247,039)
Cash flows from financing activities:		
Sale of common stock	49,920	237,037
Sale of common stock upon the exercise of stock options	10,909	3,369

Collections of notes receivable from sale of common stock	3,053	3,293
Common stock dividends and distributions paid	(162,127)	(130,823)
Preferred stock dividends paid	(165)	(165)
Net borrowings under (repayments on) notes payable and debentures	(6,856)	12,836
Net borrowings under (repayments on) revolving line of credit	(23,250)	125,000
Other	(490)	(2,817)
Net cash provided by (used in) financing activities	(129,006)	247,730
Net increase in cash and cash equivalents	$22,741	$691
Cash and cash equivalents at beginning of period	$889	$2,449
Cash and cash equivalents at end of period	$23,630	$3,140

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	September 30, 2002 (unaudited) Cost	Value

Companies More Than 25% Owned
Acme Paging, L.P.
Loan $3,525 $3,525
(Telecommunications)
Common Stock
(177 shares) 27 27 Equity
Interests 13,274 11,819

American Healthcare Services, Inc.
Debt
Securities 40,643 40,643
(Healthcare)
Common Stock (79,567,042
shares) 1,000 100 Guaranty
($915)

Avborne, Inc.
Loan 9,625 9,625
(Business Services)
Common Stock
(27,500 shares) Preferred
Stock
(12,500 shares) 14,138 3,500

Business Loan Express, Inc.
Loan 6,000 6,000
(Financial Services)
Debt
Securities 83,206 83,206
Preferred Stock (25,111
shares) 25,111 25,111
Common Stock (25,503,043
shares) 104,641 140,000
Guaranty ($48,476 See
Note 3) Standby Letters of
Credit ($10,550 See Note 3)

The Color Factory Inc.
Loan 8,590 8,590
(Consumer Products)
Preferred Stock (1,000
shares) 1,002 1,002 Common

Stock (980 shares) 6,535 8,035

EDM Consulting, LLC
Debt Securities 1,875 443
(Business Services)
Equity Interests 250

Elmhurst Consulting, LLC
Loan 14,484 14,484
(Business Services)
Equity Interests 5,165 5,165

Foresite Towers, LLC
Equity
Interests 15,522 15,022
(Tower Leasing)

Gordian Group, Inc.
Loan 7,213 7,213
(Business Services)
Common Stock
(1,000 shares) 2,088 2,088

HealthASPex, Inc.
Preferred Stock (1,451,380
shares) 4,900 2,617
(Business Services)
Preferred Stock (700,000
shares) 700 700 Common
Stock (1,451,380 shares) 4

The Hillman Companies Inc.(1)
Debt
Securities 41,494 41,494
(Consumer Products)
Common Stock (6,890,937
shares) 57,169 90,013

HMT, Inc.
Debt Securities 9,058 9,058
(Business Services)
Preferred Stock (519,484
shares) 2,078 2,078 Common
Stock (300,000
shares) 3,000 1,694
Warrants 1,155 651

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(1) Public company.
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(3) Non-U.S. company.
(4) Non-registered investment company.

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Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	September 30, 2002 (unaudited) Cost	Value
Monitoring Solutions, Inc.	(Business Services)	Debt Securities	$ 1,823	$ 153
		Common Stock (33,333 shares)		
		Warrants		
MVL Group, Inc.	(Business Services)	Loan	17,017	17,017
		Debt Securities	16,236	16,236
		Common Stock (648,638 shares)		
Powell Plant Farms, Inc.	(Consumer Products)	Loan	22,223	12,709
		Preferred Stock (1,483 shares)		
		Warrants		
Spa Lending Corporation	(Recreation)	Preferred Stock (28,672 shares)	395	276
		Common Stock (6,208 shares)		
STS Operating, Inc.	(Industrial Products)	Common Stock (3,000,000 shares)	3,177	3,177
Sure-Tel, Inc.	(Consumer Services)	Preferred Stock (1,000,000 shares)	1,000	1,000
		Common Stock (37,000 shares)	5,018	5,018
Total Foam, Inc.	(Industrial Products)	Debt Securities	258	124
		Common Stock (910 shares)	10	

