ALLIED CAPITAL CORP
Form N-2
April 07, 2005

As filed with the Securities and Exchange Commission on April , 2005

Registration No. 333-

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM N-2

REGISTRATION STATEMENT

UNDER
THE SECURITIES ACT OF 1933

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

ALLIED CAPITAL CORPORATION

(Exact Name of Registrant as Specified in Charter)

1919 Pennsylvania Avenue, N.W.

Washington, D.C. 20006-3434
(202) 331-1112
(Address and Telephone Number, including Area Code, of Principal Executive Offices)

William L. Walton, Chairman and Chief Executive Officer

Allied Capital Corporation
1919 Pennsylvania Avenue, N.W.
Washington, D.C. 20006-3434
(Name and Address of Agent for Service)

Copies of information to:

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

Approximate Date of Proposed Public Offering:

From time to time after the effective date of the Registration Statement.

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

CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

Title of Securities Being Registered	Amount Being Registered(1)	Proposed Maximum Offering Price Per Share(2)	Proposed Maximum Aggregate Offering Price	Amount of Registration Fee(3)
Common Stock, $0.0001 par value per share	3,000,000 shares	$26.52	$79,545,000	$9,362

(1) In reliance upon Rule 429 under the Securities Act of 1933, this amount is in addition to the securities previously registered by the Registrant under a registration statement on Form N-2 (File No. 333-113671). All securities unsold under such prior registration (a total of 17,000,000 shares of common stock) are carried forward into this Registration Statement.

(2) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c) under the Securities Act of 1933 on the basis of the average of the high and low sales prices of the common stock on April 5, 2005, as reported on the New York Stock Exchange.

(3) In reliance upon Rule 429 under the Securities Act of 1933, all securities unsold under a registration statement on Form N-2 (File No. 333-113671) (a total of 17,000,000 shares of common stock) are carried forward into this Registration Statement. A registration fee of $63,332 has been paid previously with respect to such securities. The registration fee of $9,362 relates solely to the registration of 3,000,000 shares of common stock not previously registered.

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this registration statement shall become effective on such date as the Commission, acting pursuant to Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

PROSPECTUS (SUBJECT TO COMPLETION)
ISSUED , 2005

20,000,000 Shares

Common Stock

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

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

Please read this prospectus and the accompanying prospectus supplement before investing, and keep it for future reference. The prospectus and the accompanying prospectus supplement contain important information about us that a prospective investor should know before investing in our common stock. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 or by telephone at (202) 331-1112 or on our website at www.alliedcapital.com. The SEC also maintains a website at www.sec.gov that contains such information.

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

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

Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of April , 2005, the last reported sale price on the New York Stock Exchange for the common stock was $.

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

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

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

, 2005

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

TABLE OF CONTENTS

ABOUT THIS PROSPECTUS

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

PROSPECTUS SUMMARY

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

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

BUSINESS *(Page 59)*

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

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

We invest in the American entrepreneurial economy. Our private finance portfolio includes investments in over 100 companies with aggregate annual revenue of approximately $11 billion that employ more than 100,000 jobs.

Our investment activity is primarily focused in three areas:

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

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

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

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

Our primary commercial real estate investments are in the non-investment grade classes of CMBS bonds. We generally invest at the initial issuance of the CMBS, and are able to review the underlying collateral of mortgage loans as if we were making an initial decision to fund such loans and to determine if we want to exclude loans that do not meet our credit, collateral, structural or other standards. We also negotiate to acquire the securities at significant discounts from their face amount. In addition to our CMBS investments, we have invested in the bonds and preferred shares of CDOs. Since we are limited as to the amount of debt capital we can use to finance our commercial real estate investments, we are evaluating various strategic alternatives for our commercial real estate platform. These alternatives may include the sale, spin-out or recapitalization of all or part of our commercial real estate investments.

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

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

Access to public equity markets generally gives us a lower cost of capital than that of other private equity funds, and

Our capital structure is perpetual in nature and may enable us to be a better long-term partner for our portfolio companies than other private equity funds, which typically have a limited life.

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

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

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

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

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

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

DETERMINATION OF

NET ASSET VALUE *(Page 84)*

Our portfolio investments are generally recorded at fair value as determined in good faith by our Board of Directors in the absence of readily available public market values. At December 31, 2004, portfolio investments recorded at fair value were approximately 92% of our total assets.

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

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

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

PLAN OF DISTRIBUTION *(Page 126)*

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

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

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

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

USE OF PROCEEDS *(Page 18)*

We intend to use the net proceeds from selling shares of common stock for general corporate purposes, which includes investing in debt or equity securities in primarily privately negotiated transactions, repayment of indebtedness, acquisitions and other general corporate purposes. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

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

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

DIVIDEND REINVESTMENT PLAN *(Page 119)*

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

RISK FACTORS *(Page 10)*

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

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

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

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

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

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

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

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

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

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

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

CERTAIN ANTI-TAKEOVER

PROVISIONS *(Page 122)*

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

FEES AND EXPENSES

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

Shareholder Transaction Expenses	
Sales load (as a percentage of offering price)(1)	%
Dividend reinvestment plan fees(2)	None
Annual Expenses (as a percentage of consolidated net assets attributable to common stock)(3)	
Operating expenses(4)	4.5%
Interest payments on borrowed funds(5)	3.8%
Total annual expenses(6)(7)	8.3%

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

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

(3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities), which at December 31, 2004, was $1,979.8 million.

(4) Operating expenses represent our operating expenses for the year ending December 31, 2004, excluding interest on indebtedness.

(5) The Interest payments on borrowed funds represents our interest expense for the year ending December 31, 2004. We had outstanding borrowings of $1,176.6 million at December 31, 2004. See Risk Factors.

(6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that Total annual expenses percentage be calculated as a percentage of *net* assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 5.1% of consolidated total assets.

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

Example

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

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$126	$288	$450	$854

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

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

may be greater or less than those shown.

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included in this prospectus. Financial information at and for the years ended December 31, 2004, 2003, and 2002, has been derived from our financial statements that were audited by KPMG LLP. Financial information at and for the years ended December 31, 2001 and 2000, has been derived from our financial statements that were audited by Arthur Andersen LLP. For important information about Arthur Andersen LLP, see the section entitled Notice Regarding Arthur Andersen LLP. **See Management s Discussion and Analysis of Financial Condition and Results of Operations on page 20 for more information.**

	Year Ended December 31,				
(in thousands, except per share data)	**2004**	**2003**	**2002**	**2001**	**2000**
Operating Data:					
Interest and related portfolio income:					
Interest and dividends	$319,642	$290,719	$264,042	$240,464	$182,307
Loan prepayment premiums and premiums from loan dispositions	5,502	8,172	2,776	2,504	16,138
Fees and other income	41,946	30,338	43,110	46,142	13,144
Total interest and related portfolio income	367,090	329,229	309,928	289,110	211,589
Expenses:					
Interest	75,650	77,233	70,443	65,104	57,412
Employee	40,728	36,945	33,126	29,656	26,025
Individual performance award	13,011				
Administrative	35,686	22,387	21,504	15,299	15,435
Total operating expenses	165,075	136,565	125,073	110,059	98,872
Net investment income before income taxes	202,015	192,664	184,855	179,051	112,717
Income tax expense (benefit)	1,057	(2,466)	930	(412)	
Net investment income	200,958	195,130	183,925	179,463	112,717
Net realized and unrealized gains (losses):					
Net realized gains	117,240	75,347	44,937	661	15,523
Net change in unrealized appreciation or depreciation	(68,712)	(78,466)	(571)	20,603	14,861
Total net gains (losses)	48,528	(3,119)	44,366	21,264	30,384
Net increase in net assets resulting from operations	$249,486	$192,011	$228,291	$200,727	$143,101
Per Share:					
Diluted earnings per common share	$ 1.88	$ 1.62	$ 2.20	$ 2.16	$ 1.94
Dividends per common share[(1)]	$ 2.30	$ 2.28	$ 2.23	$ 2.01	$ 1.82
Weighted average common shares outstanding diluted[(2)]	132,458	118,351	103,574	93,003	73,472

	At December 31,				
(in thousands, except per share data)	**2004**	**2003**	**2002**	**2001**	**2000**
Balance Sheet Data:					

Portfolio at value	$3,013,411	$2,584,599	$2,488,167	$2,329,590	$1,788,001
Total assets	3,260,998	3,019,870	2,794,319	2,460,713	1,853,817
Total debt outstanding(3)	1,176,568	954,200	998,450	1,020,806	786,648
Preferred stock issued to Small Business Administration(3)		6,000	7,000	7,000	7,000
Shareholders equity	1,979,778	1,914,577	1,546,071	1,352,123	1,029,692
Shareholders equity per common share (net asset value)(4)	$ 14.87	$ 14.94	$ 14.22	$ 13.57	$ 12.11
Common shares outstanding at year end(2)	133,099	128,118	108,698	99,607	85,057

	Year Ended December 31,				
	2004	2003	2002	2001	2000
Other Data:					
Investments funded	$1,524,523	$931,450	$506,376	$680,329	$901,545
Principal collections related to investment repayments or sales	909,189	788,328	356,641	204,441	391,275
Realized gains	267,702	94,305	95,562	10,107	28,604
Realized losses	(150,462)	(18,958)	(50,625)	(9,446)	(13,081)

	2004				2003			
(in thousands, except per share data)	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1
Quarterly Data (unaudited):								
Total interest and related portfolio income	$100,962	$96,863	$87,500	$81,765	$90,015	$88,870	$77,214	$73,130
Net investment income	54,678	52,745	48,990	44,545	54,254	53,608	44,598	42,670
Net increase in net assets resulting from operations	47,837	85,999	95,342	20,308	78,454	33,744	59,940	19,873
Diluted earnings per common share	0.35	0.66	0.73	0.15	0.62	0.28	0.52	0.18
Dividends declared per common share(5)	0.59	0.57	0.57	0.57	0.57	0.57	0.57	0.57
Net asset value per common share(4)	14.87	14.90	14.77	14.60	14.94	14.46	14.23	14.05

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

(2) Excludes 234,977 common shares held in the deferred compensation trust at and for the year ended December 31, 2000.

(3) See Senior Securities on page 56 for more information regarding our level of indebtedness.

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

(5) Dividends declared per common share for the fourth quarter of 2004 included the regular quarterly dividend of $0.57 per common share and an extra dividend of $0.02 per common share.

WHERE YOU CAN FIND

ADDITIONAL INFORMATION

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

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

RISK FACTORS

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

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

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

Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments. At December 31, 2004, portfolio investments recorded at fair value were approximately 92% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

Our borrowers may default on their payments, which may have a negative effect on our financial performance. We make long-term unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources and that may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower s ability to repay its loan, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. Deterioration in a borrower s financial condition and prospects may be accompanied by deterioration in any related collateral and may have a negative effect on our financial results.

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

Our financial results could be negatively affected if Business Loan Express fails to perform as expected. Business Loan Express, LLC (BLX) is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At

December 31, 2004, our investment in BLX totaled $335.2 million at value, or 10.3% of total assets and for the year ended December 31, 2004, interest and related portfolio income earned from our investment in BLX was $50.0 million, or 13.6% of total interest and related portfolio income.

In addition, as controlling equity owner of BLX, we have provided an unconditional guaranty to BLX s senior credit facility lenders in an amount equal to 50% of BLX s total obligations on its $275.0 million revolving credit facility. The amount we have guaranteed at December 31, 2004, was $94.6 million. This guaranty can only be called in the event of a default by BLX. At December 31, 2004, we had also provided four standby letters of credit totaling $35.6 million in connection with four term securitization transactions completed by BLX.

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

Investments in non-investment grade commercial mortgage-backed securities and collateralized debt obligations may be illiquid, may have a higher risk of default, and may not produce current returns. The commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares in which we invest are not investment grade, which means that nationally recognized statistical rating organizations rate them below the top four investment-grade rating categories (i.e., AAA through BBB), and are sometimes referred to as junk bonds. Non-investment grade commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares tend to be less liquid, may have a higher risk of default and may be more difficult to value. Non-investment grade securities usually provide a higher yield than do investment grade securities, but with the higher return comes greater risk of default. In addition, the fair value of these securities may change as interest rates change over time. Economic recessions or downturns may cause defaults or losses on collateral securing these securities to increase. Non-investment grade securities are considered speculative, and their capacity to pay principal and interest in accordance with the terms of their issue is not ensured.

We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us. Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders. Lenders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

At December 31, 2004, we had $1,176.6 million of outstanding indebtedness bearing a weighted average annual interest cost of 6.6%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.4%.

Illustration. The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) $3,261.0 million in total assets, (ii) an average cost of funds of 6.6%, (iii) $1,176.6 million in debt outstanding and (iv) $1,979.8 million of shareholders equity.

Assumed Return on Our Portfolio

(net of expenses)

	-20%	**-10%**	**-5%**	**0%**	**5%**	**10%**	**20%**
Corresponding return to shareholder	-36.8%	-20.3%	-12.1%	-3.8%	4.4%	12.7%	29.1%

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of December 31, 2004, our asset coverage for senior indebtedness was 280%.

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

Assuming that the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected the net income by less than 1% over a one year horizon.

Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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

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

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

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

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

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

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

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

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

The SEC has recently issued proposed rules to correct the unintended consequence of the Federal Reserve s 1998 margin rule amendments of apparently limiting the investment opportunities of business development companies. In general, the SEC s proposed rules would define an eligible portfolio company as any company that does not have securities listed on a national securities exchange or association. We are currently in the process of reviewing the SEC s proposed rules and assessing its impact, to the extent such proposed rules are subsequently approved by the SEC, on our investment activities. We do not believe that these proposed rules will have a material adverse effect on our operations.

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

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

- price and volume fluctuations in the overall stock market from time to time;
- significant volatility in the market price and trading volume of securities of business development companies or other financial services companies;
- volatility resulting from trading in derivative securities related to our common stock including puts, calls, long-term equity anticipation securities, or LEAPs, or short trading positions;
- changes in regulatory policies or tax guidelines with respect to business development companies or regulated investment companies;
- actual or anticipated changes in our earnings or fluctuations in our operating results or changes in the expectations of securities analysts;
- general economic conditions and trends;
- loss of a major funding source; or
- departures of key personnel.

Disclosure Regarding Forward-Looking Statements

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

- **changes in the economy;**
- **risks associated with possible disruption in our operations due to terrorism;**
- **future changes in laws or regulations and conditions in our operating areas; and**
- **other risks and uncertainties as may be detailed from time to time in our public announcements and SEC filings.**

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

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

USE OF PROCEEDS

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

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

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On April , 2005, the last reported closing sale price of our common stock was $ per share.

		Closing Sales Price		Premium of High	Premium of Low	
	NAV(1)	High	Low	Sales Price to NAV(2)	Sales Price to NAV(2)	Declared Dividends
Year ended December 31, 2003						
First Quarter	$14.05	$23.85	$19.82	170%	141%	$0.57
Second Quarter	$14.23	$25.16	$19.85	177%	139%	$0.57
Third Quarter	$14.46	$26.60	$22.97	184%	159%	$0.57
Fourth Quarter	$14.94	$28.16	$24.63	188%	165%	$0.57
Year ending December 31, 2004						
First Quarter	$14.60	$30.85	$27.15	211%	186%	$0.57
Second Quarter	$14.77	$30.25	$23.06	205%	156%	$0.57
Third Quarter	$14.90	$25.80	$22.22	173%	149%	$0.57
Fourth Quarter	$14.87	$28.47	$24.46	191%	164%	$0.57
Extra Dividend						$0.02
Year ended December 31, 2005						
First Quarter 2005	*	$27.84	$24.89	*	*	$0.57
Second Quarter (through April , 2005)	*			*	*	*

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

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

* Not determinable at the time of filing.

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

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

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

MANAGEMENT S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The information contained in this section should be read in conjunction with our 2004 Consolidated Financial Statements and the Notes thereto. In addition, this prospectus contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or other variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth above in the Risk Factors section. Other factors that could cause actual results to differ materially include:

changes in the economy;

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

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

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

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

OVERVIEW

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

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

	At December 31,		
	2004	2003	2002
Private finance	76%	74%	70%
Commercial real estate finance	24%	26%	30%

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

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

PORTFOLIO AND INVESTMENT ACTIVITY

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

	At and for the Years Ended December 31,		
($ in millions)	2004	2003	2002
Portfolio at value	$3,013.4	$2,584.6	$2,488.2
Investments funded	$1,524.5	$ 931.5	$ 506.4
Change in accrued or reinvested interest and dividends	$ 52.2	$ 45.0	$ 45.8
Principal collections related to investment repayments or sales	$ 909.2	$ 788.3	$ 356.6
Yield on interest-bearing investments[(1)]	14.0%	14.7%	14.0%

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

Private Finance

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

($ in millions)	At and for the Years Ended December 31, 2004	2003	2002
Portfolio at value:			
Loans and debt securities	$1,602.9	$1,214.9	$1,151.2
Equity interests	699.2	687.8	592.0
Total portfolio	$2,302.1	$1,902.7	$1,743.2
Investments funded[1]	$1,140.8	$ 498.0	$ 297.2
Change in accrued or reinvested interest and dividends	$ 45.6	$ 41.8	$ 43.6
Principal collections related to investment repayments or sales	$ 551.9	$ 318.6	$ 129.3
Yield on interest-bearing investments[2]	13.9%	15.0%	14.4%

(1) Investments funded for the year ended December 31, 2004, include a $47.5 million subordinated debt investment in The Hillman Companies, Inc. received in conjunction with the sale of Hillman as discussed below.

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from year to year depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. During 2002, we believed that there was a decline in the availability of senior debt capital from banks for middle market companies and there were fewer merger and acquisition transactions for these companies. By mid-2003, we began to see an increase in merger and acquisition activity for middle market companies and debt capital became more available. We believe that merger and acquisition activity in the middle market was stronger in 2004, which when combined with a lower interest rate environment resulted in an increase in private finance investments funded, as well as increased repayments.

Investments funded for the years ended December 31, 2004, 2003, and 2002, consisted of the following:

($ in millions)	Loans and Debt Securities	Equity Interests	Total
For the Year Ended December 31, 2004			
Companies more than 25% owned	$445.4	$171.2	$ 616.6
Companies 5% to 25% owned	112.0	14.4	126.4
Companies less than 5% owned	351.5	46.3	397.8
Total	$908.9	$231.9	$1,140.8

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

During 2004, we invested $616.6 million in companies where we acquired or owned a majority ownership position as compared to $87.0 million for 2003. Investments in controlled portfolio companies during 2004 included the following:

The purchase of a majority ownership in Advantage Sales & Marketing, Inc. (Advantage), a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. At the closing of the transaction in June 2004, we invested $90.2 million in loans and subordinated debt and $73.5 million in common stock. In addition, prior to completing the purchase, we had invested $93.7 million in subordinated debt in certain predecessor companies of Advantage, of which $63.5 million was invested in the first and second quarters of 2004. This existing debt was exchanged for new subordinated debt in Advantage as part of the transaction.

The purchase of a majority ownership in Insight Pharmaceuticals Corporation (Insight), a marketer and distributor of over-the-counter pharmaceutical products. At the closing of the transaction in December 2004, we invested $124.0 million in senior and subordinated debt and $31.3 million in preferred and common stock. Our debt investment in Insight includes a $19.0 million revolving line of credit facility, of which Insight had borrowed $14.4 million at December 31, 2004.

The purchase of a majority ownership in Financial Pacific Company (Financial Pacific), a specialized commercial finance company focused on providing leases for business-essential equipment to small businesses nationwide. At the closing of the transaction in August 2004, we invested $68.4 million in debt and $24.7 million in preferred and common stock.

The purchase of a majority ownership in Mercury Air Centers, Inc. (Mercury), an operator of fixed base operations, from Mercury Air Group, Inc. At the closing of the transaction in April 2004, we invested $53.4 million in debt and $29.6 million in common stock. Since closing, we have invested an additional $1.6 million in common stock. In addition, we have an $8.5 million commitment to fund senior subordinated debt for future working capital and construction commitments, of which $0.8 million was outstanding at December 31, 2004. In connection with the transaction, Mercury Air Group, Inc. repaid its $24 million subordinated debt obligation to Allied Capital.

The purchase of Legacy Partners Group, LLC, a financial advisory firm. At the closing of the transaction in May 2004, we invested $4.3 million in debt and $2.7 million in equity interests. Since closing, we have invested additional debt of $5.0 million for working capital.

We intend to continue a balanced approach to private finance investing that emphasizes a complementary mix of mezzanine investments and buyout investments, subject to regulatory diversity requirements. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains.

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

At December 31, 2004, we had outstanding investment commitments to private finance portfolio companies totaling $313.1 million including the following:

$96.4 million of financing and purchase commitments to Callidus Capital Corporation (Callidus), an asset management company that structures and manages collateralized debt obligations (CDOs), loan collateralized loan obligations (CLOs), and other related investments. We own 80% of the equity of the management company. Our commitment consists of $50 million of subordinated debt to support Callidus warehouse facilities and warehousing activities, $44.4 million to purchase below investment grade bonds and preferred equity securities in Callidus future CDO or CLO transactions, and $2.0 million for working capital needs. Callidus has a secured warehouse credit facility with a third party for up to $300 million to primarily finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate up to $45 million of our $50 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

$107.8 million of availability under our outstanding commitment in the form of a $150.0 million revolving line of credit facility to support Callidus middle market underwriting and syndication activities. At December 31, 2004, there was $42.2 million outstanding under this facility which had been funded during 2004.

$20.0 million in the form of a revolving credit facility to Business Loan Express, LLC (BLX) to provide working capital to the company. At December 31, 2004, BLX had no outstanding borrowings on the facility.

$17.5 million in the form of debt of financing commitments to S.B. Restaurant Company.

$18.9 million in the form of equity to eight private venture capital funds.

$9.0 million in the form of equity to Pennsylvania Avenue Investors, L.P., a limited partnership controlled by us that invests in private buyout equity funds.

We may have commitments to fund additional amounts under earn-out arrangements primarily related to the purchase of controlled portfolio companies in the future if those companies meet agreed-upon performance targets. In addition, we had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling $141.6 million.

On March 31, 2004, we sold our control investment in The Hillman Companies, Inc. (Hillman) for a total transaction value of $510 million, including the repayment of outstanding debt and adding the value of Hillman s outstanding trust preferred shares. We were repaid our existing $44.6 million in outstanding debt. Total consideration to us from this sale at closing, including the repayment of debt, was $244.3 million, which included net cash proceeds of $196.8 million and the receipt of a new subordinated debt instrument of $47.5 million. During the second quarter of 2004, we sold a $5.0 million participation in our subordinated debt in Hillman to a third party, which reduced our investment, and no gain or loss resulted from the transaction. For the year ended December 31, 2004, we realized a gain of $150.3 million on the transaction, including gains of $1.3 million realized after closing resulting from post-closing adjustments, which provided additional cash consideration to us in the same amount. The sale of Hillman is subject to certain other post-closing adjustments.

The yield on the private finance loans and debt securities was 13.9% at December 31, 2004, as compared to 15.0% at December 31, 2003. The yield at December 31, 2004, was lower in part due to lower yielding senior debt investments in controlled portfolio companies. During 2004, we funded most or all of the debt and equity capital upon the closing of certain buyout transactions, which included investments in lower-yielding senior debt. In addition, we have provided lower-yielding senior debt to other controlled portfolio companies during the course of 2004. We currently expect that a portion of this senior debt outstanding at December 31, 2004, may be refinanced by the portfolio companies during 2005. While senior debt in the portfolio at December 31, 2004, may be refinanced, we may continue to fund lower-yielding senior debt in new or existing portfolio companies in the future, which may cause the weighted average yield on the private finance debt portfolio to fluctuate.

Business Loan Express, LLC. Our largest investment at December 31, 2004, was in Business Loan Express, LLC (BLX). Our investment in BLX totaled $280.4 million at cost and $335.2 million at value, or 10.3% of our total assets, which includes unrealized appreciation of $54.8 million. BLX was acquired in 2000.

BLX is a national, non-bank lender utilizing the SBA s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a nationwide preferred lender, as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans, originates loans under the USDA Business and Industry Guaranteed Loan Program (B&I) and during the quarter ended March 31, 2004, began originating small investment real estate loans. BLX has offices across the United States and is headquartered in New York, New York.

Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, could negatively affect our financial results. During 2004, the SBA 7(a) loan program was faced with funding challenges and operated under certain restrictions. In December 2004, the appropriations legislation for fiscal year 2005 was signed into law and the SBA 7(a) loan program received $16.0 billion in lending authority. The maximum loan guarantee was increased from $1.0 million to $1.5 million on a maximum loan amount of $2.0 million, but piggyback lending (where the SBA 7(a) loan is in a junior lien position) is not allowed under the current program.

Summary financial data for BLX at and for the three months ended December 31, 2004, and its fiscal year ended September 30, 2004, is presented below. Summary financial data has been provided by BLX and is unaudited.

($ in millions)	At and for the Three Months Ended December 31, 2004	At and for the Fiscal Year Ended September 30, 2004
Operating Data		
Total revenue	$ 28.0	$ 118.3
Net income	$ 3.2	$ 14.5
Earnings before interest, taxes and management fees (EBITM)	$ 10.3	$ 44.6
Balance Sheet Data		
Total assets	$ 433.9	$ 446.5
Total debt	$ 216.4	$ 229.2
Total owners equity	$ 155.3	$ 153.2
Other Data		
Loan originations		
SBA 7(a)	$ 75.7	$ 358.6
Conventional	55.7	287.0
B&I		11.4
Total loan originations	$ 131.4	$ 657.0
Serviced loan portfolio	$2,600.6	$2,572.9
Number of loans	3,694	3,573
Loan delinquencies[1]	8.4%	8.9%
Serviced Loan Portfolio by Industry		
Hotels	24%	24%
Gas stations/convenience stores	20	20
Professional and retail services	12	12
Restaurants	8	8
Manufacturing and industrial	8	8
Car wash/auto repair services	7	7
Child care and health care services	6	6
Recreation	5	5
Shrimp/fishing vessels	4	4
Other	6	6
Total	100%	100%

(1) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 8.6% at December 31, 2004. SBA 7(a) loans greater than one year old at December 31, 2004, had a delinquency rate of 10.2%. BLX will from time to time grant a deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice. The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative economic conditions. Small businesses are also more vulnerable to customer preferences, competition, rising fuel prices and market conditions and, as a result, delinquencies in BLX s portfolio may increase. For instance, the shrimp and fishing industry has been affected by rising fuel costs and competition from imported shrimp, which has resulted in an increase in loan delinquencies. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and generally receives personal guarantees from the principal owners of the small business.

BLX s business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. BLX s revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX s portfolio, and other income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. The total of cash loan sale premiums, cash interest income and cash received from residual interests and other cash income is equal to approximately 93% of BLX s revenue of $28.0 million for the three months ended December 31, 2004, and approximately 83% of BLX s revenue of $118.3 million for the fiscal year ended September 30, 2004.

During the calendar year ended December 31, 2004, the SBA 7(a) loan program underwent periods of operational change due to government funding limitations. For instance, the program implemented caps on loan size and discontinued the availability of an SBA 7(a) loan in a second mortgage position, or piggy-back loan. As a result, BLX had difficulty in building a consistent pipeline of new loan originations particularly in the March and December quarters. Loans originated during the three months ended December 31, 2004, totaled $131.4 million versus $188.3 million during the three months ended December 31, 2003. Proceeds from loan sales during the three months ended December 31, 2004, totaled approximately $141.2 million. Loans originated during the fiscal year ended September 30, 2004, totaled $657.0 million. Proceeds from loan sales during the fiscal year ended September 30, 2004, totaled approximately $618.8 million. From time to time, BLX funds the construction of commercial real estate projects and as a result is unable to sell a construction loan until the loan is fully funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore, until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.4% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the three months ended December 31, 2004, and the fiscal year ended September 30, 2004, were approximately $5.7 million and $27.1 million in total, respectively. Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 5.0%.

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

When BLX sells a guaranteed piece of an SBA 7(a) loan at par, or when BLX securitizes a loan, it records a residual interest and servicing asset, together referred to as the Residual Interest, in order to account for the retained interest in the loans sold and the net present value of the future cash flows it expects to receive from the loans sold or securitized. In computing the Residual Interest, BLX discounts estimated future cash flows after making assumptions as to future loan losses and loan prepayments, which may reduce future cash flows. For the three months ended December 31, 2004, and the fiscal year ended September 30, 2004, BLX received cash payments from the Residual Interest of approximately $17.1 million and $59.7 million, respectively.

At December 31, 2004, BLX s Residual Interest totaled $226.5 million, representing BLX s estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of $970.4 million over time, with approximately $79.7 million, $67.6 million, $66.1 million, and $64.4 million (or $277.8 million in the aggregate) scheduled to be received in the next four years ending on December 31, 2005, 2006, 2007, and 2008, respectively.

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

At December 31, 2004, our subordinated debt investment in BLX was $44.6 million at cost and value. Effective January 1, 2005, this debt was exchanged for Class B equity interests, which will be included in private finance equity interests. Since the subordinated debt will no longer be outstanding, the amount of taxable income available to flow through to BLX s equity holders will increase by the amount of interest that would have otherwise been paid on this debt. As a result of this exchange, private finance loans and debt securities would be lower by $44.6 million and the weighted average yield on the remaining loans and debt securities in the private finance portfolio, assuming no other changes, at December 31, 2004, would have been 13.6%.

Total interest and related portfolio income earned from the Company s investment in BLX for the years ended December 31, 2004, 2003, and 2002, was $50.0 million, $46.7 million, and $40.2 million, respectively, which includes interest income on the subordinated debt and Class A equity interests of $23.2 million, $21.9 million, and $20.7 million, respectively, dividend income on Class B interests of $14.8 million, $7.8 million, and $0, respectively, loan prepayment premiums of $0, $0.1 million, and $0, respectively, and fees and other income of $12.0 million, $16.9 million, and $19.5 million, respectively. Interest and dividend income from BLX for the years ended December 31, 2004, 2003, and 2002, included interest and dividend income of $25.4 million, $17.5 million, and $9.5 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to the Company through the issuance of additional debt or equity interests. Accrued interest and dividends receivable at December 31, 2004, included accrued interest due from BLX totaling $4.0 million, of which $3.3 million was paid in cash in early January 2005.

We have a commitment to BLX of $20.0 million in the form of a revolving credit facility to provide working capital to the company. This facility matures on June 30, 2005. At December 31, 2004, BLX had no outstanding borrowings under this facility.

At December 31, 2004, BLX had a three-year $275.0 million revolving credit facility that matures in January 2007. The facility provides for a sub-facility for the issuance of letters of credit for up to a total of $50.0 million. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At December 31, 2004, the principal amount outstanding on the revolving credit facility was $171.8 million and letters of credit issued under the facility were $17.0 million. The total obligation guaranteed by us at December 31, 2004, was $94.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the revolving credit facility at December 31, 2004. At December 31, 2004, we had also provided four standby letters of credit totaling $35.6 million in connection with four term securitization transactions completed by BLX.

Commercial Real Estate Finance

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

	At and for the Years Ended December 31,					
	2004		2003		2002	
($ in millions)	Value	Yield(1)	Value	Yield(1)	Value	Yield(1)
Portfolio at value:						
CMBS bonds	$373.8	14.6%	$394.0	14.1%	$555.5	14.2%
CDO bonds and preferred shares	212.6	16.8%	186.6	16.7%	52.8	17.2%
Commercial mortgage loans	95.0	6.8%	83.6	8.6%	63.7	7.5%
Residual interest					69.0	9.4%
Real estate owned	16.9		12.8		4.0	
Equity interests	13.0		4.9			
Total portfolio	$711.3		$681.9		$745.0	
Investments funded	$383.7		$433.5		$209.2	
Change in accrued or reinvested interest	$ 6.6		$ 3.2		$ 2.2	
Principal collections related to investment repayments or sales	$357.3		$469.7		$227.3	

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

Our commercial real estate investments funded for the years ended December 31, 2004, 2003, and 2002, were as follows:

($ in millions)	Face Amount	Discount	Amount Funded
For the Year Ended December 31, 2004			
CMBS bonds (13 new issuances[1])	$419.1	$(183.7)	$235.4
CDO bonds and preferred shares (3 issuances)	40.5	(0.1)	40.4
Commercial mortgage loans	112.1	(8.2)	103.9
Equity interests	4.0		4.0
Total	$575.7	$(192.0)	$383.7
For the Year Ended December 31, 2003			
CMBS bonds (15 new issuances[1])	$508.5	$(225.9)	$282.6
CDO bonds and preferred shares (3 issuances)	145.8	(0.4)	145.4
Commercial mortgage loans	3.0		3.0
Equity interests	2.5		2.5
Total	$659.8	$(226.3)	$433.5
For the Year Ended December 31, 2002			
CMBS bonds (5 new issuances)	$302.5	$(140.2)	$162.3
CDO preferred shares (3 issuances)	29.0		29.0
Commercial mortgage loans	11.7	(1.7)	10.0
Real estate owned	7.9		7.9
Total	$351.1	$(141.9)	$209.2

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

At December 31, 2004, we had outstanding funding commitments related to commercial mortgage loans and equity interests of $17.1 million and commitments in the form of standby letters of credit and guarantees related to equity interests of $2.7 million.