Total companies more than 25% owned $550,629 $589,613

Companies 5% to 25% Owned

Aspen Pet Products, Inc.
Loans $16,368 $16,368
(Consumer Products)
Preferred Stock (2,024 shares) 1,981 1,981
Common Stock (1,400 shares) 140 140

Autania AG(1,3)
Debt Securities 4,486 4,486
(Industrial Products)
Common Stock (250,000 shares) 2,169 2,145

CBA-Mezzanine Capital Finance, LLC
Loan 2,418 2,418

(Financial Services)

Colibri Holding Corporation
Loans 3,486 3,486
(Consumer Products)
Preferred Stock (237
shares) 248 248 Common
Stock (3,362
shares) 1,250 1,088
Warrants 290 252

CorrFlex Graphics, LLC
Debt
Securities 11,940 11,940
(Business Services)
Warrants 17,490
Options 1,510

CyberRep
Loan 1,224 1,224
(Business Services)
Debt
Securities 14,716 14,716
Warrants 660 4,510

The Debt Exchange Inc.
Preferred Stock (921,829
shares) 1,250 1,250
(Business Services)

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	September 30, 2002 (unaudited) Cost	Value
International Fiber Corporation (Industrial Products)	Debt Securities	$22,552	$22,552
	Common Stock (1,029,069 shares)	5,483	7,755
	Warrants	550	778
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities	3,497	3,497
	Common Stock (123,929 shares)	142	142
Litterer Beteiligungs-GmbH(3) (Business Services)	Debt Securities	1,070	1,070
	Equity Interest	358	358
Logic Bay Corporation (Business Services)	Preferred Stock (1,131,222 shares)	5,000	
Magna Card, Inc. (Consumer Products)	Debt Securities	153	153
	Preferred Stock (1,875 shares)	94	94
	Common Stock (4,687 shares)		
Master Plan, Inc. (Business Services)	Loan	959	959
	Common Stock (156 shares)	42	42
MortgageRamp.com, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	3,860
Morton Grove Pharmaceuticals, Inc. (Consumer Products)	Loan	16,356	16,356
	Preferred Stock (106,947 shares)	5,000	14,000
Nobel Learning Communities, Inc.(1) (Education)	Debt Securities	9,729	9,729
	Preferred Stock (1,063,830 shares)	2,000	2,000
	Warrants	575	382
North American Archery, LLC (Consumer Products)	Loans	1,390	840
	Convertible Debentures	2,248	59
	Guaranty ($1,020)		
Packaging Advantage Corporation (Business Services)	Debt Securities	14,207	14,207
	Common Stock (232,168 shares)	2,386	2,386
	Warrants	963	963
Professional Paint, Inc. (Consumer Products)	Debt Securities	22,791	22,791
	Preferred Stock (15,000 shares)	19,500	19,500
	Common Stock (110,000 shares)	69	5,000
Progressive International Corporation (Consumer Products)	Debt Securities	3,965	3,965
	Preferred Stock (500 shares)	500	500
	Common Stock (197 shares)	13	13
	Warrants		
Redox Brands, Inc.	Debt Securities	9,744	9,744

(Consumer Products)	Preferred Stock (2,404,086 shares)	6,974	6,974
	Warrants	584	584

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	September 30, 2002 (unaudited) Cost	 Value
Staffing Partners Holding	Loan	$2,500	$2,500
Company, Inc.	Debt Securities	4,993	4,993
(Business Services)	Preferred Stock (414,600 shares)	2,073	2,073
	Common Stock (50,200 shares)	50	50
	Warrants	10	10

Total companies 5% to 25% owned $235,006 $266,131

Companies Less Than 5% Owned

ACE Products, Inc.	Loans	$17,164	$13,061
(Industrial Products)			
Advantage Mayer, Inc.	Debt Securities	10,702	10,702
(Business Services)	Warrants	382	1,455
Alderwoods Group, Inc.(1)	Common Stock (357,568 shares)	5,006	2,324
(Consumer Services)			
Allied Office Products, Inc.	Debt Securities	7,628	50
(Business Services)	Warrants	629	
American Barbecue & Grill, Inc.	Warrants	125	
(Retail)			
American Home Care Supply, LLC	Debt Securities	6,950	6,950
	Warrants	579	1,849
(Consumer Products)			
ASW Holding Corporation			

Warrants 25 25
(Industrial Products)

Bakery Chef, Inc.
Loans 17,908 17,908
(Consumer Products)

Blue Rhino Corporation(1)
Debt
Securities 13,965 13,965
(Consumer Products)
Warrants 1,200 15,300

Border Foods, Inc.
Debt
Securities 9,365 9,365
(Consumer Products)
Preferred Stock (50,919
shares) 2,000 2,000
Warrants 665 665

Camden Partners Strategic
Fund II, L.P.(4)
Limited Partnership
Interest 2,124 2,238
(Private Equity Fund)

Candlewood Hotel
Company(1)
Preferred Stock (3,250
shares) 3,250 975
(Hospitality)

Celebrities, Inc.
Loan 220 220
(Broadcasting & Cable)
Warrants 12 492

Clif Bar, Inc.
Loan 24,889 24,889
(Consumer Products)

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	September 30, 2002 (unaudited) Cost	Value
Component Hardware Group, Inc.	Debt Securities	$11,157	$11,157
(Industrial Products)	Preferred Stock (18,000 shares)	2,229	2,229
	Common Stock (2,000 shares)	200	200
Cooper Natural Resources, Inc.	Loan	299	299
(Industrial Products)	Debt Securities	1,849	1,849
	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
Coverall North America, Inc.	Loan	12,403	12,403
(Business Services)	Debt Securities	6,423	6,423
CPM Acquisition Corporation	Loan	10,055	10,055
(Industrial Products)			
CTT Holdings	Loan	1,500	1,500
(Consumer Products)			
Cumulus Media, Inc. (1)	Common Stock (11,037 shares)	198	195
(Broadcasting & Cable)			
Drilltec Patents &	Loan	10,918	
Technologies Company, Inc.	Debt Securities	1,500	
(Industrial Products)	Warrants		
eCentury Capital Partners, L.P.(4)	Limited Partnership Interest	1,875	1,675
(Private Equity Fund)			
El Dorado Communications, Inc.	Loans	306	232
(Broadcasting & Cable)			
Elexis Beta GmbH(3)	Options	426	426
(Industrial Products)			
Eparfin S.A.(3)	Loan	29	29
(Consumer Products)			
E-Talk Corporation	Debt Securities	8,852	300
(Business Services)	Warrants	1,157	
Executive Greetings, Inc.	Debt Securities	18,061	18,061
(Business Services)	Warrants	360	360
Fairchild Industrial Products	Debt Securities	5,924	5,924
Company	Warrants	280	1,100
(Industrial Products)			
Galaxy American	Debt Securities	48,989	25,000
Communications, LLC	Options		

(Broadcasting & Cable)	Standby Letter of Credit ($750)		
Garden Ridge Corporation	Debt Securities	27,133	27,133
(Retail)	Preferred Stock (1,130 shares)	1,130	1,130
	Common Stock (188,400 shares)	613	613

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	September 30, 2002 (unaudited) Cost	Value
GC-Sun Holdings II, LP (Kar Products, LP)	Loans	$ 7,738	$ 7,738
(Business Services)			
Gibson Guitar Corporation	Debt Securities	17,753	17,753
(Consumer Products)	Warrants	525	2,325
Ginsey Industries, Inc.	Loans	5,000	5,000
(Consumer Products)	Convertible Debentures	500	500
	Warrants		1,500
Global Communications, LLC	Loan	1,998	1,998
(Business Services)	Debt Securities	16,033	16,033
	Equity Interest	12,707	12,707
	Options	1,639	1,639
Grant Broadcasting Systems II	Warrants	87	3,000
(Broadcasting & Cable)			
Grotech Partners, VI, L.P.(4)	Limited Partnership Interest	2,803	2,369
(Private Equity Fund)			
The Hartz Mountain Corporation	Debt Securities	27,616	27,616
(Consumer Products)	Common Stock (200,000 shares)	2,000	2,000
	Warrants	2,613	2,613
Haven Eldercare of New England, LLC	Loan	35,633	35,633
(Healthcare)			
Headwaters Incorporated(1)	Loan	9,951	9,951
(Industrial Products)			
Hotelevision, Inc.	Preferred Stock (315,100 shares)	315	
(Broadcasting & Cable)			
Icon International, Inc.	Common Stock (35,228 shares)	1,219	2,712
(Business Services)			
Impact Innovations Group, LLC	Debt Securities	6,797	3,436
(Business Services)	Warrants	1,674	
Intellirisk Management Corporation	Loans	23,035	23,035
(Business Services)			
Interline Brands, Inc.	Debt Securities	33,733	33,733
(Business Services)	Preferred Stock (199,313 shares)	1,849	1,849
	Common Stock (15,615 shares)	139	139
	Warrants	1,181	1,181
Jakel, Inc.	Loan	23,307	14,255