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

	For the Years Ended December 31,					
	2004		2003		2002	
Loan to Value Ranges ($ in millions)	Amount	Percentage	Amount	Percentage	Amount	Percentage
Less than 60%	$ 3,581.6	22%	$ 4,114.3	22%	$ 909.3	20%
60-65%	1,436.1	9	1,582.8	9	287.3	6
65-70%	1,288.6	8	1,768.0	10	587.9	13
70-75%	3,561.2	22	4,024.3	22	1,214.5	27
75-80%	5,655.5	35	6,560.5	36	1,477.5	33
Greater than 80%	550.0	4	138.6	1	47.8	1
Total	$16,073.0	100%	$18,188.5	100%	$4,524.3	100%

Weighted average loan to value	68.6%	68.5%	68.5%

Debt Service Coverage Ratio Ranges ($ in millions)	For the Years Ended December 31, 2004 Amount	2004 Percentage	2003 Amount	2003 Percentage	2002 Amount	2002 Percentage
Greater than 2.00	$ 2,317.1	14%	$ 4,208.7	23%	$ 366.9	8%
1.76 2.00	1,508.3	9	2,094.6	12	229.6	5
1.51 1.75	2,071.3	13	3,132.8	17	477.4	11
1.26 1.50	7,316.1	46	7,362.9	40	2,739.6	60
Less than 1.25	2,860.2	18	1,389.5	8	710.8	16
Total	$16,073.0	100%	$18,188.5	100%	$4,524.3	100%
Weighted average debt service coverage ratio	1.59		1.73		1.41	

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

($ in millions)	For the Years Ended December 31, 2004	2003	2002
Cost basis	$273.0	$412.3	$205.9
Gross sales proceeds[(1)]	$295.5	$446.8	$225.6
Net realized gains (net of related hedge gains or losses)	$ 17.4	$ 31.6	$ 19.1
Weighted average yield	8.5%	10.1%	11.5%

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

During 2004, we completed a securitization of $53.7 million of commercial mortgage loans. In connection with this securitization, we received proceeds, net of costs, of $54.0 million, including $28.3 million of cash and $25.7 million of A and AA rated bonds and LLC interests, which have been included in the CMBS portfolio at December 31, 2004. The realized gain from this securitization was $0.3 million.

The CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages is generally allocated first to the senior tranches in order of priority, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages or properties securing those mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At December 31, 2004, the face value of the CMBS bonds rated BBB- and below which we held were subordinate to 84% to 99% of the face value of the bonds issued in these various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of interest and principal, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the years ended December 31, 2004, 2003, and 2002, the average discount for the CMBS bonds in which we invested was 44%, 44%, and 46%, respectively.

At December 31, 2004, the unamortized discount related to the CMBS bond portfolio was $660.4 million, of which $346.5 million has been set aside to absorb potential future losses. The yield on the CMBS bonds of 14.6% assumes that this amount that has been set aside will not be amortized. As the amount of future losses and the expected timing of recognition of such losses is difficult to predict and is subject to future events which may alter these assumptions, no assurance can be given that the anticipated yield will be achieved. At December 31, 2004, the CMBS bond portfolio had a fair value of $373.8 million, which included net unrealized depreciation on the CMBS bonds of $9.5 million.

The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB- and above rated CMBS bonds held in the portfolio. Our CMBS bond portfolio and the related yields at December 31, 2004 and 2003, were as follows:

	December 31,			
	2004		2003	
($ in millions)	Value	Yield	Value	Yield
CMBS bonds rated BB- and above	$ 39.5	6.9%	$ 88.4	8.2%
CMBS bonds rated below BB-	334.3	15.5%	305.6	15.8%
Total	$373.8	14.6%	$394.0	14.1%

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

	December 31,			
	2004		2003	
($ in millions)	Value	Percentage	Value	Percentage
Less than one year old	$ 82.9	24.8%	$ 83.9	27.5%
One to two years old	55.4	16.6	41.0	13.4
Two to three years old	29.9	8.9	43.8	14.3
Three years old or older	166.1	49.7	136.9	44.8
Total	$334.3	100.0%	$305.6	100.0%

At December 31, 2004 and 2003, we held CMBS bonds in 45 and 38 separate CMBS issuances, respectively. The underlying collateral pool, consisting of commercial mortgage loans and real estate owned (REO) properties, for these CMBS bonds consisted of the following at December 31, 2004 and 2003:

	December 31,	
($ in millions)	2004	2003
Approximate number of loans and REO properties[1]	6,200	5,600
Total outstanding principal balance	$42,759	$38,437
Loans over 30 days delinquent or classified as REO properties[2]	1.6% [3]	1.5% [3]

(1) Includes approximately 39 and 22 REO properties obtained through the foreclosure of commercial mortgage loans at December 31, 2004 and 2003, respectively.

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

(3) At December 31, 2004 and 2003, our investments included bonds in the first loss, unrated bond class in 43 and 34 separate CMBS issuances, respectively. For these issuances, loans over 30 days delinquent or classified as REO properties were 1.7% of the total outstanding principal balance at both December 31, 2004 and 2003.

Collateralized Debt Obligation Bonds and Preferred Shares. During the year ended December 31, 2004, we sold CDO bonds with a cost basis of $19.2 million for a net realized gain of $0.2 million, net of the related hedge net gain. During the year ended December 31, 2003, we sold CDO bonds and preferred shares with a cost basis of $13.9 million, respectively, for net realized losses of $0.1 million net of the related hedge gains. The yield on the CDO bonds and preferred shares sold was 7.7% and 8.0% for the years ended December 31, 2004 and 2003, respectively.

The bonds and preferred shares of the CDOs in which we have invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral that result in reduced cash flows, the preferred shares will bear this loss first and then the bonds would bear any loss after the preferred shares. At December 31, 2004, our bonds and preferred shares in the CDOs were subordinate to 70% to 98% of the more senior tranches of debt issued in the various CDO transactions. In addition, included in the CMBS collateral for the CDOs at December 31, 2004, were certain CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held directly by us.

The yield on our CDO bonds and preferred shares at December 31, 2004, 2003, and 2002, was 16.8%, 16.7%, and 17.2%, respectively. The yield on the CDO portfolio at any point in time will generally vary depending on the amount of lower yielding CDO bonds held in the portfolio.

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

	December 31,	
($ in millions)	**2004**	**2003**
Investment grade REIT debt(1)	$1,532.5	$1,338.0
Investment grade CMBS bonds(2)	918.8	662.3
Non-investment grade CMBS bonds(3)	1,636.4	1,133.7
Other collateral	355.8	32.4
Total collateral	$4,443.5	$3,166.4

(1) Issued by 44 REITs for both periods presented.

(2) Issued in 121 and 78 transactions, respectively, for the periods presented.

(3) Issued in 109 and 68 transactions, respectively, for the periods presented.

Since we are limited as to the amount of debt capital we can use to finance our commercial real estate investments, we are evaluating various strategic alternatives for our commercial real estate platform. These alternatives may include the sale, spin-out or recapitalization of all or part of our commercial real estate investments.

Hedging Activities

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were $38.2 million and $98.5 million at December 31, 2004 and 2003, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the cash collateral provided or received under the terms of the transactions were $38.2 million and $98.5 million at December 31, 2004 and 2003, respectively. The amount of the hedge will vary from period to period depending upon the amount of higher rated CMBS and CDO bonds that we own and have hedged on the balance sheet date.

Portfolio Asset Quality

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

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

	December 31,			
	2004		2003	
Grade	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
($ in millions)				
1	$ 952.5	31.6%	$ 985.1	38.1%
2	1,850.5	61.4	1,271.4	49.2
3	121.2	4.0	212.4	8.2
4	11.7	0.4	34.7	1.4
5	77.5	2.6	81.0	3.1
	$3,013.4	100.0%	$2,584.6	100.0%

Grade 2 investments at December 31, 2004, increased over Grade 2 investments at December 31, 2003, primarily due to new investments made during 2004. Investments in new portfolio companies generally enter the portfolio as Grade 2 investments. We continue to include our CMBS portfolio in Grade 2 assets, as we are uncertain as to whether the unrealized appreciation or depreciation on our CMBS portfolio at December 31, 2004, will necessarily result in a realized gain or loss.

Total Grade 3, 4, and 5 portfolio assets as a percentage of the total portfolio at value at December 31, 2004 and 2003, were 7.0% and 12.7%, respectively. Included in Grade 3, 4, and 5 assets at December 31, 2004 and 2003, were assets totaling $38.3 million and $31.1 million, respectively, that are secured by commercial real estate.

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

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

	December 31,	
($ in millions)	**2004**	**2003**
Loans and debt securities in workout status (classified as Grade 4 or 5)[1]		
Private finance		
Companies more than 25% owned	$ 34.4	$ 31.9
Companies 5% to 25% owned		2.7
Companies less than 5% owned	16.5	28.0
Commercial real estate finance	5.6	6.8
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	29.4	31.9
Companies 5% to 25% owned	0.7	
Companies less than 5% owned	15.8	16.5
Commercial real estate finance	12.5	0.2
Total	$114.9	$118.0
Percentage of total portfolio	3.8%	4.6%

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

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

	December 31,	
($ in millions)	**2004**	**2003**
Private finance	$ 73.5	$ 85.6
Commercial real estate finance		
CMBS bonds	49.0	40.3
Commercial mortgage loans	10.1	3.7
Total	$132.6	$129.6

Percentage of total portfolio	4.4%	5.0%

Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled $43.9 million and $46.1 million at December 31, 2004 and 2003, respectively, which included loans and debt securities that are secured by commercial real estate of $10.2 million and $3.9 million, respectively.

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

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

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

Accrued Interest and Dividends Receivable

Accrued interest and dividends receivable as of December 31, 2004 and 2003, was as follows:

	December 31,	
($ in millions)	**2004**	**2003**
Private finance	$59.8	$40.1
Commercial real estate finance		
CMBS and CDO bonds	18.9	12.1
Commercial mortgage loans and other	0.8	0.9
Total	$79.5	$53.1

RESULTS OF OPERATIONS

Comparison of the Years Ended December 31, 2004, 2003, and 2002

The following table summarizes our operating results for the years ended December 31, 2004, 2003, and 2002.

(in thousands, except per share amounts)	2004	2003	Change	Percent Change	2003	2002	Change	Percent Change
Interest and Related Portfolio Income								
Interest and dividends	$319,642	$290,719	$28,923	10%	$290,719	$264,042	$ 26,677	10%
Loan prepayment premiums	5,502	8,172	(2,670)	(33)%	8,172	2,776	5,396	194%
Fees and other income	41,946	30,338	11,608	38%	30,338	43,110	(12,772)	(30)%
Total interest and related portfolio income	367,090	329,229	37,861	11%	329,229	309,928	19,301	6%
Expenses								
Interest	75,650	77,233	(1,583)	(2)%	77,233	70,443	6,790	10%
Employee(1)	40,728	36,945	3,783	10%	36,945	33,126	3,819	12%
Individual performance award	13,011		13,011	**				
Administrative(1)	35,686	22,387	13,299	59%	22,387	21,504	883	4%
Total operating expenses	165,075	136,565	28,510	21%	136,565	125,073	11,492	9%
Net investment income before income taxes	202,015	192,664	9,351	5%	192,664	184,855	7,809	4%
Income tax expense (benefit)	1,057	(2,466)	3,523	**	(2,466)	930	(3,396)	**
Net investment income	200,958	195,130	5,828	3%	195,130	183,925	11,205	6%
Net Realized and Unrealized Gains (Losses)								
Net realized gains	117,240	75,347	41,893	56%	75,347	44,937	30,410	68%
Net change in unrealized appreciation or depreciation	(68,712)	(78,466)	9,754	*	(78,466)	(571)	(77,895)	*
Total net gains (losses)	48,528	(3,119)	51,647	*	(3,119)	44,366	(47,485)	*
Net income	$249,486	$192,011	$57,475	30%	$192,011	$228,291	$(36,280)	(16)%
Diluted earnings per common share	$ 1.88	$ 1.62	$ 0.26	16%	$ 1.62	$ 2.20	$ (0.58)	(26)%
Weighted average common shares outstanding diluted	132,458	118,351	14,107	12%	118,351	103,574	14,777	14%

(1) Employee and administrative expenses for the year ended December 31, 2002, include costs associated with the closing of our German office of $0.5 million and $2.5 million, respectively, for a total of $3.0 million, or $0.03 per common share.

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

** Percentage change is not meaningful.

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

37

Interest and dividend income for the years ended December 31, 2004, 2003, and 2002, was composed of the following:

($ in millions)	2004	2003	2002
Interest	$301.0	$275.3	$259.4
Dividends	18.6	15.4	4.6
Total	$319.6	$290.7	$264.0

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. The interest-bearing investments in the portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at December 31, 2004, 2003, and 2002, were as follows:

($ in millions)	2004	2003	2002
Interest-bearing portfolio	$2,301.2	$1,891.9	$1,896.2
Portfolio yield[(1)]	14.0%	14.7%	14.0%

(1) See discussion on portfolio yields above under Portfolio and Investment Activity.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the level of yield on our preferred equity interests and the timing and amount of dividends that are declared by a portfolio company on preferred or common equity interests. Dividend income increased in 2004 and 2003 primarily due to the receipt of dividends from BLX on the Class B equity interests held by us. The total dividend declared by BLX was $14.8 million and $7.8 million for the years ended December 31, 2004 and 2003, respectively, and these dividends were paid through the issuance of additional Class B equity interests.

Loan prepayment premiums were $5.5 million, $8.2 million, and $2.8 million for the years ended December 31, 2004, 2003, and 2002, 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. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment. Prepayment premiums were higher in 2004 and 2003 as compared to 2002 as a result of an increase in loan prepayments during the prepayment penalty period. Prepayment premiums in 2004 were lower than in 2003 because the loans that prepaid in 2004 generally had lower prepayment penalty requirements than those that prepaid in 2003.

Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management services to portfolio companies, guarantees, 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, corporate finance, information technology, marketing, human resources, personnel and board member recruiting, corporate governance, and risk management.

Fees and other income for the years ended December 31, 2004, 2003, and 2002, included fees relating to the following:

($ in millions)	2004	2003	2002
Structuring and diligence	$18.4	$ 6.1	$15.0
Transaction and other services provided to portfolio companies	3.2	4.5	4.4
Management services provided to portfolio companies, other advisory services and guaranty fees	17.4	18.7	23.2
Other income	2.9	1.0	0.5
Total	$41.9	$30.3	$43.1

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from year to year depending on the level and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan. Fees and other income for the year ended December 31, 2004, include structuring fees related to the purchase of majority ownership in Advantage, Financial Pacific, Mercury, and Insight totaling $10.0 million.

BLX and Advantage were our largest investments at December 31, 2004, and together represented 19.0% of our total assets. Total interest and related portfolio income earned from BLX and Advantage for the year ended December 31, 2004, was $50.0 million and $21.3 million, respectively. Total interest and related portfolio income for the year ended December 31, 2004, included $2.5 million of income earned from Hillman prior to the sale of our control investment on March 31, 2004, as discussed above.

BLX and Hillman were our largest portfolio investments at December 31, 2003 and 2002, and together represented 19.1% and 15.6% of our total assets at December 31, 2003 and 2002, respectively. Total interest and related portfolio income earned from BLX for the years ended December 31, 2003 and 2002, was $46.7 million and $40.2 million, respectively. Total interest and related portfolio income earned from Hillman for the years ended December 31, 2003 and 2002, was $9.7 million and $9.3 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 years ended December 31, 2004, 2003, and 2002, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and closing costs, at and for the years ended December 31, 2004, 2003, and 2002, were as follows:

($ in millions)	2004	2003	2002
Total outstanding debt	$1,176.6	$954.2	$998.5
Average outstanding debt	$ 985.6	$943.5	$938.1
Weighted average interest cost[1]	6.6%	7.5%	6.9%

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

In addition to interest on indebtedness, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of $5.2 million, $5.9 million, and $1.7 million for the years ended December 31, 2004, 2003, and 2002, respectively.

Employee expenses include salaries and employee benefits. The change in employee expense reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 162, 125, and 105 at December 31, 2004, 2003, and 2002, respectively. During 2003 and 2002, employee expenses included a retention award program whereby senior officers received cash awards as part of their compensation. The retention award component for the years ended December 31, 2003 and 2002, was $8.6 million and $7.9 million, respectively. Beginning January 1, 2004, we no longer provided retention awards.

In the first quarter of 2004, we established the Individual Performance Award (IPA) as a long-term incentive compensation program for certain officers. In conjunction with the program, the Board has approved a non-qualified deferred compensation plan (DCP II), which is administered through a trust by an independent third-party trustee.

The IPA, which will generally be determined annually at the beginning of each year, is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the DCP II to require the trustee to use the cash to purchase shares of our common stock in the open market.

Amounts credited to participants under the DCP II are immediately vested once deposited by us into the trust. A participant s account shall generally become distributable only after his or her termination of employment, or in the event of a change of control of the Company. The Compensation Committee of the Board of Directors may also determine other distributable events and the timing of such distributions.

For the year ended December 31, 2004, we accrued $13.4 million in IPA expense, or $0.10 per share. We contributed these amounts into the DCP II trust during the year. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust. The accounts of the DCP II are consolidated with our accounts. Further, we are required to mark to market the liability to pay the employees in our stock and this adjustment is recorded to the IPA compensation expense. The effect of this adjustment for the year ended December 31, 2004, was to reduce the individual performance award expense by $0.4 million. The Compensation Committee and the Board of Directors have determined the IPA for 2005 and it is currently expected to be approximately $7.5 million.

As a result of recent changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting top performers in private equity firms, the Compensation Committee and the Board of Directors have determined for 2005 that a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB for 2005 has been determined to be approximately $7.5 million, and will be distributed in cash to award recipients in equal bi-weekly installments as long as the recipient remains employed by us. If a recipient terminates employment during the year, any remaining cash payments under the IPB would be forfeited.

The total of the IPA and IPB for 2005 is currently estimated to be $15.0 million. These amounts are subject to change if there is a change in the composition of the pool of award recipients during the year.

Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, stock record expenses, directors fees, and various other expenses. Administrative expenses have increased to $35.7 million for the year ended December 31, 2004. This is a $13.3 million increase over administrative expenses of $22.4 million for the year ended December 31, 2003.

The largest component of the increase in expenses resulted from a net increase in legal, accounting, consulting, and other fees for 2004 as compared to 2003 of $4.9 million. This increase is primarily attributable to fees associated with the implementation of the requirements under the Sarbanes-Oxley Act of 2002 (including Section 404), the response to requests for information from regulatory and other government agencies, valuation assistance and other corporate matters.

Legal fees totaled $4.6 million for 2004 as compared to $1.4 million for 2003. We expect that legal expenses will continue to increase substantially in the near term as the result of ongoing requests for documents and information from regulatory and other government agencies related to ongoing investigations. As a result, we expect that total administrative expenses will also increase in 2005 as compared to 2004.

We have also incurred increased deal costs in 2004 related to evaluating potential new investments. Costs related to mezzanine lending are generally paid by the borrower, however, costs related to buyout investments are generally funded by us. Accordingly, if a prospective deal does not close, we incur expenses that are not recoverable. As a result, these related costs were $1.6 million higher for 2004 than for the prior year. We have increased our focus on managing buyout-related costs, however, we expect that there will be some increased costs from this activity going forward. In addition, expenses related to portfolio development and workout activities were $1.5 million higher for 2004 versus the prior year. We expect the costs related to workouts to decline given the decline in workout assets in the portfolio.

The remaining increase in administrative expenses for 2004 over 2003 was primarily due to increased rent of $1.4 million associated with the opening of an office in Los Angeles, CA and expanding our office space in Chicago, IL and New York, NY, increased other corporate expenses, including stock record expense, insurance premiums and directors fees, of $1.1 million, the incurrence of $1.0 million in excise tax related to excess taxable income carried forward into 2005, and increased travel expenses of $0.8 million.

Administrative expenses were $22.4 million for 2003, a $0.9 million increase over administrative expenses of $21.5 million for 2002. Excluding costs associated with closing the Germany office in 2002 totaling $2.5 million, administrative expenses for 2003 increased by $3.4 million over 2002. The net increase in legal, accounting, consulting and other fees for 2003 as compared to 2002 was $0.8 million. Fees related to market activity in our stock were substantially lower in 2003 as compared to 2002, however, the level of professional fees incurred in 2003 still increased over 2002 as we incurred significant legal, accounting, consulting and other fees in 2003 related to the implementation of the requirements under the Sarbanes-Oxley Act of 2002. The remaining increase in administrative expenses for 2003 over 2002 was primarily due to increased costs associated with corporate liability insurance of $1.4 million, travel costs of $0.6 million, and directors fees of $0.5 million.

Income Tax Expense (Benefit). Our wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records an expense or benefit for income taxes as appropriate. For the years ended December 31, 2004 and 2002, we recorded tax expense of $1.1 million and $0.9 million, respectively, primarily as a result of AC Corp s operating income for the periods. For the year ended December 31, 2003, we recorded a tax benefit of $2.5 million as a result of AC Corp s operating loss for the period.

Realized Gains and Losses. Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the years ended December 31, 2004, 2003, and 2002, were as follows:

($ in millions)	2004	2003	2002
Realized gains	$ 267.7	$ 94.3	$ 95.5
Realized losses	(150.5)	(19.0)	(50.6)
Net realized gains	$ 117.2	$ 75.3	$ 44.9

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the years ended December 31, 2004, 2003, and 2002, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

($ in millions)	2004	2003	2002
Reversal of previously recorded unrealized appreciation associated with realized gains	$(210.5)	$(78.5)	$(78.8)
Reversal of previously recorded unrealized depreciation associated with realized losses	151.8	20.3	49.0
Total reversal	$ (58.7)	$(58.2)	$(29.8)

Realized gains and losses for the years ended December 31, 2004, 2003, and 2002, resulted from various private finance and commercial real estate finance transactions.

Realized gains for the year ended December 31, 2004, primarily resulted from transactions involving 13 private finance portfolio companies The Hillman Companies, Inc. ($150.3 million), CorrFlex Graphics, LLC ($25.7 million), Professional Paint, Inc. ($13.7 million), Impact Innovations Group, LLC ($9.4 million), The Hartz Mountain Corporation ($8.3 million), Housecall Medical Resources, Inc. ($7.2 million), International Fiber Corporation ($5.2 million), CBA-Mezzanine Capital Finance, LLC ($4.1 million), United Pet Group, Inc. ($3.8 million), Oahu Waste Services, Inc. ($2.8 million), Grant Broadcasting Systems II ($2.7 million), Matrics, Inc. ($2.1 million), and SmartMail, LLC ($2.1 million), and one transaction involving a commercial mortgage loan ($1.8 million). In addition, gains were also realized on CMBS bonds ($17.4 million, net of a net realized loss of $3.8 million from hedges related to the CMBS bonds sold).

Realized gains for the year ended December 31, 2003, primarily resulted from transactions involving 11 private finance portfolio companies, including Blue Rhino Corporation ($12.6 million), CyberRep ($9.6 million), Morton Grove Pharmaceuticals, Inc. ($8.5 million), Warn Industries, Inc. ($8.0 million), Woodstream Corporation ($6.6 million), Kirkland s Inc. ($3.0 million), Julius Koch USA, Inc. ($2.8 million), GC-Sun Holdings II, LP ($2.5 million), Interline Brands, Inc. ($1.7 million), WyoTech Acquisition Corporation ($1.3 million), and Advantage Mayer, Inc. ($1.2 million). In addition, gains were also realized on CMBS bonds ($31.6 million, net of a net realized loss of $2.9 million from hedges related to the CMBS bonds sold) and commercial real estate investments ($1.7 million).

Realized gains for the year ended December 31, 2002, primarily resulted from transactions involving eight private finance portfolio companies, including WyoTech Acquisition Corporation ($60.8 million), Aurora Communications, LLC ($4.9 million), Oriental Trading Company, Inc. ($2.5 million), Kirkland s, Inc. ($2.2 million), American Home Care Supply, LLC ($1.3 million), Autania AG ($0.8 million), FTI Consulting, Inc. ($0.7 million), and Cumulus Media, Inc. ($0.5 million). In addition, gains were also realized on 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). The sale of WyoTech in 2002 was subject to post-closing adjustments, and during 2003, we recognized an additional realized gain of $1.3 million related to post-closing items.

Realized losses for the year ended December 31, 2004, primarily resulted from transactions involving 13 private finance portfolio companies American Healthcare Services, Inc. ($32.9 million), The Color Factory, Inc. ($24.5 million), Executive Greetings, Inc. ($19.3 million), Sydran Food Services II, L.P. ($18.2 million), Ace Products, Inc. ($17.6 million), Prosperco Finanz Holding AG ($7.5 million), Logic Bay Corporation ($5.0 million), Sun States Refrigerated Services, Inc. ($4.7 million), Chickasaw Sales & Marketing, Inc. ($3.8 million), Sure-Tel, Inc. ($2.3 million), Liberty-Pittsburgh Systems, Inc. ($2.0 million), EDM Consulting, LLC ($1.9 million), and Startec Global Communications Corporation ($1.1 million), and two transactions involving commercial mortgage loans ($2.1 million).

Realized losses for the year ended December 31, 2003, primarily resulted from transactions involving three private finance portfolio companies, including Allied Office Products, Inc. ($7.7 million), Candlewood Hotel Company ($2.7 million), and North American Archery, LLC ($2.1 million), and eight transactions involving commercial mortgage loans ($5.9 million).

Realized losses for the year ended December 31, 2002, primarily resulted from transactions involving 11 private finance portfolio companies, including Velocita, Inc. ($16.0 million), Schwinn Holdings Corporation ($7.9 million), Convenience Corporation of America ($5.8 million), Startec Global Communications Corporation ($4.5 million), The Loewen Group, Inc. ($2.7 million), Monitoring Solutions, Inc. ($1.7 million), Most Confiserie ($1.0 million), NetCare AG ($1.0 million), iSolve Incorporated ($0.9 million), Sure-Tel, Inc. ($0.5 million), and Soff-Cut Holdings, Inc. ($0.5 million), and also from nine commercial real estate investments ($4.7 million).

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to a valuation policy and a consistently applied valuation process. At December 31, 2004, portfolio investments recorded at fair value were approximately 92% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS bonds, and CDO bonds and preferred shares. The structure of each private finance 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 on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

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

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

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

In connection with our valuation process to determine the fair value of a private finance investment, we work with independent third-party consultants to obtain assistance and advice as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter (for all investments with a cost or value greater than $250,000). In addition, we may receive independent assessments of a particular private finance portfolio company s value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these independent valuation resources is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

We received quarterly valuation assistance from S&P Corporate Value Consulting (S&P CVC) during 2004, including assistance with the valuation of Business Loan Express (BLX) in the third and fourth quarters of 2004. For the full year, S&P CVC has assisted us with the valuation of 104 portfolio companies. S&P CVC has assisted us in valuing all of the portfolio company investments that were in our portfolio at December 31, 2003, and were still in the portfolio at December 31, 2004. In addition, S&P CVC has assisted us in valuing 11 portfolio company investments that were added to the portfolio during 2004, including Advantage Sales & Marketing, Inc.

Valuation Methodology CMBS Bonds and CDO Bonds and Preferred Shares. CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to discount rate may be based on the yield of comparable securities, when available. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each CMBS bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We have determined the fair value of our CMBS bonds and CDO bonds and preferred shares on an individual security-by-security basis. If we were to sell a group of these investments in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual bonds or preferred shares.

Net Change in Unrealized Appreciation or Depreciation. For the portfolio, net change in unrealized appreciation or depreciation for the years ended December 31, 2004, 2003, and 2002, consisted of the following:

($ in millions)	2004	2003	2002
Net unrealized appreciation or depreciation	$ (10.0)	$ (20.3)	$ 29.2
Reversal of previously recorded unrealized appreciation associated with realized gains	(210.5)	(78.5)	(78.8)
Reversal of previously recorded unrealized depreciation associated with realized losses	151.8	20.3	49.0
Net change in unrealized appreciation or depreciation	$ (68.7)	$ (78.5)	$ (0.6)

For the year ended December 31, 2004, our two most significant changes in net unrealized appreciation were in BLX and Advantage. The following is a summary of the methodology that we used to determine the fair value of these investments.

Business Loan Express, LLC. To determine the value of our investment in BLX at December 31, 2004, we performed four separate valuation analyses to determine a range of values: (1) analysis of comparable public company trading multiples, (2) analysis of BLX s value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. We performed the analyses with the assistance of JMP Securities. In addition, we received valuation assistance from S&P CVC for our investment in BLX at December 31, 2004.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX s value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX s pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at December 31, 2004, was made up of CapitalSource, Inc., CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at December 31, 2003.

Our investment in BLX at December 31, 2004, was valued at $335.2 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was $54.8 million at December 31, 2004. This is a decrease in unrealized appreciation of $32.3 million from December 31, 2003.

Advantage Sales & Marketing, Inc. S&P CVC assisted us with the valuation of our investment in Advantage at December 31, 2004. We determined the enterprise value of Advantage by using their trailing twelve month normalized EBITDA times a multiple. The multiple we used was consistent with our entry multiple when we acquired Advantage in June 2004. Using this enterprise value, we determined the value of our investments in Advantage to be $283.0 million, resulting in unrealized appreciation of $24.3 million.

OTHER MATTERS

Per Share Amounts. All per share amounts included in the Management s Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 132.5 million, 118.4 million, and 103.6 million for the years ended December 31, 2004, 2003, and 2002, respectively.

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

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

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

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 asset diversification requirements as defined in the Code; and (4) timely distribute to shareholders at least 90% of our annual investment company taxable income as defined in the Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

Legal Proceedings. On June 23, 2004, we were notified by the SEC that they are conducting an informal investigation of us. On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to us at this time, the inquiries appear to pertain to matters related to portfolio valuation and our portfolio company, Business Loan Express, LLC. We are cooperating with the SEC s and the U.S. Attorney s investigations.

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

While the outcome of these legal proceedings and other matters cannot at this time be predicted with certainty, we do not expect that these matters will have a material effect upon our financial condition or results of operations.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash Flow From Operating Activities

Our portfolio has historically generated significant cash flow from which we pay dividends to shareholders and fund new investment activity. Cash generated from the portfolio includes cash flow from net investment income and net realized gains and principal collections related to investment repayments or sales. Cash flow provided by our operating activities before new investment activity for the years ended December 31, 2004, 2003, and 2002, was as follows:

	For the Years Ended December 31,		
($ in millions)	**2004**	**2003**	**2002**
Net cash provided by (used in) operating activities	$ (179.3)	$ 80.3	$ 65.3
Add: portfolio investments funded	1,472.4	930.6	506.4
Total cash provided by operating activities before new investments	$1,293.1	$1,010.9	$571.7

Because of the significant amount of cash provided by operating activities before new investments, we generate sufficient cash flow to fund our operating activities as well as pay dividends to shareholders.

Dividends to common shareholders for the years ended December 31, 2004, 2003, and 2002, were $299.3 million, $267.8 million, and $229.9 million, respectively. Total regular quarterly dividends were $2.28, $2.28, and $2.20 per common share for the years ended December 31, 2004, 2003, and 2002, respectively. An extra cash dividend of $0.02 and $0.03 per common share was declared during 2004 and 2002, respectively, and was paid to shareholders on January 28, 2005, and January 9, 2003, respectively.

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

Our Board of Directors evaluates whether to retain or distribute taxable net capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but would also allow us to retain gains to support future growth. Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year.

At December 31, 2004, we had outstanding commitments to fund investments totaling $330.2 million. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

Debt and Equity Capital

Because we are a regulated investment company, we distribute our taxable income and, therefore, require external capital for asset growth. As a result, from time to time we will raise growth capital in the form of new debt or equity capital.

At December 31, 2004, 2003, and 2002, our total assets, total debt outstanding, total shareholders equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

	December 31,		
($ in millions)	**2004**	**2003**	**2002**
Total assets	$3,261.0	$3,019.9	$2,794.3
Total debt outstanding	$1,176.6	$ 954.2	$ 998.5
Total shareholders equity	$1,979.8	$1,914.6	$1,546.1
Debt to equity ratio	0.59	0.50	0.65
Asset coverage ratio(1)	280%	322%	270%

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

We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.65:1.00. During 2003, we intentionally deleveraged the balance sheet to move the leverage ratio to the lower end of the target debt to equity ratio range and have remained within the range during 2004. We recently have been through a period of economic uncertainty, and we believed that it was prudent to operate with a larger equity capital base and less leverage. For the years ended December 31, 2004, 2003, and 2002, we raised equity of $73.5 million, $422.9 million, and $172.8 million, respectively, including $86.5 million raised through a non-transferable rights offering during 2002. In addition, shareholders equity increased by $51.3 million, $21.2 million, and $22.1 million through the exercise of employee options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the years ended December 31, 2004, 2003, and 2002, respectively.

We employ an asset-liability management strategy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $396.4 million on December 31, 2004. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate investment portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

At December 31, 2004 and 2003, we had outstanding debt as follows:

($ in millions)	December 31, 2004				December 31, 2003			
	Facility Amount	Amount Outstanding	Annual Interest Cost(1)	Annual Return to Cover Interest Payments(2)	Facility Amount	Amount Outstanding	Annual Interest Cost(1)	Annual Return to Cover Interest Payments(2)
Notes payable and debentures:								
Unsecured notes payable	$ 981.4	$ 981.4	6.5%	2.0%	$ 854.0	$ 854.0	7.2%	2.0%
SBA debentures	84.8	77.5	8.2%	0.2%	101.8	94.5	8.1%	0.3%
OPIC loan	5.7	5.7	6.6%	0.0%	5.7	5.7	6.6%	0.0%
Total notes payable and debentures	1,071.9	1,064.6	6.6%	2.2%	961.5	954.2	7.3%	2.3%
Revolving line of credit	552.5	112.0	6.3% (3)	0.2%	532.5		(3)	0.1%
Total debt	$ 1,624.4	$ 1,176.6	6.6% (3)	2.4%	$ 1,494.0	$ 954.2	7.5% (3)	2.4%

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

(2) The annual portfolio return to cover interest payments is calculated as the December 31, 2004 and 2003, annualized cost of debt per class of financing outstanding divided by total assets at December 31, 2004 and 2003.

(3) The current interest rate payable on the revolving line of credit was 4.7% at December 31, 2004, which excluded the annual cost of commitment fees and other facility fees of $1.8 million. There were no amounts drawn on the revolving line of credit at December 31, 2003. The annual cost of commitment fees and other facility fees on the revolving line of credit was $2.7 million at December 31, 2003. The annual interest cost for total debt includes the annual cost of commitment fees and other facility fees on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

Unsecured Notes Payable. We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2005 and generally have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity.