(Industrial Products)			
JRI Industries, Inc.	Debt Securities	2,018	2,018
(Industrial Products)	Warrants	74	74

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	September 30, 2002 (unaudited) Cost	Value
Julius Koch USA, Inc. (Industrial Products)	Warrants	$ 259	$ 8,000
Kirker Enterprises, Inc. (Industrial Products)	Warrants	348	3,501
	Equity Interest	4	4
Kirkland s, Inc.(1) (Retail)	Common Stock (240,442 shares)	66	3,700
Kyrus Corporation (Business Services)	Debt Securities	7,145	7,145
	Warrants	348	348
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	359	213
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares)	500	500
	Warrants		
MedAssets.com, Inc. (Business Services)	Debt Securities	15,618	15,618
	Preferred Stock (260,417 shares)	2,049	2,049
	Warrants	136	136
Mid-Atlantic Venture Fund IV, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	3,975	2,555
Midview Associates, L.P. (Housing)	Warrants		
Most Confiserie GmbH & Co KG(3) (Consumer Products)	Loan	943	50
NetCare, AG(3) (Business Services)	Loan	760	50
	Common Stock (262,784 shares)	226	
Norstan Apparel Shops, Inc. (Retail)	Debt Securities	11,786	11,786
	Common Stock (29,477 shares)	4,750	4,750
	Warrants	655	655
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	278	278
Novak Biddle Venture Partners III, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	690	690
Nursefinders, Inc. (Business Services)	Debt Securities	11,178	11,178
	Warrants	900	2,200
Onyx Television GmbH(3) (Broadcasting & Cable)	Preferred Units (120,000 shares)	201	8

Opinion Research Corporation(1)	Debt Securities	14,313	14,313
(Business Services)	Warrants	996	687

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(3) Non-U.S. company.
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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	September 30, 2002 (unaudited) Cost	Value
Oriental Trading Company, Inc.	Preferred Equity Interest	$ 1,751	$ 1,751
(Consumer Products)	Common Equity Interest		2,600
Outsource Partners, Inc.	Debt Securities	24,077	24,077
(Business Services)	Warrants	826	826
Pico Products, Inc.	Loan	1,406	1,406
(Industrial Products)			
Polaris Pool Systems, Inc.	Debt Securities	10,691	10,691
(Consumer Products)	Warrants	1,145	1,145
Proeducation GmbH(3)	Loan	261	261
(Education)			
Prosperco Finanz Holding AG(3)	Convertible Debentures	5,305	5,305
(Financial Services)	Common Stock (1,528 shares)	1,059	708
	Warrants		
Raytheon Aerospace, LLC	Debt Securities	5,169	5,169
(Business Services)	Equity Interest		250
Scitor Corporation	Loan	21,893	21,893
(Business Services)			
Simula, Inc.(1)	Loan	20,863	20,863
(Industrial Products)			
Soff-Cut Holdings, Inc.	Debt Securities	8,999	8,999
(Industrial Products)	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	200
Southwest PCS, LLC	Loan	6,220	6,220
(Telecommunications)			
Startec Global Communications	Loan	23,815	23,815
Corporation(1)	Debt Securities	20,737	245
(Telecommunications)	Common Stock (258,064 shares)	3,000	
	Warrants		
SunStates Refrigerated	Loans	4,722	2,847
Services, Inc.	Debt Securities	2,445	
(Warehouse Facilities)			
Sydran Food Services II, L.P.	Debt Securities	12,973	12,973
(Retail)	Equity Interests	3,909	
	Warrants		
Tubbs Snowshoe	Debt Securities	3,924	3,924

Company, LLC	Equity Interests	500	500
(Consumer Products)	Warrants	54	54
United Pet Group, Inc.	Debt Securities	9,023	9,023
(Consumer Products)	Warrants	85	85

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Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	September 30, 2002 (unaudited) Cost	Value
Updata Venture Partners II, L.P.(4)	(Private Equity Fund)	Limited Partnership Interest	$ 502	$ 1,650
Venturehouse Group, LLC(4)	(Private Equity Fund)	Equity Interest	667	378
Walker Investment Fund II, LLLP(4)	(Private Equity Fund)	Limited Partnership Interest	1,200	887
Warn Industries, Inc.	(Consumer Products)	Debt Securities	11,522	11,522
		Warrants	1,429	3,379
Wilshire Restaurant Group, Inc.	(Retail)	Debt Securities	15,901	15,901
		Warrants	735	735
Wilton Industries, Inc.	(Consumer Products)	Loan	12,000	12,000
Woodstream Corporation	(Consumer Products)	Loan	2,621	2,621
		Debt Securities	7,665	7,665
		Equity Interests	1,700	4,547
		Warrants	450	1,203

Total companies less than 5% owned $871,077 $806,824

Total private finance (127 portfolio companies) $1,656,712 $1,662,568

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(in thousands, except number of loans)	Stated Interest	Face	September 30, 2002 (unaudited) Cost	Value
Commercial Real Estate Finance				
Commercial Mortgage-Backed Securities				
CMBS Bonds				
Mortgage Capital Funding, Series 1998-MC3	5.5%	$ 50,404	$ 24,871	$ 25,901
Morgan Stanley Capital I, Series 1999-RM1	6.4%	47,566	19,470	20,175
COMM 1999-1	5.6%	70,159	33,472	34,584
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	33,485	14,005	14,379
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	74,140	31,194	32,470
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	31,884	14,338	15,205
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	25,872	9,767	10,704
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	33,380	13,906	15,217
FUNB CMT, Series 1999-C4	6.5%	39,283	15,696	16,827
Heller Financial, HFCMC Series 2000 PH-1	6.8%	42,442	16,795	18,267
SBMS VII, Inc., Series 2000-NL1	7.2%	18,549	9,200	9,941
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	35,773	16,577	17,716
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	34,935	14,773	16,458
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	31,820	11,130	12,364
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	35,847	13,677	15,212
JP Morgan-CIBC-Deutsche 2001	5.8%	39,933	15,725	16,836
Lehman Brothers-UBS Warburg 2001-C4	6.4%	42,014	17,397	19,017
SBMS VII, Inc., Series 2001-C1	6.1%	35,536	12,559	13,789
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	39,012	16,089	17,280
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	40,150	15,464	16,515
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	37,178	12,879	13,944
SBMS VII, Inc., Series 2001-C2	6.2%	31,369	11,604	12,620
FUNB CMT, Series 2002-C1	6.0%	38,238	16,722	18,618
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	80,490	44,510	52,892
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	62,703	34,790	39,471
Total CMBS bonds		$1,052,162	$456,610	$496,402
Collateralized Debt Obligation Preferred Shares				
Crest 2001-1, Ltd.(3)		23,639	23,639	23,639
Crest 2002-1, Ltd.(3)		23,513	23,513	23,513
Crest 2002-IG, Ltd.(3)		4,915	4,915	4,915
Crest Clarendon Street 2002-1, Ltd.(3)		964	964	964
Total collateralized debt obligation preferred shares		$ 53,031	$ 53,031	$ 53,031
Total CMBS		$1,105,193	$509,641	$549,433