On March 25, 2004, we issued five-year unsecured long-term notes denominated in Euros and Sterling for a total U.S. dollar equivalent of $15.2 million. The notes have fixed interest rates and have substantially the same terms as our existing unsecured notes. Simultaneous with issuing the notes, we entered into a cross-currency swap with a financial institution which fixed our interest and principal payments in U.S. dollars for the life of the debt.

On April 30, 2004, we repaid $112.0 million of unsecured notes payable that matured on May 1, 2004.

On November 15, 2004, we issued $252.5 million of five-year and $72.5 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 5.53% and 5.99%, respectively, and have substantially the same terms as our existing unsecured long-term notes. We used a portion of the proceeds from the new long-term note issuance to repay $102.0 million of our existing unsecured long-term notes that matured on November 15, 2004, with an interest cost of 8.5%.

Small Business Administration Debentures. We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. During 2004, we repaid $17.0 million of this outstanding debt. Under the small business investment company program, we may borrow up to $119.0 million from the Small Business Administration. At December 31,

2004, we had a commitment from the Small Business Administration to borrow up to an additional $7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

Revolving Line of Credit. We have an unsecured revolving line of credit with a committed amount of $587.5 million. The commitments under the line of credit were expanded by $35.0 million on March 29, 2005. The line of credit may be expanded through new or additional commitments up to $600.0 million at our option. The credit facility generally bears interest at a rate, at our option, equal to (i) the one-month LIBOR plus 1.50%, (ii) the Bank of America, N.A. cost of funds plus 1.50% or (iii) the higher of the Bank of America, N.A. prime rate or the Federal Funds rate plus 0.50%. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity. The revolving line of credit expires in April 2005, with the right to extend the maturity for one additional year at our option under substantially similar terms. We plan to exercise our option to extend the maturity to April 2006, which will require the payment of an extension fee of 0.3% on existing commitments. The interest rate on outstanding borrowings will increase by 0.5% during the extension period.

Outstanding borrowings on the unsecured revolving line of credit at December 31, 2004, were $112.0 million. The amount available under the line at December 31, 2004, was $396.4 million, net of amounts committed for standby letters of credit of $44.1 million. Net borrowings under the revolving line of credit for the year ended December 31, 2004, were $112.0 million.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of December 31, 2004, we were in compliance with these covenants.

The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of December 31, 2004.

		Payments Due By Year					
($ in millions)	**Total**	**2005**	**2006**	**2007**	**2008**	**2009**	**After 2009**
Notes payable and debentures:							
Unsecured notes payable	$ 981.4	$165.0	$175.0	$	$153.0	$268.9	$219.5
SBA debentures	77.5	4.0					73.5
OPIC loan	5.7		5.7				
Revolving line of credit(1)	112.0		112.0				
Operating leases	33.5	4.6	4.5	4.4	4.4	4.6	11.0
Total contractual obligations	$1,210.1	$173.6	$297.2	$4.4	$157.4	$273.5	$304.0

(1) As discussed above, we plan to exercise our option to extend the maturity of the revolving line of credit to April 2006. At December 31, 2004, $396.4 million remained unused and available, net of amounts committed for standby letters of credit of $44.1 million issued under the credit facility.

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of December 31, 2004.

($ in millions)	Total	Amount of Commitment Expiration Per Year					
		2005	2006	2007	2008	2009	After 2009
Guarantees	$100.2	$0.6	$ 1.1	$94.8	$0.1	$2.5	$1.1
Standby letters of credit(1)	44.1		44.1				
Total commitments	$144.3	$0.6	$45.2	$94.8	$0.1	$2.5	$1.1

(1) Standby letters of credit are issued under our revolving line of credit. As discussed above, we plan to exercise our option to extend the maturity of the revolving line of credit to April 2006. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit will expire contemporaneously with the expiration of our line of credit in April 2006.

In addition, we had outstanding commitments to fund investments totaling $330.2 million at December 31, 2004, as discussed above.

CRITICAL ACCOUNTING POLICIES

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

Valuation of Portfolio Investments. As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS, and the bonds and preferred shares of CDOs. 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 determining the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investments. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. The value of investments in publicly traded securities is determined using quoted market prices discounted for restrictions on resale, if any.

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

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. Interest on loans and debt securities is not accrued if we have doubt about interest collection. Loans in workout status that are classified as Grade 4 or 5 assets under our internal grading system do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us depending on such company s capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. Prepayment premiums are recorded on loans and debt securities when received.

Equity Securities. Our equity 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, recent transactions involving the purchase or sale of the portfolio company s equity securities, or other liquidation events. The determined equity values are generally discounted to account for restrictions on resale and minority ownership positions.

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

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

We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed.

Net Realized Gains or Losses and Net Change in Unrealized Appreciation or Depreciation. Realized gains or losses are measured by the difference between the net proceeds from the repayment or sale and the cost basis of the investment without regard to unrealized appreciation or depreciation previously recognized, and include investments charged off during the year, net of recoveries. Net change in unrealized appreciation or depreciation reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized.

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

SENIOR SECURITIES

Information about our senior securities is shown in the following tables as of the fiscal year ended December 31, unless otherwise noted. The indicates information which the SEC expressly does not require to be disclosed for certain types of senior securities.

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Unsecured Long-term Notes Payable				
1995	$ 0	$ 0	$	N/A
1996	0	0		N/A
1997	0	0		N/A
1998	180,000,000	2,734		N/A
1999	419,000,000	2,283		N/A
2000	544,000,000	2,445		N/A
2001	694,000,000	2,453		N/A
2002	694,000,000	2,704		N/A
2003	854,000,000	3,219		N/A
2004	981,368,000	2,801		N/A
Small Business Administration Debentures (5)				
1995	$ 61,300,000	$ 2,868	$	N/A
1996	61,300,000	2,485		N/A
1997	54,300,000	2,215		N/A
1998	47,650,000	2,734		N/A
1999	62,650,000	2,283		N/A
2000	78,350,000	2,445		N/A
2001	94,500,000	2,453		N/A
2002	94,500,000	2,704		N/A
2003	94,500,000	3,219		N/A
2004	77,500,000	2,801		N/A
Overseas Private Investment Corporation Loan				
1995	$ 0	$ 0	$	N/A
1996	8,700,000	2,485		N/A
1997	8,700,000	2,215		N/A
1998	5,700,000	2,734		N/A
1999	5,700,000	2,283		N/A
2000	5,700,000	2,445		N/A
2001	5,700,000	2,453		N/A
2002	5,700,000	2,704		N/A
2003	5,700,000	3,219		N/A
2004	5,700,000	2,801		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities[(1)]	Asset Coverage Per Unit[(2)]	Involuntary Liquidating Preference Per Unit[(3)]	Average Market Value Per Unit[(4)]
Revolving Lines of Credit				
1995	$ 20,414,000	$ 2,868	$	N/A
1996	45,099,000	2,485		N/A
1997	38,842,000	2,215		N/A
1998	95,000,000	2,734		N/A
1999	82,000,000	2,283		N/A
2000	82,000,000	2,445		N/A
2001	144,750,000	2,453		N/A
2002	204,250,000	2,704		N/A
2003	0	0		N/A
2004	112,000,000	2,801		N/A
Auction Rate Reset Note				
1995	$ 0	$ 0	$	N/A
1996	0	0		N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	76,598,000	2,445		N/A
2001	81,856,000	2,453		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
Master Repurchase Agreement and Master Loan and Security Agreement				
1995	$ 0	$ 0	$	N/A
1996	85,775,000	2,485		N/A
1997	225,821,000	2,215		N/A
1998	6,000,000	2,734		N/A
1999	23,500,000	2,283		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Senior Note Payable(6)				
1995	$20,000,000	$2,868	$	N/A
1996	20,000,000	2,485		N/A
1997	20,000,000	2,215		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
Bonds Payable				
1995	$98,625,000	$2,868	$	N/A
1996	54,123,000	2,485		N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
Redeemable Cumulative Preferred Stock(5)(7)				
1995	$ 1,000,000	$ 277	$100	N/A
1996	1,000,000	242	100	N/A
1997	1,000,000	217	100	N/A
1998	1,000,000	267	100	N/A
1999	1,000,000	225	100	N/A
2000	1,000,000	242	100	N/A
2001	1,000,000	244	100	N/A
2002	1,000,000	268	100	N/A
2003	1,000,000	319	100	N/A
2004	0	0		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Non-Redeemable Cumulative Preferred Stock(5)				
1995	$6,000,000	$277	$100	N/A
1996	6,000,000	242	100	N/A
1997	6,000,000	217	100	N/A
1998	6,000,000	267	100	N/A
1999	6,000,000	225	100	N/A
2000	6,000,000	242	100	N/A
2001	6,000,000	244	100	N/A
2002	6,000,000	268	100	N/A
2003	6,000,000	319	100	N/A
2004	0	0		N/A

(1) Total amount of each class of senior securities outstanding at the end of the period presented.

(2) The asset coverage ratio for a class of senior securities representing indebtedness is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness. This asset coverage ratio is multiplied by $1,000 to determine the Asset Coverage Per Unit. The asset coverage ratio for a class of senior securities that is preferred stock is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness, plus the involuntary liquidation preference of the preferred stock (see footnote 3). The Asset Coverage Per Unit for preferred stock is expressed in terms of dollar amounts per share.

(3) The amount to which such class of senior security would be entitled upon the involuntary liquidation of the issuer in preference to any security junior to it.

(4) Not applicable, as senior securities are not registered for public trading.

(5) Issued by our small business investment company subsidiary to the Small Business Administration. These categories of senior securities are not subject to the asset coverage requirements of the 1940 Act. See Certain Government Regulations Small Business Administration Regulations.

(6) We were the obligor on $15 million of the senior notes. Our small business investment company subsidiary was the obligor on the remaining $5 million, which is not subject to the asset coverage requirements of the 1940 Act.

(7) The Redeemable Cumulative Preferred Stock was reclassified to Other Liabilities on the accompanying financial statements during 2003 in accordance with SFAS No. 150.

BUSINESS

General

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

We have participated in the private equity business since we were founded in 1958. We have financed thousands of companies nationwide. We generally invest in established,

middle market companies with adequate cash flow for debt service. We are not venture capitalists, and we generally do not provide seed, or early stage, capital.

We invest in the American entrepreneurial economy. Our private finance portfolio includes investments in over 100 companies with aggregate annual revenue of approximately $11 billion that employ more than 100,000 jobs.

Our investment objective is to achieve current income and capital gains. In order to achieve this objective, we invest in companies in a variety of industries, non-investment grade commercial mortgage-backed securities (CMBS) and collateralized debt obligation bonds and preferred shares (CDOs).

Private Equity Investing

As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, valuing, and ultimately exiting our investments. We generally target companies in less cyclical industries with, among other things, high return on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and that have the ability to generate free cash flow. Each investment is subject to an extensive due diligence process. It is not uncommon for a single investment to take from two months to a full year to complete, depending on the complexity of the transaction.

Our investment activity is primarily focused in three areas:

- Lending second lien or subordinated debt with or without equity features to middle market companies (also known as mezzanine investing),

- Buying controlling equity stakes in middle market companies (also known as buyout investing), and

- Investing in non-investment grade classes of commercial mortgage-backed securities and collateralized debt obligations.

We have chosen these investment classes because the investments can be structured to provide recurring cash flow to us as the investor. In addition to earning interest income, we may earn income from management, diligence, structuring or other fees. We may also enhance our total return through capital gains through equity features, such as a nominal cost warrants, or by investing in equity instruments. Net realized gains received over the past ten years as a percentage of total assets are shown in the chart below.

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

We believe illiquid investments generally provide better investment returns on average over time than do more liquid investments, such as public equities, public debt instruments, or large syndicated senior loans, because of the increased risk in holding such investments. Investors in illiquid investments cannot manage risk through investment trading techniques. In order to manage our risk, we focus on careful investment selection, thorough due diligence, portfolio monitoring and portfolio diversification. Our investment management processes have been designed to incorporate these tools.

We believe our business model is well suited for long-term illiquid investing. Our balance sheet is capitalized with significant equity capital and we use only a modest level of debt capital, which allows us the ability to manage through difficult market conditions with less risk of liquidity issues. Under the Investment Company Act of 1940 we are restricted to a debt to equity ratio of approximately one-to-one. Thus, our capital structure, which includes a modest level of long-term leverage, is well suited for long-term illiquid investments. However, since we are limited as to the amount of debt capital we can use to finance our commercial real estate investments, we are evaluating various strategic alternatives for our commercial real estate platform. These alternatives may include the sale, spin-out or recapitalization of all or part of our commercial real estate investments.

In general, we compete for investments with a large number of private equity funds and mezzanine funds, other business development companies, investment banks, other equity and non-equity based investment funds, and other sources of financing, including specialty finance companies and traditional financial services companies such as commercial banks. However, we primarily compete with private equity funds because they are also focused on providing long-term debt and equity capital to middle market companies. We believe that we have key structural and operational advantages when compared to private equity funds.

Many private equity funds operate with different cost structures than ours, which often include management and carried interest fees (which are sometimes referred to as incentive fees) paid to the management of an external investment adviser. We are internally managed and have no external adviser. In addition, our access to the public equity markets generally allows us the opportunity to raise equity capital at a lower cost than that of private equity funds. Our lower cost of capital may give us a pricing advantage when competing for new investments. In addition, we believe the perpetual nature of our corporate structure enables us to be a better long-term partner for our portfolio companies than a traditional private equity fund, which typically has a limited life. For additional information concerning the competitive risks we face, see Risk Factors We operate in a competitive market for investment opportunities.

Private Finance Portfolio

Our private finance portfolio is primarily composed of mezzanine loans (junior capital generally in the form of subordinated debt, with or without equity features) and equity securities (including preferred and common interests). Our capital is used to fund:

growth	note purchases
acquisitions	bridge financings
buyouts	other types of financings
recapitalizations	

We focus on mezzanine and buyout investments where we can select investments that are structured to generate current returns as well as potential future capital gains. It is our preference to structure our investments with a focus on current recurring interest and other portfolio income. Our loans generally have interest-only payments in the early years and payments of both principal and interest in the later years with maturities of five to ten years, although maturities and principal amortization schedules may vary. Our loans are also generally unsecured and generally carry a fixed rate of interest, which is generally paid to us quarterly. We generally target a minimum 10% weighted average current portfolio yield on the debt component of our private finance portfolio. The weighted average yield on our private finance loans and debt securities was 13.9% at December 31, 2004.

To the extent that we buy a controlling equity stake in a company, we generally structure our investments 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 equity, and management or transaction services fees to compensate us for the managerial assistance that we may provide to a controlled portfolio company. We believe that the transaction fees charged for the services we provide to portfolio companies are generally comparable with transaction fees charged by others in the private equity industry for performing similar services. In our buyout investments, we own a substantial percentage of the equity of the portfolio company as compared to a non-control mezzanine investment. Thus there is potential to realize larger capital gains as well as current return through buyout investing as compared to mezzanine investing.

We may fund most or all of the debt and equity capital upon the closing of buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to closing, the portfolio company may refinance all or a portion of this senior debt, resulting in a repayment to us. The amount of lower-yielding senior debt outstanding to portfolio companies at any point in time may cause the weighted average yield on the private finance debt portfolio to fluctuate.

We intend to continue a balanced approach to private finance investing that emphasizes a complementary mix of mezzanine investments and buyout investments, subject to regulatory diversity requirements. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains.

At December 31, 2004, 70% of the private finance portfolio at value consisted of loans and debt securities and 30% consisted of equity securities. At December 31, 2004, 59.1% of the private finance investments at value were in companies more than 25% owned, 8.2% were in companies 5% to 25% owned, and 32.7% were in companies less than 5% owned.

Our largest buyout investments at December 31, 2004, were in Business Loan Express, LLC and Advantage Sales & Marketing, Inc.

Business Loan Express, LLC. At December 31, 2004, our investment in Business Loan Express, LLC (BLX) totaled $335.2 million at value, or 10.3% of our total assets, which includes unrealized appreciation of $54.8 million. BLX is a national, non-bank lender utilizing the SBA s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company. BLX is a nationwide preferred lender, as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and small investment real estate loans, and originates loans under the USDA Business and Industry Guaranteed Loan Program. BLX s loan products are designed specifically for small businesses with financing needs of up to $4.0 million. We acquired BLX in December 2000. BLX has offices across the United States and is headquartered in New York, New York.

Advantage Sales and Marketing, Inc. At December 31, 2004, our investment in Advantage Sales & Marketing, Inc. (Advantage) totaled $283.0 million at value, or 8.7% of our total assets, which includes unrealized appreciation of $24.3 million. Advantage is a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. We completed the purchase of a majority ownership in Advantage in June 2004. Advantage has offices across the United States and is headquartered in Irvine, CA.

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. These investments are also generally illiquid.

When assessing a prospective private finance investment, we generally look for companies in less cyclical industries in the middle market (i.e., $50 million to $500 million in revenues) with certain target characteristics, which may or may not be present in the companies in which we invest. Our target investments generally are in companies with the following characteristics:

Management team with meaningful equity ownership

Dominant or defensible market position

High return on invested capital

Stable operating margins

Ability to generate free cash flow

Well-constructed balance sheet

The industry and geographic compositions of the private finance portfolio at value at December 31, 2004 and 2003, were as follows:

	2004	2003
Industry		
Business services	32%	22%
Financial services	21	19
Consumer products	20	30
Healthcare services	8	8
Industrial products	8	6
Retail	2	4
Energy Services	2	4
Broadcasting and cable	2	2
Other	5	5
Total	100%	100%
Geographic Region		
Mid-Atlantic	40%	40%
West	30	16
Midwest	16	26
Southeast	10	13
Northeast	4	4
International		1
Total	100%	100%

We monitor the portfolio to maintain diversity within the industries in which we invest. We currently do not have a policy with respect to concentrating (i.e., investing 25% or more of our total assets) in any particular industry and currently our portfolio is not concentrated. We may or may not concentrate in any industry or group of industries in the future. The geographic region for the private finance portfolio depicts the location of the headquarters for our portfolio companies. The portfolio companies may have a number of other locations.

Commercial Real Estate Finance Portfolio

Our commercial real estate investments are generally in the non-investment grade tranches of commercial mortgage-backed securities, also known as CMBS, and in the bonds and preferred shares of collateralized debt obligations, also known as CDOs.

With regard to CMBS, non-investment grade means that nationally recognized statistical rating organizations rate these securities below the top four investment-grade rating categories (i.e., AAA through BBB), and are sometimes referred to as junk bonds. Unlike most junk bonds, which are typically unsecured debt instruments, the non-investment grade CMBS bonds in which we invest are secured by an underlying collateral pool of commercial mortgage loans, which are, in turn, secured by commercial real estate. The underlying collateral for our CMBS bonds consist of senior mortgage loans on commercial real estate properties where the loans, on average, were underwritten to achieve a loan to value ratio of approximately 70%. We generally invest at the initial issuance of the CMBS, and are able to review the underlying collateral of mortgage loans as if we were making an initial decision to fund such loans and to determine if we want to exclude loans that do not meet our credit, collateral, structural or other standards. We also negotiate to acquire the securities at significant discounts from their face amount. When we acquire CMBS bonds at initial issuance, we have generally acquired bonds rated BB+ through unrated. From time-to-time, we may sell the BB+ through B+ rated bonds individually or in pools to provide liquidity and/or to reduce the level of lower yielding bonds in the portfolio. The yield on the CMBS bond portfolio will vary depending on the concentration of lower yielding bonds held at any point in time. At December 31, 2004, our CMBS portfolio had a weighted average yield to maturity of 14.6%.

Our CMBS bonds by rating classification at December 31, 2004, were as follows:

	2004	
($ in millions)	**Value**	**Percentage of Total Value**
AA	$ 4.6	1.2%
A	4.5	1.2
BBB-	9.0	2.4
BB+	7.7	2.1
BB	6.0	1.6
BB-	7.7	2.1
B+	15.3	4.1
B	62.6	16.7
B-	88.1	23.6
CCC+	18.6	5.0
CCC	20.3	5.4
CC	0.6	0.2
Unrated	128.8	34.4
Total	$373.8	100.0%

At December 31, 2004, the age of our bonds with a rating class of B+ and lower was as follows:

($ in millions)	Value	Percentage of Total Value
Less than one year old	$ 82.9	24.8%
One to two years old	55.4	16.6
Two to three years old	29.9	8.9
Three years old or older	166.1	49.7
Total	$334.3	100.0%

At December 31, 2004, the underlying pools of mortgage loans that are collateral for our CMBS consisted of approximately 6,200 commercial mortgage loans and real estate properties owned. The underlying mortgage loans securing the CMBS, calculated using the outstanding principal balance at December 31, 2004 and 2003, were diversified over the following property types and geographic locations:

	2004	2003
Property Type		
Retail	34%	35%
Office	26	24
Housing	24	25
Industrial	6	5
Hospitality	4	5
Other	6	6
Total	100%	100%
Geographic Region		
West	29%	31%
Mid-Atlantic	27	27
Midwest	22	21
Southeast	17	17
Northeast	5	4
Total	100%	100%

In addition to our CMBS investments, we have invested in the bonds and preferred shares of CDOs which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, investment grade and non-investment grade CMBS, and other real estate related collateral. The bonds and the preferred shares of the CDOs in which we have invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. The yield on our CDO bonds and preferred shares at December 31, 2004, was 16.8%.

Business Processes

Private Finance

Business Development and New Deal Origination. Over the years, we have developed and maintained relationships with numerous private equity investors, investment banks, business brokers, merger and acquisition advisors, financial services companies, banks, law firms and accountants through whom we source investment opportunities. Through these relationships, especially those with private equity sponsors, we believe we have been able to strengthen our position as a long-term investor. We are well known in the private equity industry, and we believe that our experience and reputation provide a competitive advantage in originating new investments.

New Deal Underwriting and Investment Execution. In a typical private finance transaction, we review, analyze, and substantiate through due diligence the business plan and operations of the potential portfolio company. We perform financial due diligence, perform operational due diligence, study the industry and competitive landscape, and conduct reference checks with company management or other employees, customers, suppliers, and competitors, as necessary. We may work with external consultants, including accounting firms and industry or operational consultants, in performing due diligence and in monitoring our portfolio investments.

Once we have determined that a prospective portfolio company is suitable for investment, we work with the management and the other capital providers, including senior, junior, and equity capital providers, to structure a deal. We negotiate among these parties to agree on how our investment is expected to perform relative to the other capital in the portfolio company s capital structure. The typical mezzanine transaction requires approximately two to six months of diligence and structuring before funding occurs. The typical buyout transaction may take up to one year to complete because the due diligence and structuring process is significantly longer when investing in a substantial equity stake in the company.

Our investments are tailored to the facts and circumstances of the deal. The specific structure is designed to protect our rights and manage our risk in the transaction. We may structure the debt instrument to require restrictive affirmative and negative covenants, default penalties, lien protection, or other protective provisions. In addition, each debt investment is individually priced to achieve a return that reflects our rights and priorities in the portfolio company s capital structure, the structure of the debt instrument, and our perceived risk of the investment. Our loans and debt securities have an annual stated interest rate; however, that interest rate is only one factor in pricing the investment. The annual stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity or upon prepayment. In addition to the interest earned on loans and debt securities, our mezzanine investments may include equity features, such as warrants or options to buy a minority interest in the portfolio company. The warrants we receive with our debt securities generally require only a nominal cost to exercise, and thus, if the portfolio company appreciates in value, we achieve additional investment return from this equity interest. We may structure the warrants to provide minority rights provisions and event-driven puts. In many cases, we will also obtain registration rights in connection with these equity interests, which may include demand and piggyback registration rights.

The key steps in our private finance investment process are:

- Initial investment screening;
- Initial investment committee approval;
- Due diligence, structuring and negotiation;
- Internal review of diligence results;
- Final investment committee approval;
- Approval by the Executive Committee of the Board of Directors (for all mezzanine investments that represent a commitment equal to or greater than $20 million and every buyout transaction); and
- Funding of the investment (due diligence must be completed with final investment committee approval before funds are disbursed).

The investment process benefits from the significant professional experience of the members of our investment committee, which is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer and other senior investment officers.

Portfolio Monitoring and Development. We monitor the progress of the companies in our portfolio. Middle market companies often lack the management expertise and experience found in larger companies. As a BDC, we are required by the 1940 Act to make available significant managerial assistance to our portfolio companies. Our senior level professionals work with portfolio company management teams to assist them to acquire other companies, to optimize their cost structures, to recruit management talent, to develop their marketing strategies, and to provide a variety of other services. We also support our portfolio companies efforts to structure and attract additional capital.

With respect to our private finance portfolio, our team of investment professionals regularly monitors the status and performance of each investment. This portfolio company monitoring process generally includes review of the company s financial performance against its business plan, review of current financial statements and compliance with financial covenants, evaluation of significant current developments and assessment of future exit strategies. We may have board observation rights for mezzanine investments, which allows us to attend portfolio company board meetings. For buyout investments, we generally hold a majority of the seats on the board of directors.

From time to time we will identify investments that require closer monitoring or become workout assets. We develop a workout strategy for workout assets and gauge our progress against the strategy at periodic portfolio management committee meetings. Our portfolio management committee is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer, and other senior professionals.

Private finance investments are priced to provide an investment return considering the fact that certain investments in the portfolio may underperform or result in loss of investment return or investment principal. As a private equity investor, we will incur losses from our investing activities, however we have a history of working with troubled portfolio companies in order to recover as much of our investments as is practicable.

Commercial Real Estate Finance

CMBS and CDOs. The typical CMBS or CDO investment takes between two to three months to complete. We receive extensive underwriting information regarding the mortgage loans and other securities comprising a CMBS or CDO pool from the issuer. We then work with the issuer, the investment bank, and the rating agencies to underwrite the collateral securing our investment. For instance when we review the underlying commercial mortgage loans securing a CMBS transaction, we analyze the estimate of cash flow and debt service coverage, and assess the collateral value and loan-to-value ratios. We study the local real estate market trends and form an opinion as to whether the loan as originally underwritten by the issuer is sound. Based on the findings of our diligence procedures, we may reject certain mortgage loans from inclusion in the collateral pool.

The key steps in our CMBS and CDO investment process are:

Initial assessment of collateral pool data;

Preparation of preliminary bid letter;

Due diligence, structuring and negotiation;

Investment committee approval;

Approval by the Executive Committee of the Board of Directors (for all investments that are equal to or greater than $20 million); and

Funding of the investment (due diligence must be completed with final investment committee approval before funds are disbursed).

The investment process benefits from the significant professional experience of our real estate investment committee members. CMBS and CDO transactions are approved by the commercial real estate investment committee, which is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer and other senior investment officers.

With respect to our CMBS and CDO portfolio, we monitor the performance of the underlying collateral pool through data provided by master and special servicers. These third-party master servicers are responsible for the day-to-day loan servicing functions, including billing, payment processing, collections on loans less than 60 days past due, tax and insurance escrow processing, and property inspections. Special servicers are responsible for collections on loans greater than 60 days past due, including workout administration and management of foreclosed properties, and loans less than 60 days past due that have had a transfer event.

When a loan moves to the designated special servicer, a workout plan is formulated by the special servicer and reviewed by us when we hold the controlling interest in the lowest rated tranche outstanding, which is generally the non-rated tranche at issuance. Once reviewed by us, the special servicer carries out the workout plan, updating us on the status. With respect to certain CMBS issuances where we own the controlling class of securities, we generally have the ability to replace the existing named special servicer at any time. In addition, we are the named special servicer on certain CMBS issuances. We act as the disposition consultant with respect to certain of our CDO investments, which allows us to approve disposition plans for individual collateral securities.

Portfolio Grading

We employ a standard 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 investment return or principal is expected. Grade 4 is for investments that are in workout and for which some loss of current investment return is expected, but no loss of principal is expected. Grade 5 is for investments that are in workout and for which some loss of principal is expected.

Portfolio Valuation

We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to a valuation policy and a consistently applied valuation process. At

December 31, 2004, portfolio investments recorded at fair value were approximately 92% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS bonds, and CDO bonds and preferred shares. The structure of each private finance 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 on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

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

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

If there is adequate enterprise value to support the repayment of our debt, the fair value of our loan or debt security normally corresponds to cost unless the borrower s condition or other factors lead to a determination of fair value at a different amount. The fair value of equity interests in portfolio companies is determined based on various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company s debt and other preference capital, and other pertinent factors such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company s equity securities, or other liquidation 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 and CDO Bonds and Preferred Shares. CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to discount rate may be based on the yield of comparable securities, when available. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each CMBS bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We have determined the fair value of our CMBS bonds and CDO bonds and preferred shares on an individual security-by-security basis. If we were to sell a group of these investments in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual bonds or preferred shares.

Valuation Process. The portfolio valuation process is managed by our Chief Valuation Officer (CVO). The CVO works with the investment professionals responsible for each investment. The following is a description of the steps we take each quarter to determine the value of our portfolio.

Our valuation process begins with each portfolio company or investment being initially valued by our deal team, led by the Managing Director or senior officer who is responsible for the portfolio company relationship.

The CVO reviews the valuation data. The CVO, members of the valuation team, and an independent third-party consultant, as applicable for private finance investments, meet with each Managing Director or responsible senior officer to discuss the preliminary valuation determined and documented by the deal team for each of their respective investments.

Each investment committee (private finance and commercial real estate finance) meets with the CVO where members of the investment committees have the opportunity to discuss the preliminary valuation results.

Valuation documentation is distributed to the members of the Board of Directors.

The Board of Directors meets to discuss valuations and review the input of the CVO and management.

To the extent there are changes or if additional information is deemed necessary, a follow-up Board meeting may take place.

The Board of Directors determines the fair value of the portfolio in good faith.

In connection with our valuation process to determine the fair value of a private finance investment, we work with independent third-party consultants to obtain assistance and advice as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter (for all investments with a cost or value greater than $250,000). In addition, we may receive independent assessments of a particular private finance portfolio company s value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these independent valuation resources is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

Disposition of Investments

We manage our portfolio of investments in an effort to maximize our expected returns. Our portfolio is large and diverse and we frequently are repaid by our borrowers and exit our debt and equity investments as portfolio companies are sold, recapitalized or complete an initial public offering. In our mezzanine investments, we frequently are in a minority ownership position in a portfolio company, and as a result, generally exit the investment when the majority equity stakeholder decides to sell or recapitalize the company. Where we have a control position in our investment, as we frequently have in buyout investments and in CMBS and CDO investments, we have more flexibility and can determine whether or not we should exit our investment. Our most common exit strategy for a buyout investment is the sale of a portfolio company to a strategic or financial buyer. If an investment has appreciated in value, we may realize a gain when we exit the investment. If an investment has depreciated in value, we may realize a loss when we exit the investment.

We are in the investment business, which includes acquiring and exiting investments. It is our policy not to comment on potential transactions in the portfolio prior to reaching a definitive agreement or, in many cases, prior to consummating a transaction. To the extent we enter into any material transactions, we would provide disclosure as required.

Dividends

We have elected to be taxed as a regulated investment company under subchapter M of the Internal Revenue Code. As such, we are not subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. We pay regular quarterly dividends based upon an estimate of annual taxable income, which includes our taxable interest, dividend, and fee income, as well as taxable net capital gains. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends, which includes contractual payment-in-kind interest, and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

We began paying quarterly dividends in 1963, and our portfolio has provided sufficient ordinary taxable income and realized net capital gains to sustain or grow our dividends over time. The percentage of our dividend generated by ordinary taxable income versus capital gain income will vary from year to year. Depending on many factors impacting portfolio activities, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make, we will be in a build or harvest mode for our portfolio investments. As illustrated in the chart below, when we are building the portfolio, ordinary taxable income typically grows as a percentage of the total dividend. When we are exiting investments, or in a harvest mode, net capital gains typically grow as a percentage of the total dividend. We believe that the ability to generate both ordinary and capital gain income has built predictability in the dividends we pay. The percentage of ordinary taxable income versus net capital gain income supporting the dividend since 1985 is shown below.

Corporate Structure and Offices

We are a Maryland corporation and a closed-end, non-diversified management investment company that has elected to be regulated as a business development company under the 1940 Act. We have a subsidiary, Allied Investment Corporation, which has also elected to be regulated as a BDC and is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company. See Certain Government Regulations below for further information about small business investment company regulation.

In addition, we have a real estate investment trust subsidiary, Allied Capital REIT, Inc., and several subsidiaries that are single-member limited liability companies established primarily to hold real estate properties. We also have a subsidiary, A.C. Corporation, that provides diligence and structuring services on private finance and commercial real estate transactions, as well as structuring, transaction, management, and advisory services to Allied Capital, our portfolio companies and other third parties.

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC 20006-3434 and our telephone number is (202) 331-1112. In addition, we have regional offices in New York, Chicago, and Los Angeles.

Employees

At December 31, 2004, we employed 162 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of these individuals are located in our Washington, DC office. We believe that our relations with our employees are excellent.

Legal Proceedings

On June 23, 2004, we were notified by the SEC that they are conducting an informal investigation of us. On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to us at this time, the inquiries appear to pertain to matters related to portfolio valuation and our portfolio company, Business Loan Express, LLC. We are cooperating with the SEC s and the U.S. Attorney s investigations.

On May 28, 2004, Ferolie Corporation, a food broker with business and contractual relationships with an entity that is now affiliated with one of our portfolio companies, Advantage Sales & Marketing Inc., filed suit against us, Advantage Sales & Marketing and the affiliated entity in the United States District Court for the District of Columbia alleging that, among other things, we and Advantage Sales & Marketing had tortiously interfered with Ferolie s contract with the affiliated entity by causing the affiliated entity (i) to breach its obligations to Ferolie regarding Ferolie s participation in a reorganization transaction involving the affiliated entity and (ii) to induce clients of Ferolie to transfer their business to the affiliated entity. Ferolie seeks actual and punitive damages against us and Advantage Sales & Marketing and declaratory and injunctive relief. On July 15, 2004, the United States District Court for the District of Columbia dismissed the lawsuit for lack of jurisdiction. On August 17, 2004, Ferolie filed a Petition to Compel Arbitration in the United States District Court for the Northern District of Illinois naming us, Advantage Sales & Marketing and the affiliated entity as respondents. Ferolie attached to its petition an Amended Demand for Arbitration and Statement of Claims that asserts essentially the same claims as were asserted in the lawsuit that was dismissed by the United States District Court for the District of Columbia. On October 29, 2004, the United States District Court for the Northern District of Illinois dismissed Ferolie s petition after finding that Ferolie had failed to adequately allege the existence of subject matter jurisdiction.

On November 4, 2004, Ferolie refiled its Petition to Compel Arbitration in the Circuit Court of Cook County, Illinois. The allegations and relief requested in this proceeding are identical to the assertions made by Ferolie in the two previously dismissed proceedings. On February 15, 2005, the Circuit Court of Cook County, Illinois entered an order denying Ferolie s motion for an order compelling the Company to arbitrate the claims asserted by Ferolie against it. In the same order, the Circuit Court of Cook County, Illinois granted Ferolie s motion to compel arbitration of the claims asserted against Advantage Sales & Marketing and the affiliated entity.

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

While the outcome of these legal proceedings and other matters cannot at this time be predicted with certainty, we do not expect that these matters will have a material effect upon our financial condition or results of operations.

PORTFOLIO COMPANIES

The following is a listing of each portfolio company or its affiliate, together referred to as portfolio companies, in which we had an equity investment at December 31, 2004. Percentages shown for class of securities held by us represent percentage of the class owned and do not necessarily represent voting ownership or economic ownership. Percentages shown for equity securities other than warrants or options represent the actual percentage of the class of security held before dilution. Percentages shown for warrants and options held represent the percentage of class of security we may own assuming we exercise our warrants or options before dilution.

The portfolio companies are presented in three categories: companies more than 25% owned which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by us under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company s board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company. We make available significant managerial assistance to our portfolio companies. We generally receive rights to observe the meetings of our portfolio companies board of directors, and may have one or more voting seats on their boards.

For information relating to the amount and nature of our investments in portfolio companies, see our consolidated statement of investments at December 31, 2004, at pages F-7 to F-17.

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
PRIVATE FINANCE			
Companies More Than 25% Owned			
Acme Paging, L.P.[1]	Paging Services	Class A Equity Interests	100.0%
6080 SW 40th Street, Suite 3		Class B Equity Interests	1.7%
Miami, FL 33155		Common Stock	
		in Affiliate	15.8%
Advantage Sales & Marketing, Inc.[1][6]	Sales and Marketing	Class A Common Stock	100.0%
19100 Von Karman Avenue Suite 600	Agency		
Irvine, CA 92612			
Alaris Consulting, LLC[1][2]	Consulting Firm	Equity Interests	100.0%
360 W. Butterfield Road			
Suite 400			
Elmhurst, IL 60126			
Avborne, Inc.[1][7]	Aviation Services	Series B Preferred Stock	23.8%
c/o Trivest, Inc.		Common Stock	27.2%
7500 NW 26th Street			
Miami, FL 33122			
Avborne Heavy Maintenance, Inc.[1][7]	Aviation Services	Series A Preferred Stock	27.5%
7500 26th Street N.W.		Common Stock	27.5%
Miami, FL 33122			
Business Loan Express, LLC[1]	Small Business Lender	Class A Equity Interests	100.0%
645 Madison Ave.		Class B Equity Interests	100.0%
19th Floor		Class C Equity Interests	94.9%
New York, NY 10022		Equity Interest in BLX	
		Subsidiary[3]	20.0%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Callidus Capital Corporation(1)(4)	Asset Manager and	Common stock	100.0%
520 Madison Avenue, 27th Floor	Finance Company		
New York, NY 10022			
Fairchild Industrial Products Company(1)	Industrial Controls	Class A Redeemable	
3920 Westpoint Boulevard	Manufacturer	Common Stock	100.0%
Winston-Salem, NC 27013		Class B Common Stock	100.0%
Financial Pacific Company(1)	Commercial Finance	Series A Preferred Stock	99.4%
3455 South 344th Way, Suite 300		Common Stock	99.4%
Federal Way, WA 98001			
ForeSite Towers, LLC(1)	Tower Leasing	Series A Preferred	
22 Iverness Center Parkway		Equity Interest	100.0%
Suite 50		Series B Preferred	
Birmingham, AL 35242		Equity Interest	100.0%
		Series D Preferred Equity	
		Interest	100.0%
		Common Equity Interest	70.0%
GAC Investments, Inc.(1)	Cable System Operator	Common Stock	99.0%
1919 Pennsylvania Ave., N.W.			
Washington, DC 20006			
Global Communications, LLC(1)	Muzak Franchisee	Preferred Equity Interest	77.8%
201 East 69th Street		Options for Common	
New York, NY 10021		Equity Interest	59.3%
Gordian Group, Inc.(1)	Financial Advisory		
	Services	Common Stock	100.0%
499 Park Avenue			
5th Floor			
New York, NY 10022			
HealthASPex, Inc.(1)	Third Party	Class A Convertible	
Foxpointe Centre	Administrator	Preferred Stock	69.9%
Building 1; Suite 301		Class B Convertible	
201 South Johnson Road		Preferred Stock	64.8%
Houston, PA 15342		Common Stock	45.8%
HMT, Inc.	Storage Tank	Class B Preferred	
4422 FM 1960 West	Maintenance &	Stock	33.5%
Suite 350	Repair	Common Stock	25.0%
Houston, TX 77068		Warrants to Purchase	
		Common Stock	9.7%
Housecall Medical Resources, Inc.(1)	Home Healthcare	Common Stock	76.8%
6501 Deane Hill Drive	Services		
Knoxville, TN 37919			
Impact Innovations Group, LLC	Information Technology	Equity Interest in	
12 Piedmont Center, Suite 210	Services Provider	Affiliate(5)	50.0%
Atlanta, GA 30305			
Insight Pharmaceuticals Corporation(1)	Marketer of Over-The-	Preferred Stock	100.0%
550 Township Line Road, Suite 300	Counter Pharmaceuticals	Common Stock	100.0%
Blue Bell, PA 19422			
Jakel, Inc.(1)	Manufacturer of Electric	Series A-1 Preferred	
400 Broadway	Motors and Blowers	Stock	32.3%
Highlands, IL 62249		Class B Common Stock	100.0%
Legacy Partners Group, LLC(1)	Merger and Acquisition	Equity Interests	100.0%
520 Madison Avenue, 27th Floor	Advisor		
New York, NY 10022			
Litterer Beteiligungs-GmbH	Scaffolding Company	Equity Interest	24.0%
Uhlandstrasse 1			
69493 Hirschberg			

Germany			
Maui Body Works, Inc.[1]	Cosmetic Surgery Services	Common Stock	100.0%
1919 Pennsylvania Ave, N.W.			
Washington, DC 20006			

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Mercury Air Centers, Inc.(1)	Fixed Base Operations	Common Stock	99.6%
1951 Airport Road			
Atlanta, GA 30341			
MVL Group, Inc.(1)	Market Research	Common Stock	64.9%
1061 E. Indiantown Road	Services		
Suite 300			
Jupiter, FL 33477			
Pennsylvania Avenue Investors, L.P.(1)	Private Equity Fund	Equity Interests	100.0%
1919 Pennsylvania Ave., N.W.			
Washington, DC 20006			
Powell Plant Farms, Inc.(1)	Plant Producer &	Preferred Stock	100.0%
Route 3, Box 1058	Wholesaler	Warrants to Purchase	
Troup, TX 75789		Common Stock	83.5%
Redox Brands, Inc.(1)	Household Cleaning	Series A Convertible	
9100 Centre Point Drive	Products	Preferred Stock	100.0%
Suite 200		Warrants to Purchase	
West Chester, OH 45069		Class A Common Stock	9.4%
Staffing Partners Holding			
Company, Inc.(1)	Temporary Employee	Series B Preferred Stock	71.4%
104 Church Lane, #100	Services	Redeemable Preferred	
Baltimore, MD 21208		Stock	48.3%
		Class A-1 Common	
		Stock	50.0%
		Class A-2 Common	
		Stock	24.4%
		Class B Common	
		Stock	48.8%
		Warrants to purchase	
		Class B Common Stock	30.3%
Startec Global Communications Corporation(1)	Telecommunications	Common Stock	68.5%
1151 Seven Locks Road	Services		
Potomac, MD 20854			
STS Operating, Inc.			
(d/b/a SunSource Technology			
Services, Inc.)(1)	Engineering Design and	Preferred Stock	100.0%
2301 Windsor Court	Services	Common Stock	77.1%
Addison, IL 60101		Options to Purchase	
		Common Stock	0.8%
Companies 5% to 25% Owned			
Air Evac Lifeteam	Air Ambulance Service	Preferred Equity Interest	6.6%
1448 W. Eighth Street			
West Plains, MO 65775			
Aspen Pet Products, Inc.	Pet Product	Series B Preferred Stock	8.7%
4735 North Florence Street	Provider	Series D Preferred Stock	6.5%
Denver, CO 80238		Series A Common Stock	6.5%
		Warrants to purchase	
		Series A Common Stock	4.1%
Becker Underwood, Inc	Speciality Chemical	Common Stock	6.1%
801 Dayton Avenue	Manufacturer		
Ames, IA 50010			
Border Foods, Inc.	Mexican Ingredient &	Series A Convertible	
1750 Valley View Lane, Suite 350	Food Product	Preferred Stock	9.4%
Farmer s Branch, TX 75234	Manufacturer	Common Stock	12.4%
		Warrants to Purchase	
		Common Stock	73.8%

The Debt Exchange, Inc.[(1)] 101 Arch Street, Suite 410 Boston, MA 02110	Online Sales of Financial Assets	Series B Convertible Preferred Stock	40.0%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
MasterPlan, Inc.	Healthcare Outsourcing	Common Stock	7.5%
21540 Plummer Street			
Chatsworth, CA 91311			
MedBridge Healthcare, LLC[1]	Sleep Diagnostic Facilities	Debt Convertible	
3600 Mansell Road, Suite 150		into Equity Interests	75.0%
Alpharetta, GA 30022			
MortgageRamp, Inc.[1]	Internet Based	Class A Common	
116 Welsh Road	Loan Origination	Stock	7.7%
Horsham, PA 19044	Service Platform		
Nexcel Synthetics, LLC	Manufacturer of Carpet	Class A Equity Interest	6.8%
6076 Southern Industrial Drive	Backing	Class B Equity Interest	6.8%
Birmingham, AL 35235			
Packaging Advantage Corporation	Personal Care,	Common Stock	5.7%
4633 Downey Road	Household and	Warrants to Purchase	
Los Angeles, CA 90058	Disinfectant Product	Common Stock	5.4%
	Packager		
Pres Air Trol LLC	Pressure Switch	Class A Equity	32.8%
1009 W. Boston Post Road	Manufacturer	Interests	
Mamaroneck, NY 10543			
Progressive International			
Corporation	Retail Kitchenware	Series A Redeemable	
6111 S. 228th Street		Preferred Stock	12.5%
Kent, WA 98064		Class A Common Stock	1.0%
		Warrants to Purchase	
		Class A Common Stock	41.6%
Soteria Imaging Services, LLC	Diagnostic Imaging	Class A Preferred Equity	
6009 Brownsboro Park Blvd., Suite H	Facilities Operator	Interest	12.1%
Louisville, KY 40207			
Universal Environmental Services, LLC	Used Oil Recycling	Preferred Equity	15.0%
411 Dividend Drive		Interests	
Peachtree City, GA 30269			
Companies Less Than 5% Owned			
Alderwoods Group, Inc.	Death Care Services	Common Stock	0.9%
311 Elm Street, Suite 1000			
Cincinnati, OH 45202			
American Barbecue & Grill, Inc.	Restaurant Chain	Warrants to Purchase	
7300 W. 110th Street, Suite 570		Common Stock	18.7%
Overland Park, KS 66210			
Apogen Technologies, Inc.	Government Information	Series A	
7450-B Boston Blvd.	Technology Services	Preferred Stock	5.2%
Springfield, VA 22153		Common Stock	4.8%
		Warrant to Purchase	
		Series A	
		Preferred Stock	0.7%
		Warrant to Purchase	
		Common Stock	0.8%
Benchmark Medical, Inc.	Outpatient Physical	Warrant to Purchase	
101 Lindin Drive, Suite 420	Therapy Services	Common Stock	2.3%
Malvern, PA 19355			
Callidus Debt Partners CLO Fund III, LTD[8]	Senior Debt Fund	Preferred Shares	68.4%
135 Lasalle Street			
Chicago, IL 60694			
Camden Partners Strategic Fund II, L.P.	Private Equity Fund	Limited Partnership	
One South Street		Interest	3.9%
Suite 2150			

Baltimore, MD 21202

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Catterton Partners V, L.P.	Private Equity Fund	Limited Partnership	
7 Greenwich Office Park		Interest	0.8%
Greenwich, CT 06830			
Colibri Holding Corporation	Outdoor Living Products	Preferred Stock	5.9%
2201 S. Walbash Street		Series B Preferred Stock	5.9%
Denver, CO 80231		Class B Common Stock	19.2%
		Warrants to Purchase	
		Class B Common Stock	10.2%
Component Hardware Group, Inc.	Designer & Developer	Class A Preferred Stock	7.9%
1890 Swarthmore Ave.	of Hardware	Class B Common Stock	13.5%
Lakewood, NJ 08701	Components		
Cooper Natural Resources, Inc.	Sodium Sulfate Producer	Series A Convertible	
P.O. Box 1477		Preferred Stock	100.0%
Seagraves, TX 79360		Warrants to Purchase	
		Series A Convertible	
		Preferred Stock	36.8%
		Warrants to Purchase	
		Common Stock	6.5%
DCS Business Services, Inc.	Collections and Default	Series A Preferred Stock	2.9%
333 N. Canyon Parkway, Suite 100	Prevention Services		
Livermore, CA 94551			
eCentury Capital Partners, L.P.	Private Equity Fund	Limited Partnership	
8270 Greensboro Drive		Interest	25.0%
Suite 1025			
McLean, VA 22102			
Elexis Beta GmbH	Distance Measurement	Options to Purchase	
Ulmenstraße 22	Device	Shares	9.8%
60325 Frankfurt am Main	Manufacturer		
Germany			
E-Talk Corporation	Telecommunications	Series B	
4040 West Royal Lane	Software Provider	Preferred Stock	66.6%
Suite 100		Series B	
Irving, TX 75063		Common Stock	66.6%
Frozen Specialties, Inc.	Private Label Frozen	Warrants to Purchase	
720 Barre Road	Food Manufacturer	Class A Common Stock	2.7%
Archbold, OH 43502			
Garden Ridge Corporation	Home Decor Retailer	Series A Preferred Stock	2.6%
19411 Atrium Place		Class A Common Stock	4.7%
Suite 170		Class B Common Stock	4.7%
Houston, TX 77084			
Geotrace Technologies, Inc.	Oil and Gas Reservoir	Warrant to Purchase	
1011 Highway 6 South, Suite 220	Analysis	Preferred Stock	8.9%
Houston, TX 77077		Warrant to Purchase	
		Common Stock	8.9%
Ginsey Industries, Inc.	Bathroom Accessories	Debt Convertible	
281 Benigno Boulevard	Manufacturer	into Common Stock	8.8%
Bellmawr, NJ 08031		Warrants to Purchase	
		Common Stock	17.9%
Grotech Partners VI, L.P.	Private Equity Fund	Limited Partnership	
c/o Grotech Capital Group		Interest	2.4%
9690 Deereco Road			
Suite 800			
Timonium, MD 21093			
Homax Holdings, Inc.	Supplier of Branded	Preferred Stock	0.1%
468 West Horton Road	Consumer Products	Common Stock	0.1%

Bellingham, WA 98226	Warrant to Purchase	
	Preferred Stock	1.2%
	Warrant to Purchase	
	Common Stock	1.2%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Icon International, Inc.	Corporate Barter	Class C Common Stock	2.0%
281 Tressor Boulevard	Services		
8th Floor			
Stamford, CT 06901			
Interline Brands, Inc.	Repair and Maintenance	Common Stock	0.5%
303 Harper Drive	Product Distributor		
Moorestown, NJ 08057			
International Fiber Corporation	Cellulose and Fiber	Series A Preferred Stock	4.7%
50 Bridge Street	Producer		
North Tonawanda, NY 14120			
MedAssets Inc.	Healthcare Outsourcing	Series B Convertible	
100 Northpoint Center		Preferred Stock	7.8%
East #150		Warrants to Purchase	
Alpharetta, GA 30022		Common Stock	0.7%
Mid-Atlantic Venture Fund IV, L.P.	Private Equity Fund	Limited Partnership	
128 Goodman Drive		Interest	6.7%
Bethlehem, PA 18015			
Mogas Energy, LLC	Natural Gas Pipeline	Warrants to Purchase	
13137 Thunderhead Falls Lane	Operator	Equity Interests	20.0%
Rapid City, SD 57702			
Nobel Learning Communities, Inc.	Educational Services	Series D	
1400 N. Providence Road		Preferred Stock	100.0%
Suite 3055		Series F Convertible	
Media, PA 19063		Preferred Stock	25.6%
		Warrants to Purchase	
		Common Stock	6.7%
Norstan Apparel Shops, Inc.	Women s Apparel Retailer	Class A Common Stock	26.4%
33-00 47th Avenue		Class B Common Stock	100.0%
Long Island City, NY 11101		Warrants to Purchase	
		Common Stock	8.0%
Novak Biddle Venture Partners III, L.P.	Private Equity Fund	Limited Partnership	
7501 Wisconsin Avenue		Interest	2.5%
East Tower, Suite 1380			
Bethesda, MD 20814			
Onyx Television GmbH	Cable Television	Preferred Units	12.0%
Immedia Park 6b			
50670 Köln			
Germany			
Opinion Research Corporation	Corporate Marketing	Warrants to Purchase	
P.O. Box 183	Research Firm	Common Stock	6.5%
Princeton, NJ 08542			
Oriental Trading Company, Inc.	Direct Marketer	Class A Common Stock	1.5%
108th Street, 4206 South	of Toys		
Omaha, NE 68137			
Polaris Pool Systems, Inc.	Pool Cleaner	Warrants to Purchase	
P.O. Box 1149	Manufacturer	Class B Common Stock	33.3%
San Marcos, CA 92079-1149			
Pro Mach, Inc.	Packaging Machinery	Equity Interests	2.3%
1000 Abernathy Road, Suite 1110	Manufacturer		
Atlanta, GA 30328			
S.B. Restaurant Company			
(d/b/a Elephant Bar)	Restaurants	Series B Convertible	
6326-A Lindmar Drive		Preferred Stock	2.5%
Goleta, CA 93117		Warrant to Purchase	
		Series A Common Stock	13.1%

SBBUT, LLC	Holding Company	Equity Interests in	
52 River Road		Affiliate Company	10.4%
Stowe, VT 05672			

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Soff-Cut Holdings, Inc.	Concrete Sawing	Series A Preferred Stock	14.3%
1112 Olympic Drive	Equipment Manufacturer	Common Stock	2.7%
Corona, CA 91719			
SPP Mezzanine Fund, L.P.	Private Equity Fund	Limited Partnership	35.7%
330 Madison Avenue, 28th Floor		Interest	
New York, NY 10017			
United Site Services, Inc.	Portable Rest Room	Common Stock	1.3%
31 Middlesex Road	Services		
Mansfield, MA 02048			
Updata Venture Partners II, L.P.	Private Equity Fund	Limited Partnership	
11600 Sunrise Valley Drive		Interest	15.0%
Reston, VA 20191			
U.S. Security Holdings, Inc.	Outsourced Facility	Warrants to Purchase	
200 Mansell Court East	Services Provider	Preferred Stock	3.5%
Suite 500		Warrants to Purchase	
Roswell, GA 30076		Class B Common Stock	29.3%
Venturehouse-Cibernet Investors, LLC	Third Party Billing	Equity Interest	3.3%
509 Seventh Street, NW			
Washington, DC 20004			
Venturehouse Group, LLC	Private Equity Fund	Common Equity Interest	3.1%
1780 Tysons Boulevard, Suite 400			
McLean, VA 22102			
VICORP Restaurants, Inc.	Restaurants	Warrant to Purchase	
400 W. 48th Avenue		Preferred Stock	0.6%
Denver, CO 80216		Warrant to Purchase	
		Common Stock	3.5%
Walker Investment Fund II, LLLP	Private Equity Fund	Limited Partnership	
3060 Washington Road		Interest	5.1%
Suite 200			
Glenwood, MD 21738			
Wear Me Apparel Corporation	Marketer of Children s	Warrant to Purchase	
31 West 34th Street	Apparel	Common Stock	2.0%
New York, NY 10001			
Wilshire Restaurant Group, Inc.	Restaurants	Warrants to Purchase	
1100 Town & Country Road		Preferred Stock	12.8%
Suite 1300		Warrants to Purchase	
Orange, CA 92868-4654		Common Stock	12.8%
Woodstream Corporation	Pest Control	Common Stock	4.4%
69 North Locust Street	Manufacturer	Warrants to Purchase	
Lititz, PA 17543		Common Stock	3.7%
COMMERCIAL REAL ESTATE FINANCE[(9)]			
Greenleaf-Crosby Development, Inc.[(1)]	Commercial Real	Common Stock	100.0%
1919 Pennsylvania Ave, N.W.	Estate Developer		
Washington, DC 20006			
NPH, Inc.[(1)]	Commercial Real	Common Stock	100.0%
1919 Pennsylvania Ave, N.W.	Estate Developer		
Washington, DC 20006			
Stemmons Freeway Hotel, LLC[(1)]	Hotel	Equity Interests	100.0%
1919 Pennsylvania Ave, N.W.			
Washington, DC 20006			
Timarron Capital, Inc.[(1)]	Commercial Real	Preferred Stock	100.0%
804 Worthington Court	Estate Loan		
Southlake, TX 76092	Origination and		
	Securitization		

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
WSA Commons LLC	Residential Real	Equity Interests	
421 East 4th Street	Estate Development		50.0%
Cincinnati, OH 45202			
Van Ness Hotel, Inc.(1)	Hotel	Common Stock	100.0%
1919 Pennsylvania Ave, N.W.			
Washington, DC 20006			

(1) The portfolio company is deemed to be an affiliated person under the 1940 Act because we hold one or more seats on the portfolio company s board of directors, are the general partner, or are the managing member.

(2) Alaris Consulting, LLC owns 95% of Alaris Consulting, Inc.

(3) Included in Class C Equity Interests in the Consolidated Statement of Investments.

(4) Callidus Capital Corporation owns 80% of Callidus Capital Management, LLC.

(5) The affiliate holds subordinated debt issued by Impact. We made an investment in and exchanged our existing subordinated debt for equity interests in the affiliate.

(6) Advantage Sales & Marketing, Inc. has issued two classes of common stock. We own 100% of the class A common stock and our economic ownership is diluted by the class B common stock and is subject to further dilution by management options, performance shares and certain adjustments provided for in the stockholder agreements.

(7) During the third quarter of 2004, Avborne, Inc. transferred certain equity securities in Avborne Heavy Maintenance, Inc. to its lenders, including us, in exchange for a reduction in contractual interest on our loan to Avborne, Inc. Avborne, Inc. and Avborne Heavy Maintenance, Inc. remain affiliated companies.

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

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

DETERMINATION OF NET ASSET VALUE

We determine the net asset value per share of our common stock quarterly. The net asset value per share is equal to the value of our total assets minus liabilities divided by the total number of common shares outstanding.

At December 31, 2004, portfolio investments recorded at fair value were approximately 92% of our total assets. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS bonds, and CDO bonds and preferred shares. The structure of each private finance 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 on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

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

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

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

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

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

Equity Securities. Our equity 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, recent transactions involving the purchase or sale of the portfolio company s equity securities, or other liquidation events. The determined equity values are generally discounted to account for restrictions on resale and minority ownership positions.

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

*Valuation Methodology CMBS Bonds and CDO Bonds and Preferred Shares*CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to discount rate may be based on the yield of comparable securities, when available. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each CMBS bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We have determined the fair value of our CMBS bonds and CDO bonds and preferred shares on an individual security-by-security basis. If we were to sell a group of these investments in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual bonds or preferred shares.

MANAGEMENT

Our Board of Directors oversees our management. The responsibilities of each director include, among other things, the oversight of our investment activity, the quarterly valuation of our assets, and oversight of our financing arrangements. The Board of Directors maintains an Executive Committee, Audit Committee, Compensation Committee, and Corporate Governance/Nominating Committee, and may establish additional committees in the future. All of our directors also serve as directors of our subsidiaries.

The management of our investment portfolio is the responsibility of our investment committees and the Executive Committee of the Board of Directors. Each new private finance investment must be approved by our private finance investment committee, which is chaired by William Walton, our Chief Executive Officer, and includes Joan Sweeney, our Chief Operating Officer, Penni Roll, our Chief Financial Officer, John Fontana, Michael Grisius, Jeri Harman, Robert D. Long, Edward Ross, Daniel Russell, John Shulman and Thomas Westbrook. Each commercial real estate investment must be approved by our real estate investment committee, which is chaired by William Walton, our Chief Executive Officer, and includes Joan Sweeney, Penni Roll, Douglas Cooper, Michael Grisius, David Iannarone, Jordan Paul, and John Scheurer.

In addition to approval of the respective investment committee, each mezzanine or commercial real estate transaction that represents a commitment equal to or greater than $20 million, every buyout transaction, and any other investment that in our judgment demonstrates unusual risk/ reward characteristics also requires the approval of the Executive Committee of the Board of Directors. Our Executive Committee is comprised of Messrs. Walton, Firestone, Hebert, Leahy, Long and Steuart.

Each member of the Executive Committee of the Board of Directors and each member of the investment committees beneficially owns shares of our common stock with a value of more than $1,000,000, based on the closing price of $26.52 on April 4, 2005, on the New York Stock Exchange. The compensation for the members of our investment committees generally includes (i) base salary, (ii) annual bonus, (iii) individual performance award and/or individual bonus award, and (iv) stock options. Compensation for the members of our Executive Committee includes (i) annual retainer, (ii) attendance fee per committee meeting, and (iii) stock options. See Biographical Information and Compensation of Executive Officers and Directors for further information about the business experience as well as the structure and methods used to compensate our directors and executive officers.

Because each of the members of the Executive Committee and the members of the investment committees provide portfolio management services only to us, there are no conflicts of interest with respect to their management of other accounts or investment vehicles.

We are internally managed and our investment professionals manage our portfolio. These investment professionals have extensive experience in managing investments in private businesses in a variety of industries, and are familiar with our approach of lending and investing. Because we are internally managed, we pay no external investment advisory fees, but instead we pay the operating costs associated with employing investment management professionals.

Structure of Board of Directors

Our Board of Directors is classified into three approximately equal classes with three-year terms, with the term of office of only one of the three classes expiring each year. Directors serve until their successors are elected and qualified.

Directors

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons of Allied Capital as defined in the 1940 Act. Information regarding our Board of Directors is as follows:

Name	Age	Position	Director Since(1)	Expiration of Term
Interested Directors				
William L. Walton	55	Chairman, Chief Executive Officer and President	1986	2007
Joan M. Sweeney	45	Chief Operating Officer	2004	2007
Robert E. Long	73	Director	1972	2007
Independent Directors				
Brooks H. Browne	55	Director	1990	2007
John D. Firestone	61	Director	1993	2005
Anthony T. Garcia	48	Director	1991	2005
Ann Torre Grant	47	Director	2003	2006
Lawrence I. Hebert	58	Director	1989	2005
John I. Leahy	74	Director	1994	2006
Alex J. Pollock	62	Director	2003	2006
Marc F. Racicot(2)	56	Director	2005	2005
Guy T. Steuart II	73	Director	1984	2006
Laura W. van Roijen	53	Director	1992	2005

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

(2) Appointed to the Board of Directors on March 21, 2005.

Each director has the same address as Allied Capital, 1919 Pennsylvania Avenue, N.W., Washington, D.C. 20006.

Executive Officers

Information regarding our executive officers is as follows:

Name	Age	Position
William L. Walton	55	Chairman, Chief Executive Officer and President
Joan M. Sweeney	45	Chief Operating Officer
Penni F. Roll	39	Chief Financial Officer
Scott S. Binder	50	Chief Valuation Officer
Suzanne V. Sparrow	39	Chief Compliance Officer, Executive Vice President and Secretary
Douglas L. Cooper	43	Managing Director
N. John Fontana	46	Managing Director
Michael J. Grisius	41	Managing Director
Jeri J. Harman	47	Managing Director
Robert D. Long	48	Managing Director
Jordan C. Paul	43	Managing Director
Edward H. Ross	39	Managing Director
Daniel L. Russell	40	Managing Director
John M. Scheurer	52	Managing Director
John D. Shulman	42	Managing Director
Thomas H. Westbrook	41	Managing Director
Kelly A. Anderson	51	Executive Vice President and Treasurer
Timothy H. Pease	45	Senior Vice President and Director of Financial Operations

Each executive officer has the same address as Allied Capital, 1919 Pennsylvania Avenue, N.W., Washington, D.C. 20006.

Biographical Information

Directors

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons of Allied Capital as defined in the 1940 Act.

Interested Directors

William L. Walton has been the Chairman, Chief Executive Officer, and President of Allied Capital since 1997. Mr. Walton s previous work experience includes serving as a Managing Director of Butler Capital Corporation, a mezzanine buyout firm, the personal investment advisor to William S. Paley, founder of CBS, and a Senior Vice President in Lehman Brothers Kuhn Loeb s Merger and Acquisition Group. He also founded two education service companies Language Odyssey and SuccessLab. Mr. Walton is a director of Riggs National Corporation.

Joan M. Sweeney is the Chief Operating Officer of Allied Capital and has been employed by Allied Capital since 1993. Ms. Sweeney oversees Allied Capital s daily operations. Prior to joining Allied Capital, Ms. Sweeney was employed by Ernst & Young, Coopers & Lybrand, and the Division of Enforcement of the Securities and Exchange Commission.

Robert E. Long has been the Chief Executive Officer and a director of GLB Group, Inc. (investment management firm) since 1997 and has been the Chairman of Emerald City Radio Partners, LLC since 1997. Mr. Long was the President of Business News Network, Inc. (1995 to 1998), the Chairman and Chief Executive Officer of Southern Starr Broadcasting Group, Inc. (1991 to 1995), and a director and the President of Potomac Asset Management, Inc. (1983 to 1991). Mr. Long is a director of AmBase Corporation, CSC Scientific, Inc., and Advanced Solutions International, Inc. Mr. Long is the father of Robert D. Long, an executive officer of Allied Capital.

Independent Directors

Brooks H. Browne has been a private investor since 2002. Mr. Browne was the President of Environmental Enterprises Assistance Fund from 1993 to 2002, and is currently a member of the board of two non-profit organizations.

John D. Firestone has been a Partner of Secor Group since 1978. Mr. Firestone is a director of Security Storage Company of Washington, DC, and is currently a member of the board of several non-profit organizations.

Anthony T. Garcia has been a private investor since 2003. Mr. Garcia was Vice President of Finance of Formity Systems, Inc., a developer of software products for business management of data networks, from January 2002 through 2003. Mr. Garcia was a private investor from 2000 to 2001, the General Manager of Breen Capital Group (investor in tax liens) from 1997 to 2000, and a Senior Vice President of Lehman Brothers Inc. from 1985 to 1996.

Ann Torre Grant has been a strategic and financial consultant since 1997. From 1995 to 1997, Ms. Grant served as Executive Vice President, CFO and Treasurer of NHP, Inc., a national real estate services firm. From 1991 to 1995, Ms. Grant was Vice President and Treasurer of US Airways. She serves on the boards and audit committees of Franklin Mutual Series and SLM Corporation (Sallie Mae).

Lawrence I. Hebert has been a director and President and Chief Executive Officer of Riggs Bank N.A. (a subsidiary of Riggs National Corporation) since 2001. In 2005, Mr. Hebert was elected Chief Executive Officer of Riggs National Corporation subject to regulatory approval and has served as a director of Riggs National Corporation since 1988. Mr. Hebert also serves as a director of Riggs Investment Advisors and Riggs Bank Europe Limited (both indirect subsidiaries of Riggs National Corporation). Mr. Hebert previously served as Vice Chairman (1983 to 1998), President (1984 to 1998), and Chairman and Chief Executive Officer (1998 to 2001) of Allbritton Communications Company. Riggs Bank N.A. has a $60 million commitment under our revolving line of credit.

John I. Leahy has been the President of Management and Marketing Associates, a management consulting firm, since 1986. Mr. Leahy was the President and Group Executive Officer, Western Hemisphere of Black & Decker Corporation from 1982 to 1985. Mr. Leahy is a director of B&L Sales, Inc. and is Trustee Emeritus of the Sellinger School of Business, Loyola College, Maryland.

Alex J. Pollock has been a Resident Fellow at the American Enterprise Institute since 2004. He was President and Chief Executive Officer of the Federal Home Loan Bank of

Chicago from 1991 to 2004. He serves as a director of the Chicago Mercantile Exchange, Great Lakes Higher Education Corporation and the Great Books Foundation. Mr. Pollock is Past President of the International Union for Housing Finance and the Bankers Club of Chicago.

Marc F. Racicot has been an attorney at the law firm of Bracewell & Giuliani, LLP since 2001. He is a former Governor (1993 to 2001) and Attorney General (1989 to 1993) of the State of Montana. Mr. Racicot was appointed by President Bush to serve as the Chairman of the Republican National Committee (2002 to 2003) and he served as Chairman of the Bush/Cheney Re-election Committee (2003 to 2004). Mr. Racicot serves on the Board of Directors for Siebel Systems, Burlington Northern Santa Fe Corporation, Massachusetts Mutual Life Insurance Company, Jobs for America s Graduates, and the Board of Visitors for the University of Montana School of Law.