	Interest Rate Ranges	Number of Loans	Cost	Value

Commercial Mortgage Loans				
	Up to 6.99%	9	$ 9,723	$10,753
	7.00%- 8.99%	18	19,514	17,150
	9.00%-10.99%	9	9,858	9,858
	11.00%-12.99%	10	14,436	13,970
	13.00%-14.99%	7	7,880	7,880
	15.00% and above	1	45	45
Total commercial mortgage loans		54	$61,456	$59,656
Residual Interest			$69,335	$69,035
Real Estate Owned			4,787	2,932
Total commercial real estate finance			**$645,219**	**$681,056**
Total portfolio			**$2,301,931**	**$2,343,624**

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001 Cost	Value

Companies More Than 25% Owned

Acme Paging, L.P.
Debt
Securities $6,992 $6,992
(Telecommunications)
Equity
Interests 3,640 2,184

American Healthcare Services,
Debt
Securities 40,194 40,194
Inc.
Common Stock (79,567,042
shares) 1,000 100
(Healthcare)
Guaranty ($195)

Business Loan Express, Inc.
Loan 6,000 6,000
(Financial Services)
Debt
Securities 76,242 76,242
Preferred Stock (25,111
shares) 25,111 25,111
Common Stock (25,503,043
shares) 104,596 120,096
Guaranty ($51,350 See
Note 3)

The Color Factory Inc.
Loan 5,346 5,346
(Consumer Products)
Preferred Stock (600
shares) 788 788 Common
Stock (980
shares) 6,535 8,035

Directory Investment
Corporation
Common Stock (470
shares) 112 32
(Publishing)

Directory Lending Corporation
Series A Common Stock (34 shares)
(Publishing)
Series B Common Stock (6 shares) 8 Series C Common Stock (10 shares) 22

EDM Consulting, LLC
Debt Securities 1,875 443
(Business Services)
Equity Interest 250

Elmhurst Consulting, LLC
Loan 7,762 7,762
(Business Services)
Equity Interests 5,157 5,157

Foresite Towers, LLC
Equity Interests 15,500 15,500
(Tower Leasing)

HealthASPex, Inc.
Preferred Stock (1,451,380 shares) 4,900 3,900
(Business Services)
Preferred Stock (611,923 shares) 612 612 Common Stock (1,451,380 shares) 4

The Hillman Companies, Inc.
Debt Securities 40,071 40,071
(Consumer Products)
Common Stock (6,890,937 shares) 57,156 57,156

HMT, Inc.
Debt Securities 8,995 8,995
(Business Services)
Common Stock (300,000 shares) 3,000 3,000
Warrants 1,155 1,155

Monitoring Solutions, Inc.
Debt Securities 1,823 153
(Business Services)
Common Stock (33,333 shares) Warrants

Spa Lending Corporation		
Preferred Stock (28,625 shares)	485	375
(Recreation)		
Common Stock (6,208 shares)	25	18

(1) Public company.
(2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
(3) Non-U.S. company.
(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	December 31, 2001	
			Cost	Value
STS Operating, Inc.	(Industrial Products)	Common Stock (3,000,000 shares)	$ 3,177	$ 3,177
Sure-Tel, Inc.	(Consumer Services)	Loan	1,207	1,207
		Preferred Stock (1,116,902 shares)	4,642	4,642
		Warrants	662	662
		Options		
Total Foam, Inc.	(Industrial Products)	Debt Securities	263	127
		Common Stock (910 shares)	10	
WyoTech Acquisition	Corporation	Debt Securities	12,588	12,588
		Preferred Stock (100 shares)	3,700	3,700
	(Education)	Common Stock (99 shares)	100	44,100

Total companies more than 25% owned $451,705 $505,620

Companies 5% to 25% Owned

Aspen Pet Products, Inc.
Loans $14,576 $14,576
(Consumer Products)
Preferred Stock (1,860 shares) 1,981 1,981
Common Stock (1,400 shares) 140 140

Autania AG(1,3)
Debt Securities 4,762 4,762
(Industrial Products)
Common Stock (250,000 shares) 2,261 2,261

Colibri Holding Corporation
Loans 3,464 3,464
(Consumer Products)
Preferred Stock (237 shares) 237 237 Common Stock (3,362 shares) 1,250 1,250
Warrants 290 290

CorrFlex Graphics, LLC
Debt Securities 2,312 2,312

(Business Services)
Warrants