Guy T. Steuart II has been a director and President of Steuart Investment Company, which manages, operates, and leases real and personal property and holds stock in operating subsidiaries engaged in various businesses, since 1960 and has been Chairman of Steuart Investment Company since 2003. Mr. Steuart is Trustee Emeritus of Washington and Lee University.

Laura W. van Roijen has been a private investor since 1992. Ms. van Roijen was a Vice President at Citicorp from 1982 to 1992.

Executive Officers who are not Directors

Penni F. Roll, Chief Financial Officer, has been employed by Allied Capital since 1995. Ms. Roll is responsible for Allied Capital s financial operations. Prior to joining Allied Capital, Ms. Roll was employed by KPMG LLP.

Scott S. Binder, Chief Valuation Officer, has been employed by Allied Capital since 1997. He has served as Chief Valuation Officer since 2003, and has also worked in the private finance investment group. He served as a consultant to Allied Capital from 1991 until 1997. Prior to joining Allied Capital, Mr. Binder formed and was President of Overland Communications Group. He has also worked in the specialty finance and leasing industries.

Suzanne V. Sparrow, Executive Vice President, Chief Compliance Officer and Corporate Secretary, has been employed by Allied Capital since 1987. Ms. Sparrow manages Allied Capital s compliance and corporate governance activities.

Douglas L. Cooper, Managing Director, has been employed by Allied Capital in its commercial real estate investment group since 1999. Prior to joining Allied Capital, Mr. Cooper was a Senior Vice President at Criimi Mae, a real estate investment trust.

N. John Fontana, Managing Director, works in Allied Capital s private finance investment group and has been employed by Allied Capital since 2004. Prior to joining Allied Capital, Mr. Fontana was a Principal of Tigris, an operations consulting firm in the consumer products and manufacturing industries from 2002 to 2004. Mr. Fontana was a turnaround manager working for a series of private equity and venture capital firms from 1999 to 2002. He participated in the buyout and served as Chief Operating Officer of Electrolux, LLC from 1998 to 1999. Previously, he served as a Partner with Deloitte & Touche Consulting Group.

Michael J. Grisius, Managing Director, works in Allied Capital s private finance investment group and has been employed by Allied Capital since 1992. Prior to joining Allied Capital, Mr. Grisius worked in corporate finance at Chemical Bank and was employed by KPMG LLP.

Jeri J. Harman, Managing Director, works in Allied Capital s private finance investment group and has been employed by Allied Capital since 2004. Prior to joining Allied Capital, Ms. Harman served as a Managing Director and Principal for American Capital Strategies, Ltd. from 2000 until 2004. She worked as a Managing Director and Head of Private Placements for First Security Van Kasper (1996 to 2000) and a Managing Director of Coopers & Lybrand (1993 to 1996). From 1982 to 1993, Ms. Harman held various senior level positions in the private placement arm of The Prudential Insurance Company of America.

Robert D. Long, Managing Director, joined Allied Capital in its private finance investment group in 2002. Prior to joining Allied Capital, Mr. Long was Managing Director and Head of Investment Banking at C.E. Unterberg from 2001 to 2002, and Managing Director at E*OFFERING/Wit SoundView from 2000 to 2001. He also held management positions at Bank of America (Montgomery Securities) (1996 to 2000), and Nomura Securities International (1992 to 1996), and prior to that he served as a Managing Director at CS First Boston.

Jordan C. Paul, Managing Director, joined Allied Capital in its real estate group in 2004. Prior to joining Allied Capital, Mr. Paul was President of Aquila Property Company, a commercial real estate investment advisory firm, from 2000 to 2004. Prior to that, Mr. Paul was President of Llama Capital Mortgage Company (1999) and held positions earlier in his career at Ocwen Financial Corporation (1993 to 1998) and practiced law (1989 to 1993).

Edward H. Ross, Managing Director, joined Allied Capital in its private finance investment group in 2002. Prior to joining Allied Capital, Mr. Ross co-founded and served as a Managing Director of Leveraged Capital at Wachovia Securities (previously First Union Securities) from 1998 to 2002, a merchant banking arm for the firm. He also held management positions in First Union s Leveraged Finance Group (1994 to 1998).

Daniel L. Russell, Managing Director, joined Allied Capital in 1998, and works in the private finance investment group. Prior to joining Allied Capital, Mr. Russell was employed by KMPG LLP.

John M. Scheurer, Managing Director, leads the commercial real estate group and has been employed by Allied Capital in the commercial real estate investment group since 1991. Prior to joining Allied Capital, Mr. Scheurer worked in the commercial real estate business with his own company, The Scheurer Company, and co-founded Hunter Associates, a leasing and consulting real estate firm in the Washington, DC area. He worked for First American Bank in Washington, DC (1977 to 1984).

John D. Shulman, Managing Director, has been employed by Allied Capital in the private finance investment group since 2001. Prior to joining Allied Capital, Mr. Shulman served as the President and CEO of Onyx International, LLC from 1995 to 2001. He currently serves as a director of ChemLink Laboratories LLC and as a member of the investment committees of Taiwan Mezzanine Fund and Greater China Private Equity Fund.

Thomas H. Westbrook, Managing Director, has been employed by Allied Capital in the private finance investment group since 1991. Prior to joining Allied Capital, Mr. Westbrook worked with the North Carolina Enterprise Fund and was a Lending Officer in NationsBank s corporate lending unit.

Kelly A. Anderson, Executive Vice President and Treasurer, has been employed by Allied Capital since 1987. Ms. Anderson is responsible for Allied Capital s treasury, cash management and infrastructure operations.

Timothy H. Pease, Senior Vice President and Director of Financial Operations, has been employed by Allied Capital since 2003. Prior to joining Allied Capital, Mr. Pease was the Principal Accounting Officer for Amicus Holdings, Inc. from 2001 to 2002. He has also held senior accounting positions at Broadband Residential, Inc. (2000 to 2001) and Host Marriott Services Corporation (1998 to 2000). Mr. Pease also served as a senior manager at Arthur Andersen LLP. Mr. Pease is responsible for managing Allied Capital s accounting and loan servicing activities.

Committees of the Board of Directors

Our Board of Directors has established an Executive Committee, an Audit Committee, a Compensation Committee, and a Corporate Governance/Nominating Committee. The Audit Committee, Compensation Committee, and Corporate Governance/Nominating Committee each operate pursuant to a committee charter. The charter of each Committee is available on our web site at www.alliedcapital.com in the Investor Resources section.

The Executive Committee has and may exercise those rights, powers, and authority that the Board of Directors from time to time grants to it, except where action by the Board is required by statute, an order of the SEC, or our charter or bylaws. The Executive Committee has been delegated authority from the Board to review and approve certain investments. The Executive Committee met 43 times during 2004. The Executive Committee members currently are Messrs. Walton, Firestone, Hebert, Leahy, Long, and Steuart. Messrs. Hebert, Firestone, Leahy and Steuart are not interested persons of Allied Capital as defined in the 1940 Act. Messrs. Walton and Long are interested persons of the Company as defined in the 1940 Act.

The Audit Committee operates pursuant to a charter approved by the Board of Directors. The charter sets forth the responsibilities of the Audit Committee. The primary function of the Audit Committee is to serve as an independent and objective party to assist the Board of Directors in fulfilling its responsibilities for overseeing and monitoring the quality and integrity of Allied Capital s financial statements, the adequacy of Allied Capital s system of internal controls, the review of the independence, qualifications and performance of Allied Capital s independent registered public accounting firm, and the performance of Allied Capital s internal audit function. The Audit Committee met 16 times during 2004. The Audit Committee is presently composed of four persons, including Messrs. Browne (Chairman) and Garcia and Mmes. Grant and van Roijen, all of whom are considered independent under the rules promulgated by the New York Stock Exchange. The Board of Directors has determined that Mr. Browne and Ms. Grant are audit committee financial experts as defined under Item 401 of Regulation S-K of the Securities Exchange Act of 1934. Mr. Browne and Ms. Grant each meet the current independence and experience requirements of Rule 10A-3 of the Exchange Act and, in addition, are not interested persons of Allied Capital as defined in the 1940 Act.

The Compensation Committee approves management s recommendations for the compensation of our executive officers and reviews the amount of salary and bonus for each of our other officers and employees. In addition, the Compensation Committee approves stock option grants for our officers under our Amended Stock Option Plan, determines the individual performance awards and individual performance bonuses for participants and determines other compensation arrangements for employees. The Compensation Committee met 11 times during 2004. The Compensation Committee members currently are Messrs. Leahy (Chairman), Browne, and Garcia, each of whom is not an interested person of Allied Capital as defined in the 1940 Act.

The Corporate Governance/Nominating Committee recommends candidates for election as directors to the Board of Directors and makes recommendations to the Board as to our corporate governance policies. The Corporate Governance/Nominating Committee met once during 2004. The Corporate Governance/Nominating Committee members currently are Messrs. Hebert (Chairman), Browne, and Pollock and Ms. van Roijen, each of whom is not an interested person of Allied Capital as defined in the 1940 Act.

During 2004, the Board of Directors formed an ad hoc Markets Committee, which was established to monitor the market activity in the Company s common stock. The Markets Committee met informally from time to time during the year.

COMPENSATION OF EXECUTIVE OFFICERS AND DIRECTORS

Under SEC rules applicable to business development companies, we are required to set forth certain information regarding the compensation of certain executive officers and directors. The following table sets forth compensation paid during the year ended December 31, 2004, to all of our directors and our three highest paid executive officers (collectively, the Compensated Persons) in each capacity in which each Compensated Person served. Certain of the Compensated Persons served as both officers and directors.

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons as defined in the Investment Company Act of 1940.

Compensation Table

Name	Aggregate Compensation from the Company (1,2)	Securities Underlying Options/ SARs (3)	Pension or Retirement Benefits Accrued as Part of Company Expenses (2)	Directors Fees Paid by the Company (4)
Interested Directors:				
William L. Walton, *Chairman and CEO*	$5,292,081	400,000	$	$
Joan M. Sweeney, *Chief Operating Officer*	3,031,545	300,000		
Robert E. Long, *Director*	76,000	5,000		76,000
Independent Directors:				
Brooks H. Browne, *Director*	103,000	5,000		103,000
John D. Firestone, *Director*	79,000	5,000		79,000
Anthony T. Garcia, *Director*	95,000	5,000		95,000
Ann Torre Grant, *Director*	80,000	5,000		80,000
Lawrence I. Hebert, *Director*	82,500	5,000		82,500
John I. Leahy, *Director*	102,500	5,000		102,500
Alex J. Pollock, *Director*	41,500	5,000		41,500
Guy T. Steuart II, *Director*	76,000	5,000		76,000
Laura W. van Roijen, *Director*	79,000	5,000		79,000
Executive Officer:				
John M. Scheurer	2,119,459	150,000		

(1) We paid no perquisites in excess of the lesser of $50,000 or 10% of the Compensated Person s total salary and bonus for the year.

(2) The following table provides detail as to aggregate compensation paid for 2004 to our three highest paid executive officers, including the Chief Executive Officer:

	Salary	Bonus	IPA	Other Benefits
Mr. Walton	$1,457,692	$750,000	$2,949,976	$134,413
Ms. Sweeney	973,077	500,000	1,461,721	96,747
Mr. Scheurer	589,615	300,000	1,120,846	108,998

In 2004, the Board of Directors established individual performance awards. See also Individual Performance Award. Included for each executive officer in Other Benefits is, among other things, an employer contribution to the 401(k) Plan, a contribution to the Deferred Compensation Plan I, and health and dental insurance. See also Employment Agreements .

(3) See Stock Option Awards for terms of options granted in 2004.

(4) Consists only of directors fees we paid for 2004. Such fees are also included in the column titled Aggregate Compensation from the Company.

Compensation of Non-Officer Directors

Each non-officer director receives an annual retainer of $40,000. In addition, committee chairs receive an annual retainer of $5,000. For each committee meeting attended, Executive Committee members receive $1,000 per meeting; Audit Committee members receive $2,500 per meeting; and members of the Compensation and Corporate Governance/ Nominating Committees receive $1,500 per meeting.

Directors may choose to defer such fees through the Company s Deferred Compensation Plan, and may choose to invest such deferred income in shares of the Company s common stock through a trust.

Non-officer directors are eligible for stock option awards under our Amended Stock Option Plan pursuant to an exemptive order from the Securities and Exchange Commission. The terms of the order, which was granted in September 1999, provided for a one-time grant of 10,000 options to each non-officer director on the date that the order was issued, or on the date that any new director is elected by stockholders to the Board of Directors. Thereafter, each non-officer director will receive 5,000 options each year on the date of the Annual Meeting of Stockholders at the fair market value on the date of grant. See Amended Stock Option Plan.

Stock Option Awards

The following table sets forth the details relating to option grants in 2004 to Compensated Persons under our Amended Stock Option Plan, and the potential realizable value of each grant, as prescribed to be calculated by the SEC. See Amended Stock Option Plan.

Options Granted During 2004

Name	Number of Securities Underlying Options Granted	Percent of Total Options Granted In 2004 (1)	Exercise Price Per Share	Expiration Date	Potential Realizable Value at Assumed Annual Rates Of Stock Appreciation Over 10-Year Term (2) 5%	10%
Interested Directors:						
William L. Walton	400,000	4.90%	$28.98	3/11/14	$7,290,146	$18,474,663
Joan M. Sweeney	300,000	3.70	28.98	3/11/14	5,467,610	13,855,997
Robert E. Long	5,000	0.06	24.44	5/12/14	76,851	194,755
Independent Directors:						
Brooks H. Browne	5,000	0.06	24.44	5/12/14	76,851	194,755
John D. Firestone	5,000	0.06	24.44	5/12/14	76,851	194,755
Anthony T. Garcia	5,000	0.06	24.44	5/12/14	76,851	194,755
Ann Torre Grant	5,000	0.06	24.44	5/12/14	76,851	194,755
Lawrence I. Hebert	5,000	0.06	24.44	5/12/14	76,851	194,755
John I. Leahy	5,000	0.06	24.44	5/12/14	76,851	194,755
Alex J. Pollock	5,000	0.06	24.44	5/12/14	76,851	194,755
Guy T. Steuart II	5,000	0.06	24.44	5/12/14	76,851	194,755
Laura W. van Roijen	5,000	0.06	24.44	5/12/14	76,851	194,755
Executive Officer:						
John M. Scheurer	150,000	1.80	28.98	3/11/14	2,733,805	6,927,998

(1) In 2004, we granted options to purchase a total of 8,169,750 shares.

(2) Potential realizable value is calculated on 2004 options granted, and is net of the option exercise price but before any tax liabilities that may be incurred. These amounts represent certain assumed rates of appreciation, as mandated by the SEC. Actual gains, if any, on stock option exercises are dependent on the future performance of the shares, overall market conditions, and the continued employment by us of the option holder. The potential realizable value will not necessarily be realized.

The following table sets forth the details of option exercises by Compensated Persons during 2004 and the values of those unexercised options at December 31, 2004.

Option Exercises and Year-End Option Values

Name	Shares Acquired On Exercise	Value Realized (1)	Number of Securities Underlying Unexercised Options as of 12/31/04		Value of Unexercised In-the-Money Options as of 12/31/04 (2)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Interested Directors:						
William L. Walton	0	$ 0	2,336,035	504,066	$ 13,884,995	$ 881,565
Joan M. Sweeney	0	0	1,249,127	379,093	6,891,866	665,682
Robert E. Long	0	0	35,000	0	122,870	0
Independent Directors:					122,870	0
Brooks H. Browne	0	0	35,000	0	122,870	0
John D. Firestone	0	0	35,000	0	122,870	0
Anthony T. Garcia	0	0	35,000	0	122,870	0
Ann Torre Grant	0	0	15,000	0	49,200	0
Lawrence I. Hebert	0	0	35,000	0	122,870	0
John I. Leahy	0	0	35,000	0	122,870	0
Alex J. Pollock	6,800	41,838	5,000	0	7,000	0
Guy T. Steuart II	0	0	35,000	0	122,870	0
Laura W. van Roijen	0	0	35,000	0	122,870	0
Executive Officer:						
John M. Scheurer	73,373	715,132	869,781	238,282	4,253,449	543,378

(1) Value realized is calculated as the closing market price on the date of exercise, net of option exercise price, but before any tax liabilities or transaction costs. This is the deemed market value, which may actually be realized only if the shares are sold at that price.

(2) Value of unexercised options is calculated as the closing market price on December 31, 2004, ($25.84), net of the option exercise price, but before any tax liabilities or transaction costs. In-the-Money Options are options with an exercise price that is less than the market price as of December 31, 2004.

Employment Agreements

We entered into employment agreements in 2004 with William L. Walton, our Chairman and CEO, and Joan M. Sweeney, our Chief Operating Officer, each of whom is a Compensated Person. We also entered into an employment agreement in 2004 with Penni F. Roll, our Chief Financial Officer. Each of the agreements provides for a three-year term that extends one day at the end of every day during its length, unless either party provides written notice of termination of such extension. In that case, the agreement would terminate three years from such notification.

Each agreement specifies each executive s base salary compensation during the term of the agreement. The Compensation Committee has the right to increase the base salary during the term of the employment agreement. In addition, each employment agreement states that the Compensation Committee may provide, at their sole discretion, an annual cash bonus. This bonus is to be determined with reference to each executive s performance in accordance with performance criteria to be determined by the Compensation Committee in its sole discretion. Under each agreement, each executive is also entitled to participate in our Amended Stock Option Plan, and to receive all other awards and benefits previously granted to each executive including life insurance premiums.

The executive has the right to voluntarily terminate employment at any time with 30 days notice, and in such case, the employee will not receive any severance pay. Among other things, the employment agreements prohibit the solicitation of our employees in the event of an executive s departure for a period of two years.

If employment is terminated with cause, the employee will not receive any severance pay. If employment is terminated without cause during the term of the agreement, or within 24 months after a change in control, the executive shall be entitled to severance pay for a period not to exceed 36 months. Severance pay shall include three times the average base salary for the preceding three years, plus three times the average bonus compensation for the preceding three years, plus a lump sum amount equal to $3,178,000 for Mr. Walton and $2,831,000 for Ms. Sweeney. In the event of a change in control, each executive would be entitled to a tax equalization payment calculated in accordance with Section 280G of the Code on distributions to which the employee is entitled upon termination, and we would also provide compensation to offset any applicable excise tax penalties imposed on the executive under Section 4999 of the Code. Such severance pay shall be paid in two installments: 75% of such pay shall be paid at the time of separation, and 25% shall be paid on the second anniversary of such separation. Stock options would cease to vest during the severance period.

Under the employment agreements, a Change in Control means (i) the sale or other disposition of all or substantially all of Allied Capital s assets; or (ii) the acquisition, whether directly, indirectly, beneficially (within the meaning of Rule 13d-3 of the 1934 Act), or of record, as a result of a merger, consolidation or otherwise, of Allied Capital s securities representing fifteen percent (15%) or more of the aggregate voting power of Allied Capital s then outstanding common stock by any person (within the meaning of Section 13(d) and 14(d) of the 1934 Act), including, but not limited to, any corporation or group of persons acting in concert, other than (A) Allied Capital or our subsidiaries and/or (B) any employee pension benefit plan (within the meaning of Section 3(2) of the Employee Retirement Income Security Act of 1974) of Allied Capital or our subsidiaries, including a trust established pursuant to any such plan; or (iii) the individuals who were members of the Board of Directors as of the Effective Date (the Incumbent Board) cease to constitute at least two-thirds (2/3) of the Board; provided, however, that any director appointed by at least two-thirds (2/3) of the then Incumbent Board or nominated by at least two-thirds (2/3) of the Corporate Governance/ Nominating Committee of the Board of Directors (a majority of the members of the Corporate Governance/ Nominating Committee shall be members of the then Incumbent Board or appointees thereof), other than any director appointed or nominated in connection with, or as a result of, a threatened or actual proxy or control contest, shall be deemed to constitute a member of the Incumbent Board.

These employment agreements may be amended during 2005 as needed in order to conform to the requirements of the Jobs Creation Act of 2004.

Retention Agreements

In March 2005, we entered into a retention agreement with John M. Scheurer, Managing Director in the commercial real estate group, in connection with our consideration of strategic alternatives for the commercial real estate investment portfolio, including a sale, spin-out or recapitalization of all or part of our commercial real estate assets. This agreement expires on June 30, 2005, if a transaction has not been completed by that date.

If Allied Capital consummates a transaction, the agreement provides that we will pay Mr. Scheurer a one-time lump sum bonus of $500,000 if 1) he remains employed by us until the transaction is consummated; or 2) we terminate his employment without cause prior to the consummation of a transaction. If Allied Capital consummates a transaction and Mr. Scheurer is hired by an acquirer and either remains employed by the acquirer for at least 90 days following the transaction or is terminated by the acquirer without cause during such period, he will receive an additional $500,000. In addition, Mr. Scheurer will receive a supplemental payment of $600,000 if a transaction is consummated and he satisfies other conditions.

If Allied Capital consummates a transaction and an acquirer either 1) does not offer to employ Mr. Scheurer; 2) offers to employ Mr. Scheurer but at a base salary below $750,000; or 3) employs Mr. Scheurer but later terminates his employment for any reason other than for cause within the initial twelve months of employment, the agreement provides that we will pay Mr. Scheurer a one-time lump sum payment of $1,200,000. Should Mr. Scheurer remain with the acquirer for twelve months after the consummation of a transaction and receive compensation of less than $1,200,000 from the acquirer during the initial 12-month period, the agreement provides that we will pay Mr. Scheurer a one-time lump sum payment equal to the difference between the amount paid to him by the acquirer during such period and $1,200,000.

Allied Capital also entered into similar agreements with four other executives in the commercial real estate group, including Douglas Cooper and Jordan Paul, both of whom are Managing Directors in the commercial real estate group. These agreements expire on June 30, 2005, if a transaction has not been completed by that date.

If Allied Capital consummates a transaction, the agreement provides that we will pay the four executives, in the aggregate, one-time lump sum bonuses totaling $900,000 if 1) the individuals remain employed by us until the transaction is consummated; or 2) we terminate the individuals employment without cause prior to the consummation of a transaction. If Allied Capital consummates a transaction and the individuals are hired by an acquirer and either remain employed by the acquirer for at least 90 days following the transaction or are terminated by the acquirer without cause during such period, the individuals in the aggregate would receive an additional amount totaling $900,000.

If Allied Capital consummates a transaction and an acquirer either 1) does not offer to employ the individuals; 2) offers to employ the individuals but at a base salary below a certain threshold; or 3) employs the individuals but later terminates the individuals employment for any reason other than for cause or does not agree to pay a minimum compensation amount within the initial twelve months of employment, the agreement provides that we will pay the individuals, in the aggregate, one-time lump sum payments totaling up to $2,750,000.

Indemnification Agreements

We have entered into indemnification agreements with our directors and certain senior officers. The indemnification agreements are intended to provide these directors and senior officers the maximum indemnification permitted under Maryland law and the Investment Company Act of 1940. Each indemnification agreement provides that Allied Capital shall indemnify the director or senior officer who is a party to the agreement (an Indemnitee), including the advancement of legal expenses, if, by reason of his or her corporate status, the Indemnitee is, or is threatened to be, made a party to or a witness in any threatened, pending, or completed proceeding, other than a proceeding by or in the right of Allied Capital.

Compensation Plans

Amended Stock Option Plan

Our Amended Stock Option Plan is intended to encourage stock ownership in Allied Capital by officers and directors, thus giving them a proprietary interest in our performance. The Stock Option Plan was most recently approved by stockholders on May 12, 2004.

The Compensation Committee s principal objective in awarding stock options to our eligible officers and directors is to align each optionee s interests with our success and the financial interests of our stockholders by linking a portion of such optionee s compensation with the performance of our stock and the value delivered to stockholders.

Stock options are granted under the Amended Stock Option Plan at a price not less than the prevailing market value at the time of the grant and will have realizable value only if our stock price increases. The Compensation Committee determines the amount and features of the stock options, if any, to be awarded to optionees. The Compensation Committee evaluates a number of criteria, including the past service of each such optionee to Allied Capital, the present and potential contributions of such optionee to the success of Allied Capital, and such other factors as the Compensation Committee shall deem relevant in connection with accomplishing the purposes of the Amended Stock Option Plan, including the recipient s current stock holdings, years of service, position with Allied Capital, and other factors. The Compensation Committee does not apply a formula assigning specific weights to any of these factors when making its determination. The Compensation Committee awards stock options on a subjective basis and such awards depend in each case on the performance of the officer under consideration, and in the case of new hires, their potential performance.

We have received approval from the SEC to grant options under the Amended Stock Option Plan to non-officer directors. Pursuant to the SEC order, initially each incumbent non-officer director received options to purchase 10,000 shares and each will receive options to purchase 5,000 shares each year thereafter on the date of the annual meeting of stockholders. New non-officer directors receive options to purchase 10,000 shares upon election by stockholders to the Board of Directors, and options to purchase 5,000 shares each year thereafter, on the date of our annual meeting.

The Amended Stock Option Plan is designed to satisfy the conditions of Section 422 of the Code so that options granted under the Amended Stock Option Plan may qualify as incentive stock options. To qualify as incentive stock options, options may not become exercisable for the first time in any year if the number of incentive options first exercisable in that year multiplied by the exercise price exceeds $100,000.

401(k) Plan

We maintain a 401(k) plan (the 401(k) Plan). All full-time employees who are at least 21 years of age have the opportunity to contribute pre-tax salary deferrals into the 401(k) Plan up to $14,000 annually for the 2005 plan year, and to direct the investment of these contributions. Plan participants who reach the age of 50 during the 2005 plan year are eligible to defer an additional $4,000 during 2005. The 401(k) Plan allows eligible participants to invest in shares of our common stock, among other investment options. In addition, during the 2005 plan year, we expect to contribute up to 5% of each participant s eligible compensation for the year, up to a maximum compensation of $210,000, to each participant s plan account on the participant s behalf, which fully vests at the time of the contribution. The contribution with respect to compensation in excess of $210,000 is made to the Deferred Compensation Plan I. On February 25, 2005, the 401(k) Plan held less than 1% of our outstanding shares.

Individual Performance Award

The Compensation Committee has established a long-term incentive compensation program whereby the Compensation Committee of the Board of Directors determines an individual performance award for certain officers annually, generally at the beginning of each year. In determining the award for any one officer, the Compensation Committee considers individual performance factors, as well as the individual s contribution to the returns generated for stockholders, among other factors. The individual performance awards are deposited in a trust in approximately equal cash installments, on a quarterly basis, and the cash is used to purchase shares of our common stock in the market. See Compensation Plans Deferred Compensation Plan II below. The following table presents the individual performance awards that have been awarded by the Compensation Committee for 2005 to the Compensated Persons as well as for all other participants as a group:

Name and Position	2005 Individual Performance Award(1)
William L. Walton, *Chief Executive Officer*	$1,475,000
Joan M. Sweeney, *Chief Operating Officer*	750,000
John M. Scheurer, *Managing Director*	550,000
All Executive Officers as a Group (excluding the Compensated Persons)	3,385,500
Non-Executive Officers as a Group	1,345,000

(1) Represents individual performance awards expected to be expensed for financial reporting purposes for 2005 for these officers, assuming each participant remains employed by us throughout the year. These amounts are subject to change if there is a change in the composition of the pool of award recipients during the year.

Individual Performance Bonus

As a result of recent changes in regulation imposed by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting and retaining top performers in private equity firms, the Compensation Committee recommended to the Board and the Board has approved that for 2005 a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB for 2005 has been determined to be approximately $7.5 million. The IPB will be distributed in cash to award recipients in equal bi-weekly installments as long as each recipient remains employed by us. If a recipient terminates employment during the year, any remaining cash payments under the IPB would be forfeited. The following table presents the individual performance bonuses that have been awarded for 2005 for the Compensated Persons, as well as for all other recipients as a group:

Name and Position	2005 Individual Performance Bonus[(1)]
William L. Walton, *Chief Executive Officer*	$1,475,000
Joan M. Sweeney, *Chief Operating Officer*	750,000
John M. Scheurer, *Managing Director*	550,000
All Executive Officers as a Group (excluding the Compensated Persons)	3,385,500
Non-Executive Officers as a Group	1,345,000

(1) Represents individual performance bonuses expected to be expensed for financial reporting purposes for 2005 for these officers, assuming each recipient remains employed by us throughout the year. These amounts are subject to change if there is a change in the composition of the pool of award recipients during the year.

Deferred Compensation Plan I

We maintain a deferred compensation plan (the DCP I). The DCP I is an unfunded plan, as defined by the Code, that provides for the deferral of compensation by our directors, employees, and consultants. Any of our directors, senior officers, or consultants are eligible to participate in the plan at such time and for such period as designated by the Board of Directors. The DCP I is administered through a trust, and we fund this plan through cash contributions. Directors may choose to defer director s fees through the DCP I, and may choose to invest such deferred income in shares of our common stock through a trust. On February 25, 2005, the DCP I held 1,372 shares of our common stock. The DCP I may be amended during 2005 as needed in order to conform to the requirements of the Jobs Creation Act of 2004.

Deferred Compensation Plan II

In conjunction with the IPA, we established a non-qualified deferred compensation plan (DCP II) in 2004, which is administered through a trust by an independent third-party trustee. The individual performance awards are generally deposited in the trust in equal installments, on a quarterly basis, in the form of cash. The Compensation Committee designed the DCP II to require the trustee to use the cash to purchase shares of our common stock in the market. A participant only vests in the award as it is deposited into the trust. The Compensation Committee, in its sole discretion, shall designate the senior officers who will receive individual performance awards and participate in the DCP II. During any period of time in which a participant has a deferral account in the DCP II, any dividends declared and paid on shares of common stock allocated to the participant s account shall be reinvested by the trustee as soon as practicable in shares of our common stock purchased in the open market.

In the event of termination of employment, one-third of the participant s deferral account will be immediately distributed, one half of the then current remaining balance will be distributed on the first anniversary of his or her employment termination date, and the remainder of the account balance will be distributed on the second anniversary of the employment termination date. In the event of a change of control, which is defined in Employment Agreements, all amounts in a participant s deferral account will be immediately distributed to the participant.

The aggregate maximum number of shares of our common stock that the trustee is authorized to purchase in the open market for the purpose of investing the cash from individual performance awards is 3,500,000 shares, subject to appropriate adjustments in the event of a stock dividend, stock split, or similar change in capitalization affecting the Company s common stock. On February 25, 2005, the DCP II held 506,065 shares of our common stock.

A participant who violates certain non-solicitation covenants contained in the DCP II during the two years after the termination of his or her employment will forfeit back to us the remaining value of his or her deferral account.

The DCP II is administered by the Compensation Committee of our Board of Directors. The Board of Directors reserves the right to amend, terminate, or discontinue DCP II, provided that no such action will adversely affect a participant s rights under DCP II with respect to the amounts paid to his or her deferral account. The DCP II may be amended during 2005 as needed in order to conform to the requirements of the Jobs Creation Act of 2004.

CONTROL PERSONS AND PRINCIPAL HOLDERS OF SECURITIES

As of March 21, 2005, there were no persons that owned 25% or more of our outstanding voting securities, and no person would be deemed to control us, as such term is defined in the 1940 Act.

The following table sets forth, as of March 21, 2005, each stockholder who owned more than 5% of our outstanding shares of common stock, each director, the chief executive officer, our executive officers and our directors and executive officers as a group. Unless otherwise indicated, we believe that each beneficial owner set forth in the table has sole voting and investment power.

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons as defined in the Investment Company Act of 1940.

Name of Beneficial Owner	Number of Shares Owned Beneficially(1)	Percentage of Class(2)	Dollar Range of Equity Securities Beneficially Owned by Directors(3)
Capital Research and Management Company	7,646,020(4)	5.7%	
333 South Hope Street, 55th Floor			
Los Angeles, CA 90071-1447			
Interested Directors:			
William L. Walton	3,090,004(5,6,7)	2.3%	over $100,000
Joan M. Sweeney	1,618,904(5)	1.2%	over $100,000
Robert E. Long	47,111(8)	*	over $100,000
Independent Directors:			
Brooks H. Browne	78,713(7,8)	*	over $100,000
John D. Firestone	67,426(7,8)	*	over $100,000
Anthony T. Garcia	93,512(8)	*	over $100,000
Ann Torre Grant	18,500(7,8)	*	over $100,000
Lawrence I. Hebert	56,800(8)	*	over $100,000
John I. Leahy	52,318(8)	*	over $100,000
Alex J. Pollock	20,617(7,8,9)	*	over $100,000
Marc F. Racicot	0		
Guy T. Steuart II	359,144(8,10)	*	over $100,000
Laura W. van Roijen	67,079(7,8)	*	over $100,000
Executive Officers:			
Kelly A. Anderson	254,165(5)	*	
Scott S. Binder	708,676(5,7,11)	*	
Douglas L. Cooper	340,461(5,7)	*	
N. John Fontana	76,910(5)	*	
Michael J. Grisius	521,184(5,7)	*	
Jeri J. Harman	75,000(5)		
Robert D. Long	685,846(5,7,12)	*	
Jordan C. Paul	75,000(5)	*	
Timothy H. Pease	54,572(5)		
Penni F. Roll	547,652(5)	*	
Edward H. Ross	367,661(5)	*	
Daniel L. Russell	240,234(5)	*	
John M. Scheurer	1,180,355(5)	*	
John D. Shulman	633,327(5)	*	

Name of Beneficial Owner	Number of Shares Owned Beneficially(8)	Percentage of Class(1)
Suzanne V. Sparrow	417,353(5,6)	*
Thomas H. Westbrook	925,430(5,7)	*
All directors and executive officers as a group(29 in number)	12,389,419(13)	8.7%

* Less than 1%

(1) Beneficial ownership has been determined in accordance with Rule 16a-1(a)(2) of the Securities Exchange Act of 1934.

(2) Based on a total of 133,509,037 shares of our common stock issued and outstanding on March 21, 2005, and 9,574,778 shares of our common stock issuable upon the exercise of stock options exercisable within 60 days held by executive officers and non-officer directors.

(3) Beneficial ownership has been determined in accordance with Rule 16a-1(a)(2) of the Securities Exchange Act of 1934.

(4) Information regarding share ownership was obtained from the Schedule 13G/A that Capital Research and Management Company filed with the SEC on February 7, 2005.

(5) Share ownership for the following directors and executive officers includes:

	Owned Directly	Owned Through Deferred Compensation Plan II	Options Exercisable Within 60 Days of March 21, 2005	Allocated to 401(k) Plan
Interested Directors:				
William L. Walton	444,797	112,769	2,336,035	6,922
Joan M. Sweeney	298,966	55,877	1,249,127	14,934
Executive Officers:				
Kelly A. Anderson	112,160	4,943	131,781	5,281
Scott S. Binder	77,709	26,204	602,935	1,828
Douglas L. Cooper	16,354	10,839	312,604	664
N. John Fontana	0	1,910	75,000	0
Michael J. Grisius	55,522	18,804	429,562	17,296
Jeri J. Harman	0	0	75,000	0
Robert D. Long	21,000	22,569	639,903	2,374
Jordan C. Paul	0	0	75,000	0
Timothy H. Pease	1,100	971	52,501	0
Penni F. Roll	83,096	16,467	438,127	9,962
Edward H. Ross	8,500	17,769	341,392	0
Daniel L. Russell	1,060	9,979	229,195	0
John M. Scheurer	279,936	42,845	821,781	35,793
John D. Shulman	4,799	17,966	610,562	0
Suzanne V. Sparrow	78,930	5,373	136,647	24,472
Thomas H. Westbrook	171,487	33,817	720,126	0

(6) Includes 196,403 shares held by the 401(k) Plan, of which Mr. Walton and Ms. Sparrow are sub-trustees of the fund holding our shares. The sub-trustees disclaim beneficial ownership of such shares.

(7) Includes certain shares held in IRA or Keogh accounts: Walton 12,015 shares; Browne 12,280 shares; Firestone 3,415 shares; Grant 3,500 shares; Pollock 1,000 shares; van Roijen 6,623 shares; Binder 273 shares; Cooper 1,309 shares; Grisius 1,061 shares; R.D. Long 17,000 shares; Westbrook 16,365 shares.

(8) Beneficial ownership for these non-officer directors includes exercisable options to purchase 35,000 shares, except with respect to Ms. Grant who has exercisable options to purchase 15,000 shares, and Mr. Pollock who has exercisable options to purchase 5,000 shares.

(9) Includes 2,417 shares held in the Deferred Compensation Plan for Mr. Pollock.

(10) Includes 276,691 shares held by a corporation for which Mr. Steuart serves as an executive officer.

(11) Includes 10,000 shares held in a charitable remainder trust.

(12) Includes 4,000 shares held by a trust for the benefit of Mr. Long s children.

(13) Includes a total of 9,574,778 shares underlying stock options exercisable within 60 days of March 21, 2005, which are assumed to be outstanding for the purpose of calculating the group s percentage ownership, and 196,403 shares held by the 401(k) Plan.

CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

The following table sets forth certain information, as of March 21, 2005, regarding indebtedness to Allied Capital in excess of $60,000 of any person serving as a director or executive officer of Allied Capital at any time since January 1, 2004. All of such indebtedness results from loans we made to enable the exercise of stock options. The loans are required to be fully collateralized and are full recourse against the borrower and have varying terms not exceeding ten years. The interest rates charged generally reflect the applicable federal rate on the date of the loan. As of December 31, 2004, the total loans outstanding to such executive officers of Allied Capital was $5.5 million or 0.2% of Allied Capital s total assets at December 31, 2004.

As a business development company under the Investment Company Act of 1940, we are entitled to provide and have provided loans to our officers in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, we are prohibited from making new loans to our executive officers since July 30, 2002.

Name and Position with Company	Highest Amount Outstanding During 2004	Range of Interest Rates		Amount Outstanding at March 21, 2005
Executive Officers who are Interested Directors(1):				
William L. Walton, *Chairman and Chief Executive Officer*	$2,416,230	4.45%	6.24%	$
Joan M. Sweeney, *Director and Chief Operating Officer*	$2,231,157	4.45%	6.63%	$ 399,962
Executive Officers:				
Penni F. Roll, *Chief Financial Officer*	$1,273,924	4.45%	6.24%	$1,174,832
Scott S. Binder, *Chief Valuation Officer*	$ 297,923	4.93%	4.93%	$
Douglas L. Cooper, *Managing Director*	$ 282,845	4.45%	4.98%	$ 276,845
Michael J. Grisius, *Managing Director*	$ 242,788	3.91%	4.68%	$ 230,727
John M. Scheurer, *Managing Director*	$2,058,996	4.73%	6.63%	$ 167,453
John D. Shulman, *Managing Director*	$ 99,991	2.85%	2.85%	$ 99,991
Thomas H. Westbrook, *Managing Director*	$ 370,134	4.98%	4.98%	$ 370,134
Kelly A. Anderson, *Executive Vice President and Treasurer*	$1,432,225	3.91%	6.34%	$ 469,225
Suzanne V. Sparrow, *Chief Compliance Officer and Secretary*	$ 713,809	4.45%	6.18%	$ 626,309

(1) Interested directors are interested persons as defined by the Investment Company Act of 1940.

TAX STATUS

The following discussion is a general summary of the material United States federal income tax considerations applicable to us and to an investment in our common stock. This summary does not purport to be a complete description of the income tax considerations applicable to such an investment. The discussion is based upon the Internal Revenue Code (the Code), Treasury Regulations, and administrative and judicial interpretations, each as of the date of this prospectus and all of which are subject to change. You should consult your own tax advisor with respect to tax considerations that pertain to your purchase of our common stock.

This summary is intended to apply to investments in our common stock and assumes that investors hold our common stock as capital assets. This summary does not discuss all aspects of federal income taxation relevant to holders of our common stock in light of particular circumstances, or to certain types of holders subject to special treatment under federal income tax laws, including dealers in securities, pension plans and trusts and financial institutions. This summary does not discuss any aspects of U.S. estate and gift tax or foreign, state or local tax. It does not discuss the special treatment under federal income tax laws that could result if we invested in tax-exempt securities or certain other investment assets.

Except as specifically indicated herein, this summary is intended to apply to U.S. Stockholders (as defined below) and does not purport to discuss all U.S. federal income tax consequences to persons who are not U.S. Stockholders (Non-U.S. Stockholders) from an investment in our common stock. (A U.S. Stockholder is a stockholder who is (i) a citizen or resident of the United States, (ii) a corporation or partnership created in or organized under the laws of the United States or any political subdivision thereof, (iii) an estate, the income of which is subject to United States federal income taxation regardless of its source, or (iv) a trust subject to the supervision of a court within the United States and the control of a United States person.) Non-U.S. Stockholders should consult their own tax advisors to discuss the consequences of an investment in our common stock.

Taxation as a Regulated Investment Company

We intend to be treated for tax purposes as a regulated investment company under Subchapter M of Chapter 1 of the Code. If we (i) qualify as a regulated investment company and (ii) distribute to stockholders in a timely manner at least 90% of our investment company taxable income, as defined in the Code (i.e., net ordinary investment income, including accrued original issue discount, and net short-term capital gain in excess of net long-term capital loss) (the 90% Distribution Requirement) each year, we generally will not be subject to federal income tax on the portion of our investment company taxable income and net capital gain (i.e., net long-term capital gain in excess of net short-term capital loss) we distribute (or treat as deemed distributed) to stockholders. (We will, however, be subject to such tax to the extent that, prior to February 2, 2013, BLX sells property held by BLX, Inc. on the date of its corporate reorganization, but only to the extent (i) such property had a built-in gain (that is, value in excess of tax basis) on such date and (ii) such built-in gain is recognized on such sale.) In addition, we are generally required to distribute in a timely manner an amount at least equal to the sum of (i) 98% of our ordinary income for each calendar year, (ii) 98% of our capital gain net income for the one-year period ending December 31 of that calendar year, and (iii) any income not distributed in prior years, in order to avoid the 4% nondeductible federal excise tax on certain undistributed income of regulated investment companies (the Excise Tax Avoidance Requirements). If we do not satisfy the excise tax avoidance requirements for any year, we will be required to pay this 4% excise tax on the undistributed ordinary income or net capital gain income. The ordinary income or net capital gain income on which the excise tax is paid is generally carried forward and distributed to shareholders in the next tax year. Depending on the level of ordinary income or net capital gain income for a tax year, we may choose to carry forward the portion of such income in excess of our current year distributions into the next tax year and pay the 4% excise tax on such income, as required. We will be subject to federal income tax at the regular corporate rate for any amounts of investment company taxable income or net capital gain not distributed (or deemed distributed) to our stockholders.

In order to qualify as a regulated investment company for federal income tax purposes, we must, among other things: (a) continue to qualify as a business development company under the 1940 Act; (b) derive in each taxable year at least 90% of our gross income from (i) dividends, interest, payments with respect to securities loans, gains from the sale of stock or other securities, or other income derived with respect to our business of investing in such stock or securities or (ii) net income derived from an interest in a qualified publicly traded partnership (the 90% Income Test); and (c) diversify our holdings so that at the end of each quarter of the taxable year (i) at least 50% of the value of our assets consists of cash, cash items, U.S. government securities, securities of other regulated investment companies, and other securities if such other securities of any one issuer do not represent more than 5% of our assets or more than 10% of the outstanding voting securities of the issuer, and (ii) no more than 25% of the value of our assets is invested in the securities of any one issuer (other than U.S. government securities or securities of other regulated investment companies), the securities of two or more issuers that are controlled (as determined under applicable Code rules) by us and are engaged in the same or similar or related trades or businesses, or the securities of one or more qualified publicly traded partnerships (the Diversification Tests). The failure of one or more of our subsidiaries to continue to qualify as regulated investment companies could adversely affect our ability to satisfy the Diversification Tests.

If we acquire or are deemed to have acquired debt obligations that were issued originally at a discount or that otherwise are treated under applicable tax rules as having original issue discount or market discount, we must include in income each year a portion of the original issue discount that accrues over the life of the obligation regardless of whether cash representing such income is received by us in the same taxable year. Any amount accrued as original issue discount will be included in our investment company taxable income for the year of accrual and may have to be distributed to our stockholders in order to satisfy the 90% Distribution Requirement or the Excise Tax Avoidance Requirements even though we have not received any cash representing such income.

Although we do not currently intend to do so, if we were to invest in certain options, futures, or forward contracts, we may be required to report income from such investments on a mark-to-market basis, which could result in us recognizing unrealized gains and losses for federal income tax purposes even though we may not realize such gains and losses when we ultimately dispose of such investments. We could also be required to treat such gains and losses as 60% long-term capital gain or loss and 40% short-term capital gain or loss regardless of our holding period for the investments. In addition, if we were to engage in certain hedging transactions, including hedging transactions in options, future contracts, and straddles, or other similar transactions, we could be subject to special tax rules (including constructive sale, mark-to-market, straddle, wash sale, and short sale rules), the effect of which may be to accelerate our income, defer our losses, cause adjustments in the holding periods of our securities, convert long-term capital gains into short-term capital gains or convert short-term capital losses into long-term capital losses. These rules could affect our investment company taxable income or net capital gain for a taxable year and thus affect the amounts that we would be required to distribute to our stockholders pursuant to the 90% Distribution Requirement and the Excise Tax Avoidance Requirements for such year.

Although we do not presently expect to do so, we are authorized to borrow funds and to sell assets in order to satisfy distribution requirements. However, under the 1940 Act, we are not permitted to make distributions to stockholders while our debt obligations and other senior securities are outstanding unless certain asset coverage tests are met. Moreover, our ability to dispose of assets to meet our distribution requirements may be limited by other requirements relating to our status as a regulated investment company, including the Diversification Tests. If we dispose of assets in order to meet the 90% Distribution Requirement or the Excise Tax Avoidance Requirements, we may make such dispositions at times that, from an investment standpoint, are not advantageous.

If we fail to satisfy the 90% Distribution Requirement or otherwise fail to qualify as a regulated investment company in any taxable year, we will be subject to tax in that year on all of our taxable income, regardless of whether we make any distributions to our stockholders. In that case, all of our distributions to our stockholders will be characterized as ordinary income (to the extent of our current and accumulated earnings and profits), although such distributions would constitute qualified dividend income to individual shareholders subject to the same reduced maximum rate of tax applicable to long-term capital gains. In contrast, as is explained below, if we qualify as a regulated investment company, a portion of our distributions or deemed distributions may be characterized as long-term capital gain in the hands of our stockholders.

The remainder of this summary assumes that we qualify as a regulated investment company and satisfy the 90% Distribution Requirement.

Taxation of Stockholders

Our distributions generally are taxable to stockholders as ordinary income or capital gains. Our distributions of investment company taxable income will be taxable as ordinary income to stockholders to the extent of our current or accumulated earnings and profits, whether paid in cash or reinvested in additional common stock (including any dividends reinvested through our dividend reinvestment plan). A portion of our distributions of investment company taxable income may constitute qualified dividend income. Qualified dividend income of individual shareholders currently is subject to the same reduced maximum rate of tax applicable to long-term capital gains. Our distributions of net capital gains properly designated by us as capital gain dividends will be taxable to each stockholder as long-term capital gains regardless of the stockholder s holding period for his or her common stock and regardless of whether paid in cash or reinvested in additional common stock (including any dividends reinvested through our dividend reinvestment plan). Distributions in excess of the Company s earnings and profits will be designated as a return of capital and first will reduce a stockholder s adjusted tax basis in such stockholder s common stock and, after the adjusted basis is reduced to zero, will generally constitute capital gains to such stockholder.

At our option, we may elect to retain some or all of our net capital gains for a tax year, but designate the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount for the benefit of our stockholders, the stockholders will be required to report their share of the deemed distribution on their tax returns as if it had been distributed to them, and the stockholders will report a credit for the tax paid thereon by us. The amount of the deemed distribution net of such tax will be added to the stockholder s cost basis for his or her common stock. Since we would be required to pay tax at our regular corporate capital gain tax rate on any retained net capital gains which are deemed to be distributed, and since that rate is in excess of the maximum rate currently payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid and for which they will receive a credit will exceed the amount of tax that such stockholders would be required to pay on the retained net capital gains. Such excess generally will be available to offset other tax liabilities of the stockholders. A stockholder that does not have a sufficient amount of other tax liabilities or that is not subject to U.S. federal income tax should be able to file a return on the appropriate form or a claim for refund that allows such stockholder to recover the taxes paid on his or her behalf. In the event we select this option, we must provide written notice to the stockholders prior to the expiration of 60 days after the close of the relevant tax year.

Any dividend declared by us in October, November, or December of any calendar year, payable to stockholders of record on a specified date in such a month and actually paid during January of the following year, will be treated as if it had been received by the stockholders on December 31 of the year in which the dividend was declared to the extent of earnings and profits for the calendar year.

You should consider the tax implications of buying common stock just prior to a distribution. Even if the price of the common stock includes the amount of the forthcoming distribution, you may be taxed upon receipt of the distribution and will not be entitled to offset the distribution against the tax basis in your common stock.

You may recognize taxable gain or loss if you sell or exchange your common stock. The amount of the gain or loss will be measured by the difference between your adjusted tax basis in your common stock and the amount of the proceeds you receive in exchange for such stock. Any gain or loss arising from the sale or exchange of common stock generally will be a capital gain or loss. This capital gain or loss normally will be treated as a long-term capital gain or loss if you have held your common stock for more than one year; otherwise, it will be classified as short-term capital gain or loss. However, any capital loss arising from the sale or exchange of common stock held for six months or less generally will be treated as a long-term capital loss to the extent of the amount of capital gain dividends received (or treated as deemed distributed) with respect to such stock and, for this purpose, the special rules of Section 852(b)(4)(C) of the Code generally apply in determining the holding period of such stock. In addition, all or a portion of any loss realized upon a taxable disposition of common stock will be disallowed if other shares of our common stock are purchased (under our dividend reinvestment plan or otherwise) within 30 days before or after the disposition.

In general, non-corporate stockholders currently are subject to a maximum federal income tax rate on their net long-term capital gain (the excess of net long-term capital gain over net short-term capital loss) for a taxable year (including a long-term capital gain derived from an investment in our common stock) which is lower than the maximum rate for other income (excluding other income that constitutes a qualified dividend income).

Corporate taxpayers currently are subject to federal income tax on net capital gains at a maximum rate equal to the maximum rate applied to ordinary income. Non-corporate stockholders with net capital losses for a year (i.e., capital losses in excess of capital gains) generally may deduct up to $3,000 of such losses against their ordinary income each year; any net capital losses of a non-corporate stockholder in excess of $3,000 generally may be carried forward and used in subsequent years as provided in Section 1212(b) of the Code. Corporate stockholders generally may not deduct any net capital losses for a year, but may carryback such losses for three years or carry forward such losses for five years, but only to the extent of capital gains in those years.

We will send to each of our stockholders, as promptly as possible after the end of each calendar year, a notice detailing, on a per share and per distribution basis, the amounts includible in such stockholder s taxable income for such year as ordinary income (including the amount of any qualified dividend income) and as long-term capital gains. In addition, the federal tax status of each year s distributions generally will be reported to the IRS. Distributions may also be subject to additional state, local, and foreign taxes depending on a stockholder s particular situation. Our ordinary income dividends to corporate stockholders may, if certain conditions are met, qualify for the dividends received deduction to the extent that we have received qualifying dividend income during the taxable year; capital gain dividends distributed by us are not eligible for the dividends received deduction.

A Non-U.S. Stockholder may be subject to withholding of U.S. federal tax at a 30% rate (or lower applicable treaty rate) on distributions (including certain redemptions of common stock) from us. However, the portion of our distributions that are properly designated by us as long-term capital gain dividends, short-term capital gain dividends or interest-related dividends may be exempt from such withholding if you have provided to us (or another appropriate withholding agent) in a timely manner a properly completed Form W-8BEN or applicable form. Non-U.S. Stockholders should consult their own tax advisors with respect to the appropriate forms to file to avoid withholding tax and for all other issues concerning U.S. federal income and withholding tax, and state, local, and foreign tax, consequences of an investment in our common stock.

We may be required to withhold U.S. federal income tax (backup withholding) at a 28% rate from all taxable distributions payable to (i) any stockholder who fails to furnish us with its correct taxpayer identification number or a certificate that the stockholder is exempt from backup withholding, and (ii) any stockholder with respect to whom the IRS notifies us that the stockholder has failed to properly report certain interest and dividend income to the IRS and to respond to notices to that effect. We may be required to report annually to the IRS and to each Non-U.S. Stockholder the amount of dividends paid to such stockholder and the amount, if any, of tax withheld pursuant to the backup withholding rules with respect to such dividends. This information may also be made available to the tax authorities in the Non-U.S. Stockholder s country of residence. Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules from payments made to a stockholder may be refunded or credited against such stockholder s United States federal income tax liability, if any, provided that the required information is furnished to the IRS.

You should consult your own tax advisor with respect to the particular tax consequences to you of an investment in us, including the possible effect of any pending legislation or proposed regulation.

CERTAIN GOVERNMENT REGULATIONS

We operate in a highly regulated environment. The following discussion generally summarizes certain government regulations.

Business Development Company. A business development company is defined and regulated by the 1940 Act. A business development company must be organized in the United States for the purpose of investing in or lending to primarily private companies and making managerial assistance available to them. A business development company may use capital provided by public shareholders and from other sources to invest in long-term, private investments in businesses. A business development company provides shareholders the ability to retain the liquidity of a publicly traded stock, while sharing in the possible benefits, if any, of investing in primarily privately owned companies.

As a business development company, we may not acquire any asset other than qualifying assets unless, at the time we make the acquisition, the value of our qualifying assets represent at least 70% of the value of our total assets. The principal categories of qualifying assets relevant to our business are:

- Securities purchased in transactions not involving any public offering, the issuer of which is an eligible portfolio company;
- Securities received in exchange for or distributed with respect to securities described in the bullet above or pursuant to the exercise of options, warrants or rights relating to such securities; and
- Cash, cash items, government securities or high quality debt securities (within the meaning of the 1940 Act), maturing in one year or less from the time of investment.

An eligible portfolio company is generally a domestic company that is not an investment company (other than a small business investment company wholly owned by a business development company, such as our investment in Allied Investment Corporation) and that:

- does not have a class of securities with respect to which a broker may extend margin credit at the time the acquisition is made;
- is actively controlled by the business development company and has an affiliate of a business development company on its board of directors; or
- meets such other criteria as may be established by the SEC.

Control as defined by the 1940 Act is presumed to exist where a business development company beneficially owns more than 25% of the outstanding voting securities of the portfolio company.

To include certain securities described above as qualifying assets for the purpose of the 70% test, a business development company must make available to the issuer of those securities significant managerial assistance such as providing significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company. We offer to provide significant managerial assistance to our portfolio companies. See Risk Factors Our ability to invest in private companies may be limited in certain circumstances.

As a business development company, we are entitled to issue senior securities in the form of stock or senior securities representing indebtedness, including debt securities and preferred stock, as long as each class of senior security has an asset coverage of at least 200% immediately after each such issuance. In addition, while any senior securities remain outstanding, we must make provisions to prohibit any distribution to our shareholders unless we meet the applicable asset coverage ratio at the time of the distribution. This limitation is not applicable to borrowings by our small business investment company subsidiary, and therefore any borrowings by this subsidiary are not included in this asset coverage test pursuant to exemptive relief. See Risk Factors.

We may also be prohibited under the 1940 Act from knowingly participating in certain transactions with our affiliates without the prior approval of our Board of Directors who are not interested persons and, in some cases, prior approval by the SEC. We have been granted an exemptive order by the SEC permitting us to engage in certain transactions that would be permitted if we and our subsidiaries were one company and permitting certain transactions among our subsidiaries, subject to certain conditions and limitations.

We have designated a chief compliance officer and established a compliance program pursuant to the requirements of the 1940 Act. We are periodically examined by the SEC for compliance with the 1940 Act.

As with other companies regulated by the 1940 Act, a business development company must adhere to certain substantive regulatory requirements. A majority of our directors must be persons who are not interested persons, as that term is defined in the 1940 Act. Additionally, we are required to provide and maintain a bond issued by a reputable fidelity insurance company to protect us against larceny and embezzlement. Furthermore, as a business development company, we are prohibited from protecting any director or officer against any liability to us or our shareholders arising from willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person s office.

We maintain a code of ethics that establishes procedures for personal investment and restricts certain transactions by our personnel. Our code of ethics generally does not permit investment by our employees in securities that may be purchased or held by us. The code of ethics is filed as an exhibit to our registration statement which is on file with the SEC. You may read and copy the code of ethics at the SEC s Public Reference Room in Washington, D.C. You may obtain information on operations of the Public Reference Room by calling the SEC at (202) 942-8090. In addition, the code of ethics is available on the EDGAR Database on the SEC Internet site at http://www.sec.gov. You may obtain copies of the code of ethics, after paying a duplicating fee, by electronic request at the following email address: publicinfo@sec.gov, or by writing to the SEC s Public Reference Section, 450 5th Street, NW, Washington, D.C. 20549. Our code of ethics is also posted on our website at www.alliedcapital.com.

As a business development company under the 1940 Act, we are entitled to provide and have provided loans to our officers in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, we have been prohibited from making new loans to our executive officers since July 2002.

We may not change the nature of our business so as to cease to be, or withdraw our election as, a business development company unless authorized by vote of a majority of the outstanding voting securities, as defined in the 1940 Act. A majority of the outstanding voting securities of a company is defined under the 1940 Act as the lesser of: (i) 67% or more of such company s shares present at a meeting if more than 50% of the outstanding shares of such company are present and represented by proxy or (ii) more than 50% of the outstanding shares of such company.

Small Business Administration Regulations. Allied Investment Corporation, a wholly owned subsidiary of Allied Capital, is licensed by the Small Business Administration as a small business investment company under Section 301(c) of the Small Business Investment Act of 1958, and has elected to be regulated as a business development company.

Small business investment companies are designed to stimulate the flow of private equity capital to eligible small businesses. Under present Small Business Administration regulations, eligible small businesses include businesses that have a tangible net worth not exceeding $18 million and have average annual fully taxed net income not exceeding $6 million for the two most recent fiscal years. In addition, a small business investment company must devote 20% of its investment activity to smaller concerns as defined by the Small Business Administration. A smaller concern is one that has a tangible net worth not exceeding $6 million and has average annual fully taxed net income not exceeding $2 million for the two most recent fiscal years. Small Business Administration regulations also provide alternative size standard criteria to determine eligibility, which depend on the industry in which the business is engaged and are based on such factors as the number of employees and gross sales. According to Small Business Administration regulations, small business investment companies may make loans to small businesses, invest in the equity securities of such businesses, and provide them with consulting and advisory services. Allied Investment provides long-term loans to qualifying small businesses; equity investments and consulting and advisory services are typically provided only in connection with such loans.

Allied Investment is periodically examined and audited by the Small Business Administration s staff to determine its compliance with small business investment company regulations.

We, through Allied Investment, have debentures payable to the Small Business Administration with contractual maturities 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 $119.0 million from the Small Business Administration. At December 31, 2004, we had $77.5 million outstanding and the Small Business Administration had a commitment to lend up to an additional $7.3 million above the amount outstanding. The commitment expires on September 30, 2005.

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

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

Dividends declared and paid by the Company in a year generally differ from taxable income for that year as such dividends may include the distribution of current year taxable income, the distribution of prior year taxable income carried forward into and distributed in the current year, or returns of capital. We are generally required to distribute 98% of our taxable income (and 100% of any previously undistributed taxable income) during the year the income is earned to avoid paying an excise tax. If this requirement is not met, the Code imposes a nondeductible excise tax equal to 4% of the amount by which 98% of the current year s taxable income (and 100% of any previously undistributed taxable income) exceeds the distribution for the year. The taxable income on which an excise tax is paid is generally carried forward and distributed to shareholders in the next year. Depending on the level of taxable income earned in a tax year, we may choose to carry forward taxable income in excess of current year distributions into the next tax year and pay a 4% excise tax on such income, as required.

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 asset diversification requirements as defined in the Code; and (4) timely distribute to shareholders at least 90% of our annual investment company taxable income as defined in the Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

Compliance with the Sarbanes-Oxley Act of 2002 and NYSE Corporate Governance Regulations. The Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) imposes a wide variety of regulatory requirements on publicly held companies and their insiders. Many of these requirements apply to us, including:

Our Chief Executive Officer and Chief Financial Officer certify the accuracy of the financial statements contained in our periodic reports, and so certified through the filing of Section 302 certifications;

Our periodic reports disclose our conclusions about the effectiveness of our disclosure controls and procedures;

Our annual report on Form 10-K contains a report from our management on internal control over financial reporting, including a statement that our management is responsible for establishing and maintaining adequate internal control over financial reporting as well as our management s assessment of the effectiveness of our internal control over financial reporting, which must be audited by our independent registered public accounting firm;

Our periodic reports disclose whether there were significant changes in our internal control over financial reporting or in other factors that could significantly affect our internal control over financial reporting subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses; and

We may not make any loan to any director or executive officer and we may not materially modify any existing loans.

We have adopted procedures to comply with the Sarbanes-Oxley Act and the regulations promulgated thereunder. We will continue to monitor our compliance with all future regulations that are adopted under the Sarbanes-Oxley Act and will take actions necessary to ensure that we are in compliance therewith.

Proxy Voting Policies and Procedures

We vote proxies relating to our portfolio securities in the best interest of our shareholders. We review on a case-by-case basis each proposal submitted to a shareholder vote to determine its impact on the portfolio securities held by us. Although we generally vote against proposals that may have a negative impact on our portfolio securities, we may vote for such a proposal if there exists compelling long-term reasons to do so.

Our proxy voting decisions are made by the senior officers who are responsible for monitoring each of our investments. To ensure that our vote is not the product of a conflict of interest, we require that: (i) anyone involved in the decision making process disclose to our Chief Compliance Officer any potential conflict that he or she is aware of and any contact that he or she has had with any interested party regarding a proxy vote; and (ii) employees involved in the decision making process or vote administration are prohibited from revealing how we intend to vote on a proposal in order to reduce any attempted influence from interested parties.

Shareholders may obtain information regarding how we voted proxies with respect to our portfolio securities by making a written request for proxy voting information to: Corporate Secretary, Allied Capital Corporation, 1919 Pennsylvania Avenue, N.W., Washington, D.C. 20006.

STOCK TRADING PLANS AND OWNERSHIP GUIDELINES

During the second quarter of 2004, our Board of Directors established a policy to permit our officers and directors to enter into trading plans to sell shares of our common stock in accordance with Rule 10b5-1 of the Securities Act of 1934. The policy allows our participating officers and directors to adopt a pre-arranged stock trading plan to buy or sell pre-determined amounts of our shares of common stock over a period of time. Our Board of Directors established the policy in recognition of the liquidity and diversification objectives of our officers and directors, including the desire of certain of our officers and directors to sell certain shares of our common stock (such as formula award shares that they had acquired in connection with the 1997 merger of the five Allied Capital affiliated companies and shares of our common stock they acquired upon exercise of stock options).

Our Board of Directors also established a retained stock ownership policy for our officers and directors who enter into any trading plans pursuant to Rule 10b5-1. The policy aligns the interests of our officers and directors with the interests of shareholders and further promotes our commitment to sound corporate governance. The policy requires that our officers and directors who chose to sell pursuant to Rule 10b5-1 not sell in any one year more than 10% of their owned shares of our common stock and more than 10% of their shares of our common stock issuable upon the exercise of vested employee stock options.

DIVIDEND REINVESTMENT PLAN

We currently maintain a dividend reinvestment plan that provides for reinvestment of our distributions on behalf of our shareholders by our transfer agent. The dividend reinvestment plan is an opt in plan, which means that if our Board of Directors declares a cash dividend then our shareholders that have not opted in to our dividend reinvestment plan will receive cash dividends, rather than reinvesting dividends in additional shares of common stock.

To enroll in the dividend reinvestment plan, each shareholder must complete an enrollment status form and return it to the plan agent. The plan agent shall then automatically reinvest any dividend in additional shares of common stock. You may change your status in the dividend reinvestment plan at any time by contacting our transfer agent and plan administrator in writing.

A shareholder s ability to participate in a dividend reinvestment plan may be limited according to how the shares of common stock are held. A nominee may preclude beneficial owners holding shares in street name from participating in the dividend reinvestment plan. Shareholders who wish to participate in a dividend reinvestment plan may need to hold their shares of common stock in their own name. Shareholders who hold shares in the name of a nominee should contact the nominee for details.

All distributions to investors who do not participate (or whose nominee elects not to participate) in the dividend reinvestment plan will be paid directly, or through the nominee, to the record holder by or under the discretion of the plan agent. The plan agent is American Stock Transfer and Trust Company, 59 Maiden Lane, New York, New York 10038. Their telephone number is (800) 937-5449.

Under the dividend reinvestment plan, we may issue new shares unless the market price of the outstanding shares of common stock is less than 110% of the last reported net asset value. Alternatively, the plan agent may buy shares of common stock in the market. We value newly issued shares of common stock for the dividend reinvestment plan at the average of the reported last sale prices of the outstanding shares of common stock on the last five trading days prior to the payment date of the distribution, but not less than 95% of the opening bid price on such date. The price in the case of shares bought in the market will be the average actual cost of such shares of common stock, including any brokerage commissions. There are no other fees charged to shareholders in connection with the dividend reinvestment plan. Any distributions reinvested under the plan will nevertheless remain taxable to the shareholders.

DESCRIPTION OF CAPITAL STOCK

The following summary description is based on relevant portions of the Maryland General Corporation Law and our charter and bylaws. This summary is not necessarily complete, and we refer you to the Maryland General Corporation Law and our charter and bylaws for a detailed description of the provisions summarized below.

Capital Stock

Our authorized capital stock consists of 200,000,000 shares, $0.0001 par value per share, all of which has been initially designated as common stock. Our Board of Directors may classify and reclassify any unissued shares of our capital stock by setting or changing in one or more respects the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications, terms or conditions or redemption or other rights of such shares of capital stock.

Common Stock

At April , 2005, there were shares of common stock outstanding and shares of common stock reserved for issuance under our amended stock option plan. The following are the outstanding classes of securities of Allied Capital as of April , 2005:

	(1) Title of Class	(2) Amount Authorized	(3) Amount Held by Us or for Our Account	(4) Amount Outstanding Exclusive of Amounts Shown Under(3)
Allied Capital Corporation	Common Stock	200,000,000		

All shares of common stock have equal rights as to earnings, assets, dividends and voting and all outstanding shares of common stock are fully paid and non-assessable. Distributions may be paid to the holders of common stock if and when declared by our Board of Directors out of funds legally available therefor. Our common stock has no preemptive, exchange, conversion, or redemption rights and is freely transferable, except where their transfer is restricted by federal and state securities law or by contract. In the event of liquidation, dissolution or winding-up of Allied Capital, each share of common stock is entitled to share ratably in all of our assets that are legally available for distributions after payment of all debts and liabilities and subject to any prior rights of holders of preferred stock, if any, then outstanding. Each share of common stock is entitled to one vote on all matters submitted to a vote of shareholders, including the election of directors. Except as provided with respect to any other class or series of capital stock, the holders of our common stock will possess exclusive voting power. There is no cumulative voting in the election of directors, which means that holders of a majority of the shares, if they so choose, could elect all of the directors, and holders of less than a majority of the shares would, in that case, be unable to elect any director. All shares of common stock offered hereby will be, when issued and paid for, fully paid and non-assessable.

Preferred Stock

Our charter authorizes our Board of Directors to classify and reclassify any unissued shares of stock into other classes or series of stock, including preferred stock. Prior to issuance of shares of each class or series, the Board of Directors is required by Maryland law and by our charter to set the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption for each class or series. Thus, the Board of Directors could authorize the issuance of shares of preferred stock with terms and conditions which could have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for holders of our common stock or otherwise be in their best interest.

In addition, any issuance of preferred stock must comply with the requirements of the 1940 Act. The 1940 Act requires, among other things, that (1) immediately after issuance and before any dividend or other distribution is made with respect to our common stock, such preferred stock together with all other senior securities must not exceed an amount equal to 50% of our total assets after deducting the amount of such dividend or distribution, as the case may be, and (2) the holders of shares of preferred stock, if any are issued, must be entitled as a class to elect two directors at all times and to elect a majority of the directors if dividends on such preferred stock are in arrears by two years or more.

Limitation on Liability of Directors and Officers; Indemnification and Advance of Expenses

We have adopted provisions in our charter limiting the liability of our directors and officers for monetary damages. The effect of these provisions in the charter is to eliminate the rights of Allied Capital and its shareholders (through shareholders derivative suits on our behalf) to recover monetary damages against a director or officer for breach of the fiduciary duty of care as a director or officer (including breaches resulting from negligent behavior) except for liability resulting from (i) actual receipt of an improper benefit or profit in money, property or services or (ii) active and deliberate dishonesty established by a final judgment as being material to the cause of action. These provisions do not limit or eliminate the rights of Allied Capital or any shareholder to seek non-monetary relief such as an injunction or rescission in the event of a breach of a director s or officer s duty of care. These provisions will not alter the liability of directors or officers under federal securities laws.

Our charter and bylaws authorize us, to the maximum extent permitted by Maryland law and subject to the requirements of the 1940 Act, to indemnify any present or former director or officer or any individual who, while a director and at our request, serves or has served another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or other enterprise as a director, officer, partner or trustee, from and against any claim or liability to which that person may become subject or which that person may incur by reason of his or her status as a present or former director or officer and to pay or reimburse their reasonable expenses in advance of final disposition of a proceeding. The charter and bylaws also permit us to indemnify and advance expenses to any person who served a predecessor of us in any of the capacities described above and any of our employees or agents or any employees or agents of our predecessor. In accordance with the 1940 Act, we will not indemnify any person for any liability to which such person would be subject by reason of such person s willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office.

Maryland law requires a corporation (unless its charter provides otherwise, which our charter does not) to indemnify a director or officer who has been successful, on the merits or otherwise, in the defense of any proceeding to which he or she is made a party by reason of his or her service in that capacity. Maryland law permits a corporation to indemnify its present and former directors and officers, among others, against judgments, penalties, fines, settlements and reasonable expenses actually incurred by them in connection with any proceeding to which they may be made a party by reason of their service in those or other capacities unless it is established that (a) the act or omission of the director or officer was material to the matter giving rise to the proceeding and (1) was committed in bad faith or (2) was the result of active and deliberate dishonesty, (b) the director or officer actually received an improper personal benefit in money, property or services or (c) in the case of any criminal proceeding, the director or officer had reasonable cause to believe that the act or omission was unlawful. However, under Maryland law, a Maryland corporation may not indemnify for an adverse judgment in a suit by or in the right of the corporation or for a judgment of liability on the basis that a personal benefit was improperly received, unless in either case a court orders indemnification, and then only for expenses. In addition, Maryland law permits a corporation to advance reasonable expenses to a director or officer upon the corporation s receipt of (a) a written affirmation by the director or officer of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification by the corporation and (b) a written undertaking by him or her or on his or her behalf to repay the amount paid or reimbursed by the corporation if it is ultimately determined that the standard of conduct was not met.

We have entered into indemnification agreements with our directors and certain our of senior officers. The indemnification agreements provide these directors and senior officers the maximum indemnification permitted under Maryland law and the 1940 Act.

Certain Anti-Takeover Provisions

Our charter and bylaws and certain statutory and regulatory requirements contain certain provisions that could make more difficult the acquisition of Allied Capital by means of a tender offer, a proxy contest or otherwise. These provisions are expected to discourage certain types of coercive takeover practices and inadequate takeover bids and to encourage persons seeking to acquire control of us to negotiate first with the Board of Directors. We believe that the benefits of these provisions outweigh the potential disadvantages of discouraging such proposals because, among other things, negotiation of such proposals might result in an improvement of their terms. The description set forth below is intended only to be a summary of certain of our anti-takeover provisions and is qualified in its entirety by reference to our charter and the bylaws.

Classified Board of Directors

Our bylaws provide for our Board of Directors to be divided into three classes of directors serving staggered three-year terms, with each class to consist as nearly as possible of one-third of the directors then elected to the board. A classified board may render more difficult a change in control of Allied Capital or removal of incumbent management. We believe, however, that the longer time required to elect a majority of a classified Board of Directors helps to ensure continuity and stability of our management and policies.

Issuance of Preferred Stock

Our Board of Directors, without shareholder approval, has the authority to reclassify authorized but unissued common stock as preferred stock and to issue preferred stock. Such stock could be issued with voting, conversion or other rights designed to have an anti-takeover effect.

Number of Directors; Vacancies; Removal

Our charter provides that the number of directors will be set only by the Board of Directors in accordance with our bylaws. Our bylaws provide that a majority of our entire Board of Directors may at any time increase or decrease the number of directors. However, unless our bylaws are amended, the number of directors may never be less than three nor more than fifteen. Except as may be provided by the Board of Directors in setting the terms of any class or series of preferred stock, any and all vacancies on the Board of Directors may be filled only by the affirmative vote of a majority of the remaining directors in office, even if the remaining directors do not constitute a quorum, and any director elected to fill a vacancy will serve for the remainder of the full term of the directorship in which the vacancy occurred and until a successor is elected and qualified.

Our bylaws provides that a director may be removed by shareholders only with cause and then only by the affirmative vote of at least a majority of the votes entitled to be cast in the election of directors.

Action by Shareholders

Under the Maryland General Corporation Law, shareholder action can be taken only at an annual or special meeting of shareholders or by unanimous written consent in lieu of a meeting. These provisions, combined with the requirements of our bylaws regarding the calling of a shareholder-requested special meeting of shareholders discussed below, may have the effect of delaying consideration of a shareholder proposal until the next annual meeting.

Advance Notice Provisions for Shareholder Nominations and Shareholder Proposals

Our bylaws provide that with respect to an annual meeting of shareholders, nominations of persons for election to the Board of Directors and the proposal of business to be considered by shareholders may be made only (1) pursuant to our notice of the meeting, (2) by the Board of Directors or (3) by a shareholder who is entitled to vote at the meeting and who has complied with the advance notice procedures of the bylaws. With respect to special meetings of shareholders, only the business specified in our notice of the meeting may be brought before the meeting. Nominations of persons for election to the Board of Directors at a special meeting may be made only (1) pursuant to our notice of the meeting, (2) by the Board of Directors or (3) provided that the Board of Directors has determined that directors will be elected at the meeting, by a shareholder who is entitled to vote at the meeting and who has complied with the advance notice provisions of the bylaws.

The purpose of requiring shareholders to give us advance notice of nominations and other business is to afford our Board of Directors a meaningful opportunity to consider the qualifications of the proposed nominees and the advisability of any other proposed business and, to the extent deemed necessary or desirable by our Board of Directors, to inform shareholders and make recommendations about such qualifications or business, as well as to provide a more orderly procedure for conducting meetings of shareholders. Although our bylaws do not give our Board of Directors any power to disapprove shareholder nominations for the election of directors or proposals recommending certain action, they may have the effect of precluding a contest for the election of directors or the consideration of shareholder proposals if proper procedures are not followed and of discouraging or deterring a third party from conducting a solicitation of proxies to elect its own slate of directors or to approve its own proposal without regard to whether consideration of such nominees or proposals might be harmful or beneficial to us and our shareholders.

Calling of Special Meetings of Shareholders

Our bylaws provide that special meetings of shareholders may be called by our Board of Directors and certain of our officers. Additionally, our bylaws provide that, subject to the satisfaction of certain procedural and informational requirements by the shareholders requesting the meeting, a special meeting of shareholders will be called by our Corporate Secretary upon the written request of shareholders entitled to cast not less than a majority of all the votes entitled to be cast at such meeting.

Amendments; Supermajority Vote Requirements

Our bylaws impose supermajority vote requirements in connection with the amendment of provisions of our bylaws, including those provisions relating to the classified Board of Directors, the ability of shareholders to call special meetings and the advance notice provisions for shareholder meetings.

Maryland General Corporation Law

We are subject to the Maryland Business Combination Statute and the Control Share Acquisition Statute, as defined below. The partial summary of the foregoing statutes contained in this prospectus is not intended to be complete and reference is made to the full text of such statutes for their entire terms.

Business Combination Statute. Certain provisions of the Maryland General Corporation Law establish special requirements with respect to business combinations between Maryland corporations and interested shareholders unless exemptions are applicable (the Business Combination Statute). Among other things, the Business Combination Statute prohibits for a period of five years a merger or other specified transactions between a company and an interested shareholder and requires a supermajority vote for such transactions after the end of such five-year period.

Interested shareholders are all persons owning beneficially, directly or indirectly, 10% or more of the outstanding voting stock of a Maryland corporation. Business combinations include certain mergers or similar transactions subject to a statutory vote and additional transactions involving transfer of assets or securities in specified amounts to interested shareholders or their affiliates.

Unless an exemption is available, a business combination may not be consummated between a Maryland corporation and an interested shareholder or its affiliates for a period of five years after the date on which the shareholder first became an interested shareholder and thereafter may not be consummated unless recommended by the board of directors of the Maryland corporation and approved by the affirmative vote of at least 80% of the votes entitled to be cast by all holders of outstanding shares of voting stock and 66 2/3% of the votes entitled to be cast by all holders of outstanding shares of voting stock other than the interested shareholder or its affiliates or associates, unless, among other things, the corporation s shareholders receive a minimum price (as defined in the Business

Combination Statute) for their shares and the consideration is received in cash or in the same form as previously paid by the interested shareholder for its shares.

A business combination with an interested shareholder which is approved by the board of directors of a Maryland corporation at any time before an interested shareholder first becomes an interested shareholder is not subject to the five-year moratorium or special voting requirements. An amendment to a Maryland corporation s charter electing not to be subject to the foregoing requirements must be approved by the affirmative vote of at least 80% of the votes entitled to be cast by all holders of outstanding shares of voting stock and 66 2/3% of the votes entitled to be cast by holders of outstanding shares of voting stock who are not interested shareholders. Any such amendment is not effective until 18 months after the vote of shareholders and does not apply to any business combination of a corporation with a shareholder who became an interested shareholder on or prior to the date of such vote.

Control Share Acquisition Statute. The Maryland General Corporation Law imposes limitations on the voting rights of shares acquired in a control share acquisition. The control share statute defines a control share acquisition to mean the acquisition, directly or indirectly, of control shares subject to certain exceptions. Control shares of a Maryland corporation are defined to be voting shares of stock which, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors with one of the following ranges of voting power:

(1) one-tenth or more but less than one-third;

(2) one-third or more but less than a majority; or

(3) a majority of all voting power.

The requisite shareholder approval must be obtained each time an acquiror crosses one of the thresholds of voting power set forth above. Control shares do not include shares which the acquiring person is entitled to vote as a result of having previously obtained shareholder approval. Control shares of a Maryland corporation acquired in a control share acquisition have no voting rights except to the extent approved by a vote of two-thirds of the votes entitled to be cast by shareholders in the election of directors, excluding shares of stock as to which the acquiring person, officers of the corporation and directors of the corporation who are employees of the corporation are entitled to exercise or direct the exercise of the voting power of the shares in the election of the directors.

The control share statute also requires Maryland corporations to hold a special meeting at the request of an actual or proposed control share acquiror generally within 50 days after a request is made with the submission of an acquiring person statement, but only if the acquiring person:

(1) gives a written undertaking and, if required by the directors of the issuing corporation, posts a bond for the cost of the meeting; and

(2) submits definitive financing agreements for the acquisition of the control shares to the extent that financing is not provided by the acquiring person.

In addition, unless the issuing corporation s charter or bylaws provide otherwise, the control share statute provides that the issuing corporation, within certain time limitations, shall have the right to redeem control shares (except those for which voting rights have previously been approved) for fair value as determined pursuant to the control share statute in the event:

(1) there is a shareholder vote and the grant of voting rights is not approved; or

(2) an acquiring person statement is not delivered to the target within 10 days following a control share acquisition.

Moreover, unless the issuing corporation s charter or bylaws provide otherwise, the control share statute provides that if, before a control share acquisition occurs, voting rights are accorded to control shares which result in the acquiring person having majority voting power, then all shareholders other than the acquiring person have appraisal rights as provided under the Maryland General Corporation Law. An acquisition of shares may be exempted from the control share statute provided that a charter or bylaw provision is adopted for such purpose prior to the control share acquisition by any person with respect to Allied Capital. The control share acquisition statute does not apply to shares acquired in a merger, consolidation or share exchange to which the corporation is a party.

Regulatory Restrictions

Allied Investment, our wholly owned subsidiary, is a small business investment company. The Small Business Administration prohibits, without prior Small Business Administration approval, a change of control or transfers which would result in any person (or group of persons acting in concert) owning 10% or more of any class of capital stock of a small business investment company. A change of control is any event which would result in a transfer of the power, direct or indirect, to direct the management and policies of a small business investment company, whether through ownership, contractual arrangements or otherwise.

PLAN OF DISTRIBUTION

We may offer, from time to time, up to 20,000,000 shares of our common stock. We may sell the shares of our common stock through underwriters or dealers, directly to one or more purchasers, through agents or through a combination of any such methods of sale. Any underwriter or agent involved in the offer and sale of the shares of our common stock will be named in the applicable prospectus supplement.

The distribution of the shares of our common stock may be effected from time to time in one or more transactions at a fixed price or prices, which may be changed, at prevailing market prices at the time of sale, at prices related to such prevailing market prices, or at negotiated prices, provided, however, that the offering price per share of our common stock, less any underwriting commissions or discounts, must equal or exceed the net asset value per share of our common stock at the time of the offering.

In connection with the sale of the shares of our common stock, underwriters or agents may receive compensation from us or from purchasers of the shares of our common stock, for whom they may act as agents, in the form of discounts, concessions or commissions. Underwriters may sell shares of our common stock to or through dealers and such dealers may receive compensation in the form of discounts, concessions or commissions from the underwriters and/or commissions from the purchasers for whom they may act as agents. Underwriters, dealers and agents that participate in the distribution of shares of our common stock may be deemed to be underwriters under the Securities Act, and any discounts and commissions they receive from us and any profit realized by them on the resale of shares of our common stock may be deemed to be underwriting discounts and commissions under the Securities Act. Any such underwriter or agent will be identified and any such compensation received from us will be described in the applicable prospectus supplement.

Any common stock sold pursuant to a prospectus supplement will be quoted on the New York Stock Exchange, or another exchange on which the common stock is traded.

Under agreements into which we may enter, underwriters, dealers and agents who participate in the distribution of shares of our common stock may be entitled to indemnification by us against certain liabilities, including liabilities under the Securities Act. Underwriters, dealers and agents may engage in transactions with, or perform services for, us in the ordinary course of business.

If so indicated in the applicable prospectus supplement, we will authorize underwriters or other persons acting as our agents to solicit offers by certain institutions to purchase shares of our common stock from us pursuant to contracts providing for payment and delivery on a future date. Institutions with which such contracts may be made include commercial and savings banks, insurance companies, pension funds, investment companies, educational and charitable institutions and others, but in all cases such institutions must be approved by us. The obligations of any purchaser under any such contract will be subject to the condition that the purchase of shares of our common stock shall not at the time of delivery be prohibited under the laws of the jurisdiction to which such purchaser is subject. The underwriters and such other agents will not have any responsibility in respect of the validity or performance of such contracts. Such contracts will be subject only to those conditions set forth in the prospectus supplement, and the prospectus supplement will set forth the commission payable for solicitation of such contracts.

The maximum commission or discount to be received by any member of the National Association of Securities Dealers, Inc. or independent broker-dealer will not be greater than 10% for the sale of any securities being registered and 0.5% for due diligence.

In order to comply with the securities laws of certain states, if applicable, shares of our common stock offered hereby will be sold in such jurisdictions only through registered or licensed brokers or dealers.

LEGAL MATTERS

The legality of shares of our common stock offered hereby will be passed upon for us by Sutherland Asbill & Brennan LLP, Washington, D.C. Certain legal matters will be passed upon for underwriters, if any, by the counsel named in the prospectus supplement.

SAFEKEEPING, TRANSFER AND DIVIDEND PAYING AGENT

AND REGISTRAR

Our investments are held in safekeeping by Riggs Bank, N.A., 808 17th Street, N.W., Washington, D.C. 20006, as well as by LaSalle National Bank, 25 Northwest Point Boulevard, Suite 800, Elk Grove Village, Illinois 60007. American Stock Transfer and Trust Company, 59 Maiden Lane, New York, New York 10038 acts as our transfer, dividend paying and reinvestment plan agent and registrar.

BROKERAGE ALLOCATION AND OTHER PRACTICES

Since we generally acquire and dispose of our investments in privately negotiated transactions, we infrequently use brokers in the normal course of business.

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The consolidated financial statements as of December 31, 2004 and 2003, and for each of the years in the three-year period ended December 31, 2004, and the related financial statement schedule as of December 31, 2004, have been included herein in reliance upon the reports of KPMG LLP, independent registered public accounting firm, appearing elsewhere herein, and upon the authority of said firm as experts in accounting and auditing.

NOTICE REGARDING ARTHUR ANDERSEN LLP

Section 11(a) of the Securities Act provides that if any part of a registration statement at the time it becomes effective contains an untrue statement of a material fact or an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring a security pursuant to such registration statement, unless it is proved that at the time of such acquisition such person knew of such untruth or omission, may sue, among others, every accountant who has consented to be named as having prepared or certified any part of the registration statement or as having prepared or certified any report or valuation which is used in connection with the registration statement with respect to the statement in such registration statement, report or valuation which purports to have been prepared or certified by the accountant. Certain condensed consolidated financial data as of December 31, 2001 and 2000, and for the years then ended, which is included in this prospectus, was audited by our former independent auditor, Arthur Andersen LLP.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Allied Capital Corporation:

We have audited the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries as of December 31, 2004 and 2003, including the consolidated statement of investments as of December 31, 2004, and the related consolidated statements of operations, changes in net assets and cash flows, and the financial highlights (included in Note 15), for each of the years in the three-year period ended December 31, 2004. These consolidated financial statements and financial highlights are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included physical counts of securities owned as of December 31, 2004 and 2003. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Allied Capital Corporation and subsidiaries as of December 31, 2004 and 2003, and the results of their operations, their cash flows, changes in their net assets, and financial highlights for each of the years in the three-year period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles.

Our audits were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating balance sheet and related consolidating statements of operations and cash flows are presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Allied Capital Corporation s internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 14, 2005, expressed an unqualified opinion on management s assessment of, and the effective operation of, internal control over financial reporting.

Washington, D.C.

March 14, 2005

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	December 31, 2004	December 31, 2003
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2004-$1,389,342; 2003-$755,024)	$1,359,641	$ 900,317
Companies 5% to 25% owned (cost: 2004-$194,750; 2003-$195,600)	188,902	218,305
Companies less than 5% owned (cost: 2004-$800,828; 2003-$955,507)	753,543	784,050
Total private finance (cost: 2004-$2,384,920; 2003-$1,906,131)	2,302,086	1,902,672
Commercial real estate finance (cost: 2004-$722,612; 2003-$694,929)	711,325	681,927
Total portfolio at value (cost: 2004-$3,107,532; 2003-$2,601,060)	3,013,411	2,584,599
Deposits of proceeds from sales of borrowed Treasury securities	38,226	98,527
Accrued interest and dividends receivable	79,489	53,079
Other assets	72,712	69,498
Cash and cash equivalents	57,160	214,167
Total assets	$3,260,998	$3,019,870
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures (maturing within one year: 2004-$169,000; 2003-$221,000)	$1,064,568	$ 954,200
Revolving line of credit	112,000	
Obligations to replenish borrowed Treasury securities	38,226	98,525
Accounts payable and other liabilities	66,426	46,568
Total liabilities	1,281,220	1,099,293
Commitments and contingencies		
Preferred stock		6,000
Shareholders equity:		
Common stock, $0.0001 par value, 200,000,000 shares authorized; 133,098,807 and 128,117,985 shares issued and outstanding at December 31, 2004 and 2003, respectively	13	13
Additional paid-in capital	2,094,421	1,985,652
Common stock held in deferred compensation trust	(13,503)	

Notes receivable from sale of common stock	(5,470)	(18,632)
Net unrealized appreciation (depreciation) on portfolio	(107,767)	(39,055)
Undistributed (distributions in excess of) earnings	12,084	(13,401)
Total shareholders equity	1,979,778	1,914,577
Total liabilities and shareholders equity	$3,260,998	$3,019,870
Net asset value per common share	$ 14.87	$ 14.94

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 Years Ended December 31, 2004	2003	2002
Interest and Related Portfolio Income:			
Interest and dividends			
Companies more than 25% owned	$ 91,710	$ 62,563	$ 40,185
Companies 5% to 25% owned	25,702	25,727	28,629
Companies less than 5% owned	202,230	202,429	195,228
Total interest and dividends	319,642	290,719	264,042
Loan prepayment premiums			
Companies more than 25% owned		141	
Companies 5% to 25% owned	765	685	200
Companies less than 5% owned	4,737	7,346	2,576
Total loan prepayment premiums	5,502	8,172	2,776
Fees and other income			
Companies more than 25% owned	29,774	18,862	25,344
Companies 5% to 25% owned	1,618	629	1,123
Companies less than 5% owned	10,554	10,847	16,643
Total fees and other income	41,946	30,338	43,110
Total interest and related portfolio income	367,090	329,229	309,928
Expenses:			
Interest	75,650	77,233	70,443
Employee	40,728	36,945	33,126
Individual performance award	13,011		
Administrative	35,686	22,387	21,504
Total operating expenses	165,075	136,565	125,073
Net investment income before income taxes	202,015	192,664	184,855
Income tax expense (benefit)	1,057	(2,466)	930
Net investment income	200,958	195,130	183,925
Net Realized and Unrealized Gains (Losses)			
Net realized gains (losses)			
Companies more than 25% owned	86,812	1,302	58,444
Companies 5% to 25% owned	43,818	19,975	866
Companies less than 5% owned	(13,390)	54,070	(14,373)
Total net realized gains	117,240	75,347	44,937
Net change in unrealized appreciation or depreciation	(68,712)	(78,466)	(571)
Total net gains (losses)	48,528	(3,119)	44,366

Net increase in net assets resulting from operations	$249,486	$192,011	$228,291
Basic earnings per common share	$ 1.92	$ 1.64	$ 2.23
Diluted earnings per common share	$ 1.88	$ 1.62	$ 2.20
Weighted average common shares outstanding basic	129,828	116,747	102,107
Weighted average common shares outstanding diluted	132,458	118,351	103,574

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

	For the Years Ended December 31,		
(in thousands, except per share amounts)	**2004**	**2003**	**2002**
Operations			
Net investment income	$ 200,958	$ 195,130	$ 183,925
Net realized gains	117,240	75,347	44,937
Net change in unrealized appreciation or depreciation	(68,712)	(78,466)	(571)
Net increase in net assets resulting from operations	249,486	192,011	228,291
Shareholder distributions			
Common stock dividends	(299,326)	(267,838)	(229,935)
Preferred stock dividends	(62)	(210)	(230)
Net decrease in net assets resulting from shareholder distributions	(299,388)	(268,048)	(230,165)
Capital share transactions			
Sale of common stock	70,251	422,005	172,847
Issuance of common stock for portfolio investments	3,227	884	
Issuance of common stock upon the exercise of stock options	32,274	8,571	14,517
Issuance of common stock in lieu of cash distributions	5,836	6,598	6,263
Net decrease in notes receivable from sale of common stock	13,162	6,072	1,324
Purchase of common stock held in deferred compensation trust	(13,503)		
Other	3,856	413	871
Net increase in net assets resulting from capital share transactions	115,103	444,543	195,822
Total increase in net assets	65,201	368,506	193,948
Net assets at beginning of year	1,914,577	1,546,071	1,352,123
Net assets at end of year	$ 1,979,778	$ 1,914,577	$ 1,546,071
Net asset value per common share	$ 14.87	$ 14.94	$ 14.22
Common shares outstanding at end of year	133,099	128,118	108,698

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 Years Ended December 31, 2004	2003	2002
Cash flows from operating activities			
Net increase in net assets resulting from operations	$ 249,486	$ 192,011	$ 228,291
Adjustments			
Portfolio investments	(1,472,396)	(930,566)	(506,376)
Principal collections related to investment repayments or sales	909,189	788,328	356,641
Change in accrued or reinvested interest and dividends	(52,193)	(44,952)	(45,809)
Amortization of discounts and fees	(5,235)	(12,514)	(12,931)
Changes in other assets and liabilities	18,716	(9,352)	(7,252)
Depreciation and amortization	1,433	1,638	1,572
Realized gains from the receipt of notes and other securities as consideration from sale of investments	(47,497)	(1,668)	
Realized losses	150,462	18,958	50,625
Net change in unrealized (appreciation) or depreciation	68,712	78,466	571
Net cash provided by (used in) operating activities	(179,323)	80,349	65,332
Cash flows from financing activities			
Sale of common stock	70,251	422,005	172,847
Sale of common stock upon the exercise of stock options	32,274	8,571	12,136
Collections of notes receivable from sale of common stock	13,162	6,072	3,706
Borrowings under notes payable and debentures	340,212	300,000	
Repayments on notes payable and debentures	(231,000)	(140,000)	(81,856)
Net borrowings under (repayments on) revolving line of credit	112,000	(204,250)	59,500
Redemption of preferred stock	(7,000)		
Purchase of common stock held in deferred compensation trust	(13,687)		
Other financing activities	(3,004)	(5,137)	(727)
Common stock dividends and distributions paid	(290,830)	(264,419)	(220,411)
Preferred stock dividends paid	(62)	(210)	(230)
Net cash provided by (used in) financing activities	22,316	122,632	(55,035)
Net increase (decrease) in cash and cash equivalents	(157,007)	202,981	10,297
Cash and cash equivalents at beginning of year	214,167	11,186	889
Cash and cash equivalents at end of year	$ 57,160	$ 214,167	$ 11,186

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[1][2]	December 31, 2004 Principal	Cost	Value
Companies More Than 25% Owned				
Acme Paging, L.P.[4]	Loan (6.8%, Due 12/07 1/08)[6]	$ 4,631	$ 4,631	$
(Telecommunications)	Equity Interests		13,274	1,230
	Common Stock (4,656 shares)		27	
Advantage Sales & Marketing, Inc.	Loan (12.0%, Due 9/09)	60,000	59,729	59,729
(Business Services)	Debt Securities (18.5%, Due 12/09)	125,498	125,498	125,498
	Common Stock (18,957,011 shares)		73,472	97,724
Alaris Consulting, LLC	Loan (16.3%, Due 12/05 12/07)[6]	23,665	23,724	4,663
(Business Services)	Equity Interests		5,165	
	Guaranty ($1,100)			
American Healthcare Services, Inc.	Loan (1.0%, Due 12/04 12/05)[6]	5,200	4,801	4,225
and Affiliates	Guaranty ($640)			
(Healthcare Services)				
Avborne, Inc.[7]	Loan (25.0%, Due 8/07)	1,092	1,092	1,092
(Business Services)	Preferred Stock (12,500 shares)		14,138	7,320
	Common Stock (27,500 shares)			
	Standby Letter of Credit ($6,978)			
Avborne Heavy Maintenance, Inc.[7]	Preferred Stock (1,568 shares)			
(Business Services)	Common Stock (2,750 shares)			
Business Loan Express, LLC	Debt Securities (25.0%, Due 12/08)	44,628	44,615	44,615
(Financial Services)	Class A Equity Interests	53,862	53,862	53,862
	Class B Equity Interests		72,661	98,741
	Class C Equity Interests		109,301	137,988
	Guaranty ($94,633 See Note 3)			
	Standby Letters of Credit ($35,550 See Note 3)			
Callidus Capital Corporation	Loan (4.9%, Due 12/05)	42,213	42,213	42,213
(Financial Services)	Loan (12.0%, Due 12/06)	66	66	66
	Debt Securities (18.0%, Due 10/08)	4,051	4,051	4,051
	Common Stock (10 shares)		1,871	3,600
Fairchild Industrial Products	Loan (8.5%, Due 7/09)	7,038	7,038	7,038
Company	Debt Securities (12.0%, Due 7/09)	3,833	3,833	3,833
(Industrial Products)	Common Stock (1,000 shares)		2,841	2,123

(1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.

(2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
(3) Public company.
(4) Non-U.S. company or principal place of business outside the U.S.
(5) Non-registered investment company.
(6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
(7) During the third quarter of 2004, Avborne, Inc. transferred certain equity securities in Avborne Heavy Maintenance, Inc. to its lenders, including the Company, in exchange for a reduction in contractual interest on the Company s loan to Avborne, Inc. Avborne, Inc. and Avborne Heavy Maintenance, Inc. remain affiliated companies.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(1)(2)	December 31, 2004 Principal	Cost	Value
Financial Pacific Company (Financial Services)	Loan (17.4%, Due 2/12 8/12)	$68,788	$68,473	$68,473
	Preferred Stock (9,950 shares)		9,950	10,448
	Common Stock (14,735 shares)		14,819	14,819
ForeSite Towers, LLC (Tower Leasing)	Equity Interests		18,672	21,511
GAC Investments, Inc. (Broadcasting & Cable)	Loan (10.0%, Due 9/10)(6)	11,000	11,000	7,517
	Common Stock (101 shares)		43,350	
	Guaranty ($800)			
	Standby Letter of Credit ($200)			
Global Communications, LLC (Business Services)	Loan (14.2%, Due 12/03 12/06)	6,269	6,269	6,269
	Debt Securities (13.0%, Due 9/02 9/05)	18,196	18,193	18,193
	Preferred Equity Interest		14,067	14,609
	Options		1,639	2,161
Gordian Group, Inc. (Business Services)	Loan (10.0%, Due 12/08)(6)	9,392	9,439	7,381
	Common Stock (1,000 shares)		5,820	
HealthASPex, Inc. (Business Services)	Preferred Stock (1,000,000 shares)		700	700
	Preferred Stock (1,451,380 shares)		4,900	1,753
	Common Stock (1,451,380 shares)		4	
HMT, Inc. (Energy Services)	Debt Securities (13.3%, Due 12/08)	10,000	9,314	9,314
	Preferred Stock (554,052 shares)		2,488	2,537
	Common Stock (300,000 shares)		3,000	3,610
	Warrants		1,155	1,390
Housecall Medical Resources, Inc. (Healthcare Services)	Loan (16.8%, Due 11/07 11/09)	15,668	15,610	15,610
	Common Stock (864,000 shares)		86	31,898
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate (See Note 3)			772
Insight Pharmaceuticals Corporation (Consumer Products)	Senior Loan (8.3%, Due 12/07)	66,470	66,115	66,115
	Loan (15.0%, Due 12/09)	57,500	57,213	57,213
	Preferred Stock (25,000 shares)		25,000	25,000
	Common Stock (6,200 shares)		6,325	6,325
Jakel, Inc. (Industrial Products)	Loan (15.5%, Due 3/08)(6)	5,412	5,412	5,412
	Debt Securities (15.5%, Due 3/08)(6)	8,330	8,330	8,330
	Preferred Stock (6,460 shares)		6,460	836
	Common Stock (158,061 shares)		9,347	
Legacy Partners Group, LLC (Financial Services)	Loan (14.0%, Due 5/09)(6)	6,647	6,647	6,647
	Debt Securities (18.0%, Due 5/09)(6)	2,952	2,952	1,896
	Equity Interests		2,729	

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(1)(2)	December 31, 2004 Principal	Cost	Value
Litterer Beteiligungs-GmbH(4) (Business Services)	Debt Securities (8.0%, Due 3/07)	$ 715	$ 715	$ 715
	Equity Interest		1,756	2,596
Maui Body Works, Inc. (Healthcare Services)	Common Stock (100 shares)		2,500	1,080
Mercury Air Centers, Inc. (Business Services)	Senior Loan (10.0%, Due 4/09)	20,000	20,000	20,000
	Loan (16.0%, Due 4/09)	34,791	34,613	34,613
	Common Stock (52,796 shares)		31,214	31,214
	Standby Letters of Credit ($1,322)			
MVL Group, Inc. (Business Services)	Loan (12.2%, Due 10/07 7/09)	16,124	15,656	15,656
	Debt Securities (14.4%, Due 7/09)	18,039	17,526	17,526
	Common Stock (648,661 shares)		643	9,800
Pennsylvania Avenue Investors, L.P. (5) (Private Equity Fund)	Equity Interests		1,027	792
Powell Plant Farms, Inc. (Consumer Products)	Loan (15.0%, Due 1/05)	32,040	23,192	23,192
	Debt Securities (20.0%, Due 6/03)(6)	19,291	19,224	10,588
	Preferred Stock (1,483 shares)			
	Warrants			
Redox Brands, Inc. (Consumer Products)	Loan (19.0%, Due 12/07)	3,334	3,325	3,325
	Debt Securities (16.0%, Due 3/08)	11,122	10,672	10,672
	Preferred Stock (2,726,444 shares)		7,903	11,664
	Warrants		584	584
	Guaranty ($125)			
Staffing Partners Holding Company, Inc. (Business Services)	Loan (13.5%, Due 10/06)(6)	1,000	1,000	1,000
	Debt Securities (13.5%, Due 10/06)(6)	6,084	6,084	6,084
	Preferred Stock (439,600 shares)		4,968	1,961
	Common Stock (69,773 shares)		50	
	Warrants		10	
Startec Global Communications Corporation (Telecommunications)	Loan (10.0%, Due 5/07 5/09)	16,521	16,521	16,521
	Common Stock (19,180,000 shares)		37,255	7,800
STS Operating, Inc. (Industrial Products)	Preferred Stock (6,000,000 shares)		6,346	6,276
	Common Stock (3,000,000 shares)		3,177	9,632
	Options			
Total companies more than 25% owned			$1,389,342	$1,359,641
Companies 5% to 25% Owned				
Air Evac Lifeteam (Healthcare Services)	Debt Securities (12.6%, Due 7/10)	$40,144	$ 39,964	$ 39,964
	Equity Interests		3,000	1,092

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[1][2]	December 31, 2004		
		Principal	Cost	Value
Aspen Pet Products, Inc. (Consumer Products)	Loans (19.0%, Due 6/08)	$ 18,876	$ 18,784	$ 18,784
	Preferred Stock (2,709 shares)		2,154	897
	Common Stock (1,400 shares)		140	
	Warrants			
Becker Underwood, Inc. (Industrial Products)	Loan (14.5%, Due 8/12)	23,049	22,939	22,939
	Common Stock (4,364 shares)		5,000	5,000
Border Foods, Inc. (Consumer Products)	Loan (13.0%, Due 12/10)	3,000	3,000	3,000
	Debt Securities (13.0%, Due 12/10)	10,000	9,510	9,510
	Preferred Stock (50,919 shares)		2,000	2,000
	Common Stock (1,810 shares)		45	
	Warrants		665	
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,875 shares)		1,250	1,457
MasterPlan, Inc. (Business Services)	Loan (12.0%, Due on demand)	959	959	1,204
	Common Stock (1,350 shares)		42	3,300
MedBridge Healthcare, LLC (Healthcare Services)	Loan (5.1%, Due 8/09 8/14)	11,311	11,311	11,311
	Convertible Debenture (2.0%, Due 8/14) [6]	3,000	1,015	678
MortgageRamp, Inc. (Business Services)	Common Stock (772,000 shares)		3,860	903
Nexcel Synthetics, LLC (Consumer Products)	Loan (14.5%, Due 6/09)	10,248	10,211	10,211
	Equity Interests		1,690	687
Packaging Advantage Corporation (Business Services)	Debt Securities (18.5%, Due 4/08)	15,439	14,731	14,731
	Common Stock (232,168 shares)		2,386	1,479
	Warrants		963	597
Pres Air Trol LLC (Industrial Products)	Debt Securities (12.0%, Due 4/10)	6,350	6,021	6,021
	Equity Interests		1,323	900
Progressive International Corporation (Consumer Products)	Loan (16.0%, Due 12/09)	7,253	7,221	7,221
	Preferred Stock (500 shares)		500	586
	Common Stock (197 shares)		13	13
	Warrants			
Soteria Imaging Services, LLC (Healthcare Services)	Loan (12.5%, Due 11/10)	9,500	8,340	8,340
	Equity Interests		2,114	2,114
Universal Environmental Services, LLC (Business Services)	Loan (13.5%, Due 2/09)	12,150	12,099	12,099
	Equity Interests		1,500	1,864
Total companies 5% to 25% owned			$ 194,750	$ 188,902

Companies Less Than 5% Owned			
Alderwoods Group, Inc.[3] (Consumer Services)	Common Stock (357,568 shares)	$ 5,006	$ 4,062

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(1)(2)	December 31, 2004 Principal	Cost	Value
American Barbecue & Grill, Inc. (Retail)	Warrants		$ 125	$
Anthony, Inc. (Industrial Products)	Loan (12.2%, Due 9/11 9/12)	$ 14,524	14,455	14,455
Apogen Technologies, Inc. (Business Services)	Debt Securities (13.0%, Due 1/10)	5,000	4,982	4,982
	Preferred Stock (270,008 shares)		2,700	3,155
	Common Stock (1,256,452 shares)		50	2,295
	Warrants			448
Aviation Technologies, Inc. (Industrial Products)	Loan (17.0%, Due 5/11)	21,130	21,050	21,050
Benchmark Medical, Inc. (Healthcare Services)	Debt Securities (14.0%, Due 12/08)	13,718	13,656	13,656
	Warrants		18	18
Callidus Debt Partners CLO Fund III, LTD (4) (Senior Debt CLO Fund)	Preferred Shares (23,600,000 shares)		23,869	23,869
Camden Partners Strategic Fund II, L.P.(5) (Private Equity Fund)	Limited Partnership Interest		2,463	3,055
Catterton Partners V, L.P.(5) (Private Equity Fund)	Limited Partnership Interest		1,589	1,415
CBS Personnel Holdings, Inc. (Business Services)	Loan (15.5%, Due 12/09)	20,000	19,905	19,905
Colibri Holding Corporation (Consumer Products)	Debt Securities (12.5%, Due 9/08)	3,750	3,511	3,511
	Preferred Stock (459 shares)		523	780
	Common Stock (3,362 shares)		1,250	511
	Warrants		290	119
Community Education Centers, Inc. (Education Services)	Loan (15.0%, Due 12/10)	23,394	23,295	23,295
Component Hardware Group, Inc. (Industrial Products)	Preferred Stock (18,000 shares)		2,605	2,657
	Common Stock (2,000 shares)		200	600
Cooper Natural Resources, Inc. (Industrial Products)	Debt Securities (0%, Due 11/07)	1,500	1,500	1,500
	Preferred Stock (6,316 shares)		1,424	20
	Warrants		830	
Coverall North America, Inc. (Business Services)	Loan (20.0%, Due 7/08)	15,955	15,918	17,504
	Debt Securities (20.0%, Due 7/08)	8,249	8,229	9,049

CTT Holdings (Consumer Products)	Loan (0%, Due 3/10)(6)	1,125	1,125	563
DCS Business Services, Inc. (Business Services)	Debt (15.8%, Due 7/10)	21,646	21,559	21,559
	Preferred Stock (478,816 shares)		1,239	3,195

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(1)(2)	December 31, 2004 Principal	Cost	Value
Drilltec Patents & Technologies Company, Inc. (Energy Services)	Loan (10.0%, Due 8/06)(6)	$10,994	$10,918	$
	Debt Securities (15.0%, Due 8/06)(6)	1,500	1,500	
eCentury Capital Partners, L.P.(5) (Private Equity Fund)	Limited Partnership Interest		5,024	889
EDM Consulting, LLC (Business Services)	Loan (5.3%, Due 12/06)	100	100	100
Elexis Beta GmbH(4) (Industrial Products)	Options		426	50
E-Talk Corporation (Business Services)	Preferred Stock (133 shares)		10,009	
	Common Stock (8,656 shares)			
Frozen Specialties, Inc. (Consumer Products)	Debt Securities (16.0%, Due 5/08)	11,000	10,637	10,637
	Warrants		435	435
Garden Ridge Corporation (Retail)	Debt Securities (12.9%, Due 12/05 12/07)(6)	27,271	27,271	12,722
	Preferred Stock (1,130 shares)		1,130	
	Common Stock (847,800 shares)		613	
Geotrace Technologies, Inc. (Energy Services)	Debt Securities (12.0%, Due 6/09)	18,400	16,296	16,296
	Warrants		2,350	2,350
Ginsey Industries, Inc. (Consumer Products)	Loans (12.5%, Due 3/06)	4,505	4,505	4,505
	Convertible Debentures (12.5%, Due 3/06)	500	500	663
	Warrants			1,737
Grant Broadcasting Systems II (Broadcasting & Cable)	Loan (5.0%, Due 6/09)	2,750	2,750	2,750
Grotech Partners, VI, L.P.(5) (Private Equity Fund)	Limited Partnership Interest		5,574	3,444
Haven Eldercare of New England, LLC (Healthcare Services)	Loans (9.3%, Due 10/05)	46,671	46,668	46,668
The Hillman Companies, Inc.(3) (Consumer Products)	Loan (13.5%, Due 9/11)	43,024	42,807	42,807
Homax Holdings, Inc. (Consumer Products)	Debt (12.0%, Due 8/11)	14,000	12,920	12,920
	Preferred Stock (89 shares)		89	84
	Common Stock (28 shares)		6	6
	Warrants		1,106	1,371

Icon International, Inc. (Business Services)	Common Stock (25,707 shares)	76	
Interline Brands, Inc.[3] (Business Services)	Common Stock (152,371 shares)	2,286	2,600

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[1][2]	December 31, 2004 Principal	Cost	Value
International Fiber Corporation (Industrial Products)	Debt Securities (14.0%, Due 6/12)	$21,114	$21,016	$21,016
	Preferred Stock (25,000 shares)		2,500	2,500
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares)		2,049	2,726
	Warrants		136	25
Mid-Atlantic Venture Fund IV, L.P. [5] (Private Equity Fund)	Limited Partnership Interest		6,600	3,171
Mogas Energy, LLC (Energy Services)	Debt Securities (9.5%, Due 3/12 4/12)	17,479	15,956	15,956
	Warrants		1,774	2,800
Nobel Learning Communities, Inc.[3] (Education)	Preferred Stock (1,214,356 shares)		2,764	2,764
	Warrants		575	308
Norstan Apparel Shops, Inc. (Retail)	Loan (16.0%, Due 12/07)[6]	500	500	500
	Debt Securities (17.8%, Due 12/07 9/08)[6]	13,588	12,960	2,585
	Common Stock (29,663 shares)		4,750	
	Warrants		655	
	Guaranty ($)			
Norwesco, Inc. (Industrial Products)	Loan (14.0%, Due 12/11)	15,000	14,925	14,925
Novak Biddle Venture Partners III, L.P.[5] (Private Equity Fund)	Limited Partnership Interest		979	1,142
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		239	300
Onyx Television GmbH [4] (Broadcasting & Cable)	Preferred Units		201	
Opinion Research Corporation[3] (Business Services)	Loan (13.2%, Due 11/07 5/09)	20,625	20,533	20,533
	Warrants		996	480
Oriental Trading Company, Inc. (Consumer Products)	Common Stock (13,820 shares)		10	5,400
Polaris Pool Systems, Inc. (Consumer Products)	Debt Securities (12.0%, Due 9/07)	12,500	11,334	12,477
	Warrants		1,145	7,396
Pro Mach, Inc. (Industrial Products)	Loan (13.8%, Due 6/12)	19,000	18,906	18,906
	Equity Interests		1,500	1,500
RadioVisa Corporation	Loan (15.5%, Due 12/08)	25,892	25,779	25,779

(Broadcasting & Cable)				
Resun Leasing, Inc. (Business Services)	Loan (15.5%, Due 11/07)	30,000	30,000	30,000

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(1)(2)	December 31, 2004		
		Principal	Cost	Value
S.B. Restaurant Company (Retail)	Debt Securities (15.0%, Due 11/08)	$15,215	$14,667	$14,667
	Preferred Stock (54,125 shares)		135	135
	Warrants		619	619
SBBUT, LLC (Consumer Products)	Equity Interests		85	85
Soff-Cut Holdings, Inc. (Industrial Products)	Preferred Stock (300 shares)		300	
	Common Stock (2,000 shares)		200	
SPP Mezzanine Fund, L.P.(5) (Private Equity Fund)	Limited Partnership Interest		1,663	1,543
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loan (7.8%, Due 1/05)(6)	450	450	180
United Site Services, Inc. (Business Services)	Loan (12.2%, Due 6/10 12/10)	53,731	53,446	53,446
	Common Stock (160,588 shares)		1,000	1,000
Universal Tax Systems, Inc. (Business Services)	Loan (14.5%, Due 7/11)	18,592	18,506	18,506
Updata Venture Partners II, L.P.(5) (Private Equity Fund)	Limited Partnership Interest		4,375	4,322
U.S. Security Holdings, Inc. (Business Services)	Warrants		826	2,400
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest		34	34
Venturehouse Group, LLC(5) (Private Equity Fund)	Equity Interest		598	415
VICORP Restaurants, Inc.(3) (Retail)	Warrants		33	504
Walker Investment Fund II, LLLP(5) (Private Equity Fund)	Limited Partnership Interest		1,330	378
Wear Me Apparel Corporation (Consumer Products)	Debt Securities (15.0%, Due 12/10)	50,000	48,777	48,777
	Warrants		1,219	1,219
Weston Solutions, Inc. (Business Services)	Loan (17.3%, Due 6/10)	7,350	7,322	7,322
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities (20.0%, Due 6/07)(6)	19,107	18,566	15,636
	Warrants		735	

Wilton Industries, Inc. (Consumer Products)	Loan (19.3%, Due 6/08)	7,200	7,200	7,200
Woodstream Corporation (Consumer Products)	Loan (14.0%, Due 11/10)	257	256	256
	Debt Securities (14.0%, Due 11/10)	17,520	16,929	16,929
	Common Stock (180 shares)		1,800	2,639
	Warrants		587	861

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

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

Private Finance Portfolio Company (in thousands, except number of shares and number of portfolio companies)	**Investment(1)(2)**	**December 31, 2004**		
		Principal	**Cost**	**Value**
Other companies	Other investments(6)	$228	$ 228	$ 228
	Other investments	791	798	791
	Guaranty ($226)			
Total companies less than 5% owned			$ 800,828	$ 753,543
Total private finance (116 portfolio companies)			$2,384,920	$2,302,086

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

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

	Stated Interest	December 31, 2004 Face	Cost	Value
Commercial Real Estate Finance				
(in thousands, except number of issuances)				
Commercial Mortgage-Backed Securities				
Mortgage Capital Funding, Series 1998-MC3	5.5%	$ 51,105	$ 35,635	$ 31,332
Morgan Stanley Capital I, Series 1999-RM1	6.4%	27,936	9,169	9,169
COMM 1999-1	5.7%	50,032	28,192	27,399
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	20,168	10,603	7,575
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	39,165	13,344	13,789
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	18,173	4,685	4,685
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	11,151	1,581	1,748
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	20,576	5,137	9,191
FUNB CMT, Series 1999-C4	6.5%	18,587	7,700	6,866
Heller Financial, HFCMC Series 2000 PH-1	6.6%	23,536	8,433	8,528
SBMS VII, Inc., Series 2000-NL1	7.2%	8,122	4,388	3,474
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	24,793	11,271	10,128
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	12,290	3,693	2,511
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	13,841	3,421	1,704
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	16,861	4,147	5,010
JP Morgan-CIBC-Deutsche 2001	5.8%	20,528	6,884	5,920
Lehman Brothers-UBS Warburg 2001-C2	6.4%	22,203	6,433	8,935
SBMS VII, Inc., Series 2001-C1	6.1%	10,637	2,564	1,651
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	18,446	6,766	6,766
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	16,881	5,416	3,468
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	21,141	5,786	5,786
SBMS VII, Inc., Series 2001-C2	6.2%	21,735	5,743	5,743
FUNB CMT, Series 2002-C1	6.0%	18,087	7,288	6,625
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	25,965	7,163	7,163
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	23,053	7,601	7,601
GE Capital Commercial Mortgage Corp., Series 2002-3	5.1%	27,796	6,326	6,326
Morgan Stanley Dean Witter Capital I Trust 2002-IQ3	6.0%	12,508	1,819	1,819
LB-UBS Commercial Mortgage Trust 2003-C1	4.6%	23,999	3,953	3,953
GS Mortgage Securities Corporation II Series 2003-C1	4.7%	20,147	5,553	5,553
Credit Suisse First Boston Mortgage Securities Corp., Series 2003-CK2	4.9%	32,170	12,399	12,837
COMM 2003-LNB1	4.4%	20,094	3,281	3,281
Wachovia Bank Commercial Mortgage Trust, Series 2003-C5	4.3%	34,527	8,086	8,086
GMAC Commercial Mortgage Securities, Inc., Series 2003-C2	5.5%	30,654	6,662	6,662
Wachovia Bank Commercial Mortgage Trust, Series 2003-C9	5.3%	28,737	8,933	8,933
GE Commercial Mortgage Corporation, Series 2004-C1	5.0%	27,083	7,179	7,179
LB-UBS Commercial Mortgage Trust 2004-C1	4.9%	21,365	5,836	5,836
MezzCapp Commercial Mortgage Trust, Series 2004-C1	10.0%	1,990	816	816
COMM 2004-LNB3	5.3%	26,708	9,658	9,658
GMAC Commercial Mortgage Securities, Inc. Series 2004-C1	5.3%	23,035	10,616	10,646
GS Mortgage Securities Corporation II, Series 2004-C1	4.6%	20,076	8,224	8,224
J.P. Morgan Chase Commercial Mortgage Securities Corp., Series 2004-LN2	5.3%	29,590	9,372	9,372
Wachovia Bank Commercial Mortgage Trust, Series 2004-C14	5.3%	21,947	5,305	5,305
COMM 2004-LNB4	4.7%	43,033	20,888	21,191
Credit Suisse First Boston Mortgage Security Corp., Series 2004-C5	4.7%	12,125	9,445	9,466

ACGS, 2004-1	5.4%	9,292	9,218	9,197
ACGS, 2004-1, LLC Interests (See Note 3)		21,800	16,698	16,698
Total commercial mortgage-backed securities (45 issuances)		$1,043,688	$383,310	$373,805

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

	Interest Rate Ranges	Number of Loans	December 31, 2004 Cost	Value
Commercial Real Estate Finance				
(in thousands, except number of loans)				
Collateralized Debt Obligations				
Crest 2001-1, Ltd.(4)			$ 22,032	$ 22,032
Crest 2002-1, Ltd.(4)			24,487	24,487
Crest 2002-IG, Ltd.(4)			4,119	4,119
Crest Clarendon Street 2002-1, Ltd.(4)			974	974
Crest 2003-1, Ltd.(4)			93,754	93,754
Crest 2003-2, Ltd.(4)			27,164	27,164
TIAA Real Estate CDO 2003-1, Ltd.(4)			986	986
Crest Exeter Street Solar 2004-1, Ltd.(4)			1,818	1,818
Fairfield Street Solar 2004-1, Ltd.(4)			5,956	5,939
Crest 2004-1, Ltd.(4)			31,300	31,300
Total collateralized debt obligations (10 issuances)			$212,590	$212,573
Commercial Mortgage Loans				
	Up to 6.99%	13	$ 31,167	$ 29,567
	7.00% 8.99%	14	30,169	30,169
	9.00% 10.99%	4	19,129	19,129
	11.00% 12.99%	3	4,484	1,753
	13.00% 14.99%	3	10,454	10,468
	15.00% and above	2	3,970	3,970
Total commercial mortgage loans(6)		39	$ 99,373	$ 95,056
Real Estate Owned			$ 16,170	$ 16,871
Equity Interests(2)				
Companies more than 25% owned (Guarantees $2,681)			$ 11,169	$ 10,474
Companies less than 5% owned				2,546
Total equity interests			$ 11,169	$ 13,020
Total commercial real estate finance			$ 722,612	$ 711,325
Total portfolio			$3,107,532	$3,013,411

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

(5) Non-registered investment company.
(6) Commercial mortgage loans totaling $18.0 million were on non-accrual status and therefore were considered non-income producing.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Organization

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

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

In accordance with specific rules prescribed for investment companies, subsidiaries hold investments on behalf of the Company or provide substantial services to the Company. Portfolio investments are held for purposes of deriving investment income and future capital gains. The Company consolidates the results of its subsidiaries for financial reporting purposes. The financial results of the Company s portfolio investments are not consolidated in the Company s financial statements.

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company has invested in companies in a variety of industries, non-investment grade commercial mortgage-backed securities (CMBS) and collateralized debt obligation bonds and preferred shares (CDOs).

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of ACC and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2003 and 2002 balances to conform with the 2004 financial statement presentation.

The private finance portfolio and the interest and related portfolio income and net realized gains (losses) on the private finance portfolio are presented in three categories: companies more than 25% owned, which represent portfolio companies where the Company directly or indirectly owns more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by the Company under the 1940 Act; companies owned 5% to 25%, which represent portfolio companies where the Company directly or indirectly owns 5% to 25% of the outstanding voting securities of such portfolio company or where the Company holds one or more seats on the portfolio company s board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where the Company directly or indirectly owns less than 5% of the outstanding voting

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

securities of such portfolio company and where the Company has no other affiliations with such portfolio company. The interest and related portfolio income and net realized gains (losses) from the commercial real estate finance portfolio and other sources are included in the companies less than 5% owned category on the consolidated statement of operations.

In the ordinary course of business, the Company enters into transactions with portfolio companies in the more than 25% owned and the 5% to 25% owned categories that may be considered related party transactions.

Valuation of Portfolio Investments

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

Loans and Debt Securities

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

generally becomes due at maturity, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Interest on loans and debt securities is not accrued if the Company has doubt about interest collection. Loans in workout status that are classified as Grade 4 or 5 assets under the Company s internal grading system do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by the Company depending on such company s working capital needs. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. Prepayment premiums are recorded on loans and debt securities when received.

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

Equity Securities

The Company s equity 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, recent transactions involving the purchase or sale of the portfolio company s equity securities, or other liquidation events. The determined equity values are generally discounted to account for restrictions on resale and minority ownership positions.

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

Dividend income is recorded on 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) and Collateralized Debt Obligations (CDO)

CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar CMBS bonds and CDO bonds and preferred shares, when available. The Company recognizes unrealized

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed.

Net Realized Gains or Losses and Net Change in Unrealized Appreciation or Depreciation

Realized gains or losses are measured by the difference between the net proceeds from the repayment or sale and the cost basis of the investment without regard to unrealized appreciation or depreciation previously recognized, and include investments charged off during the year, net of recoveries. Net change in unrealized appreciation or depreciation reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized.

Fee Income

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

Guarantees

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

Financing Costs

Debt financing costs are based on actual costs incurred in obtaining debt financing and are deferred and amortized as part of interest expense over the term of the related debt instrument. Costs associated with the issuance of common stock, such as underwriting,

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

accounting and legal fees, and printing costs are recorded as a reduction to the proceeds from the sale of common stock.

Cash and Cash Equivalents

Cash and cash equivalents include cash in banks and all highly liquid investments with original maturities of three months or less.

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company has a stock-based employee compensation plan, which is described more fully in Note 10. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation cost is reflected in net increase in net assets resulting from operations, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net increase in net assets resulting from operations and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation for the years ended December 31, 2004, 2003, and 2002.

(in thousands, except per share amounts)	2004	2003	2002
Net increase in net assets resulting from operations as reported	$249,486	$192,011	$228,291
Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(16,908)	(12,294)	(6,863)
Pro forma net increase in net assets resulting from operations	232,578	179,717	221,428
Less preferred stock dividends	(62)	(210)	(230)
Pro forma net income available to common shareholders	$232,516	$179,507	$221,198
Basic earnings per common share:			
As reported	$ 1.92	$ 1.64	$ 2.23
Pro forma	$ 1.79	$ 1.54	$ 2.17
Diluted earnings per common share:			
As reported	$ 1.88	$ 1.62	$ 2.20
Pro forma	$ 1.76	$ 1.52	$ 2.14

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

weighted average assumptions were used to calculate the fair value of options granted during the years ended December 31, 2004, 2003, and 2002:

	2004	2003	2002
Risk-free interest rate	2.9%	2.8%	3.2%
Expected life	5.0	5.0	5.0
Expected volatility	37.0%	38.4%	39.7%
Dividend yield	8.8%	8.9%	8.5%
Weighted average fair value per option	$4.17	$3.47	$3.78

Federal and State Income Taxes

The Company intends to comply with the requirements of the Internal Revenue Code (Code) that are applicable to regulated investment companies (RIC) and real estate investment trusts (REIT). The Company and its subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of their annual taxable income to shareholders; therefore, the Company has made no provision for federal income taxes for these entities. AC Corp is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate.

Per Share Information

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

Use of Estimates in the Preparation of Financial Statements

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

The consolidated financial statements include portfolio investments at value of $3.0 billion and $2.6 billion at December 31, 2004 and 2003, respectively. At December 31, 2004 and 2003, 92% and 85%, respectively, of the Company s total assets represented portfolio investments whose fair values have been determined by the Board of Directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the Board of Directors determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Recent Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities,* which provides new guidance on the consolidation of certain entities defined as variable interest entities. FIN 46 specifies that any enterprise subject to SEC Regulation S-X Rule 6-03(c)(1) shall not consolidate any entity that is not also subject to the same rule. The Company is subject to Rule 6-03(c)(1), therefore FIN 46 does not apply to its portfolio investments. The Company has adopted FIN 46 and the adoption had no effect on the Company s financial position or results of operations.

In December 2004, the FASB issued Statement No. 123 (Revised 2004), *Share-Based Payment*, (the Statement) which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement expresses no preference for a type of valuation model and is effective for most public companies interim or annual periods beginning after June 15, 2005. The scope of the Statement includes a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The Statement replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company is currently evaluating the effects of the Statement on its financial position and results of operations with respect to the selection of a valuation model. See the Company s current disclosure under APB Opinion No. 25 above.

Note 3. Portfolio

Private Finance

At December 31, 2004 and 2003, the private finance portfolio consisted of the following:

	2004			2003		
($ in thousands)	**Cost**	**Value**	**Yield[(1)]**	**Cost**	**Value**	**Yield[(1)]**
Loans and debt securities[(2)]	$1,679,855	$1,602,869	13.9%	$1,406,052	$1,214,886	15.0%
Equity interests	705,065	699,217		500,079	687,786	
Total	$2,384,920	$2,302,086		$1,906,131	$1,902,672	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At December 31, 2004 and 2003, the cost and value of loans and debt securities include the Class A equity interests in BLX and the guaranteed dividend yield on these equity interests is included in interest income. The weighted average yield is computed as of the balance sheet date.

(2) The principal balance outstanding on loans and debt securities was $1.7 billion and $1.4 billion at December 31, 2004 and 2003, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling $29.8 million and $40.8 million at December 31, 2004 and 2003, respectively.

The Company s private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. The Company s private finance investments are generally issued by private companies and are

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

generally illiquid and subject to restrictions on resale. Private finance investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company s equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. The annual stated interest rate is only one factor in pricing the investment relative to our rights and priority in the portfolio company s capital structure, and will vary depending on many factors, including if the Company has received nominal cost equity or other components of investment return, such as loan origination fees or market discount. The stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity. At December 31, 2004 and 2003, approximately 94% and 97%, respectively, of the Company s loans and debt securities had fixed interest rates.

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

Equity interests consist primarily of securities issued by private companies and may be subject to restrictions on their resale and are generally illiquid. The Company may incur closing costs associated with making control investments, which will be added to the cost basis of the Company s equity investment. Equity securities generally do not produce a current return, but are held with the potential for investment appreciation and ultimate gain on sale.

The Company s largest investments at December 31, 2004, were in Business Loan Express, LLC and Advantage Sales & Marketing, Inc. The Company s largest investments at December 31, 2003, were in Business Loan Express, LLC and The Hillman Companies, Inc. The Company s investment in Hillman Companies, Inc. was sold on March 31, 2004.

At December 31, 2004 and 2003, the Company had an investment at cost and value totaling $280.4 million and $335.2 million and $255.1 million and $342.2 million, respectively, in Business Loan Express, LLC (BLX), a small business lender that participates in the U.S. Small Business Administration s 7(a) Guaranteed Loan Program. At December 31, 2004 and 2003, the Company owned 94.9% of the voting Class C equity interests. BLX has an equity appreciation rights plan for management which will dilute the value available to the Class C equity interest holders. BLX is headquartered in New York, NY.

During the year ended December 31, 2004, the Company provided BLX a new $20 million revolving credit facility for working capital. At December 31, 2004, there were no amounts outstanding under this facility.

BLX completed its corporate reorganization to a limited liability company during the first quarter of 2003 by merging BLX, Inc. into BLX, LLC. Prior to this transaction, BLX converted $43 million of the Company s subordinated debt to preferred stock in BLX, Inc., which was exchanged upon the merger for Class A equity interests of BLX, LLC. In addition, as part of the merger, the Company exchanged its existing preferred stock and

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

common equity investments in BLX, Inc. for similar classes of members equity in BLX, LLC represented by Class B and Class C equity interests, respectively.

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

Total interest and related portfolio income earned from the Company s investment in BLX for the years ended December 31, 2004, 2003, and 2002, was $50.0 million, $46.7 million, and $40.2 million, respectively, which included interest income on the subordinated debt and Class A equity interests of $23.2 million, $21.9 million, and $20.7 million, respectively, dividend income on Class B interests of $14.8 million, $7.8 million, and $0, respectively, loan prepayment premiums of $0, $0.1 million, and $0, respectively, and fees and other income of $12.0 million, $16.9 million, and $19.5 million, respectively. Interest and dividend income from BLX for the years ended December 31, 2004, 2003, and 2002, included interest and dividend income of $25.4 million, $17.5 million, and $9.5 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to the Company through the issuance of additional debt or equity interests.

Net change in unrealized appreciation or depreciation for the year ended December 31, 2004, includes a net decrease in unrealized appreciation of $32.3 million on the Company s investment in BLX. Net change in unrealized appreciation or depreciation for the years ended December 31, 2003 and 2002, include $51.7 million and $19.9 million, respectively, of unrealized appreciation related to BLX.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company in 2003, for tax purposes BLX had a built-in gain representing the aggregate fair market value of its assets in excess of the tax basis of its assets. As a RIC, the Company will be subject to special built-in gain rules on the assets of BLX. Under these rules, taxes will be payable by the Company at the time and to the extent that the built-in gains on BLX s assets at the date of reorganization are recognized in a taxable disposition of such assets in the 10-year period following the date of the reorganization. At such time, the built-in gains realized upon the disposition of these assets will be included in the Company s taxable income, net of the corporate level taxes paid by the Company on the built-in gains. However, if these assets are disposed of after the 10-year period, there will be no corporate level taxes on these built-in gains.

While the Company has no obligation to pay the built-in gains tax until these assets are disposed of in the future, it may be necessary to record a liability for these taxes in the future should the Company intend to sell the assets of BLX within the 10-year period. The Company estimates that its future tax liability resulting from the built-in gains at the date

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

of BLX s reorganization may total up to $40 million. At December 31, 2004 and 2003, the Company considered the increase in fair value of its investment in BLX due to BLX s tax attributes as an LLC and has also considered the reduction in fair value of its investment due to these estimated built-in gain taxes in determining the fair value of its investment in BLX.

As the controlling equity owner of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) on BLX s three-year $275.0 million revolving credit facility, which includes a sub-facility for the issuance of letters of credit for up to a total of $50.0 million. The facility matures in January 2007. The amount guaranteed by the Company at December 31, 2004, was $94.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at December 31, 2004. At December 31, 2004, the Company had also provided four standby letters of credit totaling $35.6 million in connection with four term securitization transactions completed by BLX. In consideration for providing the guaranty and the standby letters of credit, BLX paid the Company fees of $6.0 million, $4.1 million, and $3.1 million for the years ended December 31, 2004, 2003, and 2002, respectively.

In June 2004, the Company completed the purchase of a majority ownership in Advantage Sales & Marketing, Inc. (Advantage). At December 31, 2004, the Company s investment totaled $258.7 million at cost and $283.0 at value. Advantage is a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

At the closing of the transaction, the Company invested $90.2 million in loans and subordinated debt and $73.5 million in common stock. In addition, prior to completing the purchase, the Company had invested $93.7 million in subordinated debt in certain predecessor companies of Advantage, of which $63.5 million was invested in the first and second quarters of 2004. This existing debt was exchanged for new subordinated debt in Advantage as part of the transaction.

Total interest and related portfolio income earned from the Company s investment in Advantage for the year ended December 31, 2004, (since and including June 30, 2004), was $21.3 million, which includes interest income of $15.5 million and fees and other income of $5.8 million. Net change in unrealized appreciation or depreciation for the year ended December 31, 2004, includes $24.3 million of unrealized appreciation related to Advantage.

At December 31, 2003, the Company had an investment in The Hillman Companies, Inc. (Hillman) totaling $94.6 million at cost and $234.5 million at value. On March 31, 2004, the Company sold its control investment in Hillman for a total transaction value of $510 million, including the repayment of outstanding debt and adding the value of Hillman s outstanding trust preferred shares. The Company was repaid its existing $44.6 million in outstanding debt. Total consideration to the Company from the sale at closing, including the repayment of debt, was $244.3 million, which included net cash proceeds of $196.8 million and the receipt of a new subordinated debt instrument of

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

$47.5 million. During the second quarter of 2004, the Company sold a $5.0 million participation in its subordinated debt in Hillman to a third party, which reduced the Company s investment, and no gain or loss resulted from the transaction. For the year ended December 31, 2004, the Company realized a gain of $150.3 million on the transaction, including gains of $1.3 million realized after closing resulting from post-closing adjustments, which provided additional cash consideration to the Company in the same amount. The sale of Hillman is subject to certain other post-closing adjustments.

Total interest and related portfolio income earned from the Company s control investment in Hillman for the years ended December 31, 2004, 2003, and 2002, was $2.5 million, $9.7 million, and $9.3 million, respectively, which includes interest and dividend income of $2.1 million, $7.9 million, and $7.5 million, respectively, and fees and other income of $0.4 million, $1.8 million, and $1.8 million, respectively.

Other activities in portfolio companies more than 25% owned excluding changes in unrealized appreciation or depreciation during the year ended December 31, 2004, included:

a $155.3 million debt and equity investment to purchase a majority ownership in Insight Pharmaceuticals Corporation;

a $93.1 million debt and equity investment to purchase a majority ownership in Financial Pacific Company;

an $83.0 million debt and equity investment to purchase a majority ownership in Mercury Air Centers, Inc. and additional common stock and debt investments of $1.6 million and $0.8 million, respectively;

an additional $42.2 million debt investment in Callidus Capital Corporation related to its middle market underwriting and syndication facility;

a $7.0 million debt and equity investment to purchase Legacy Partners Group, LLC and an additional debt investment of $5.0 million for working capital;

an equity investment of $7.5 million and an exchange of existing subordinated debt with a cost basis of $7.3 million for equity interests in an affiliate of Impact Innovations Group, LLC (this investment was repaid during the third quarter of 2004);

GAC Investments, Inc. s (GACI) acquisition of certain of the assets of Galaxy American Communications, LLC (Galaxy) out of bankruptcy during the third quarter of 2004. The Company exchanged its outstanding debt in Galaxy for debt and equity in GACI to facilitate the asset acquisition. The company is doing business as Longview Cable & Data. The Company s investment in GACI was $54.4 million at cost at December 31, 2004, which included additional equity investments of $3.7 million during 2004;

an exchange of existing debt securities, along with accrued and unpaid interest thereon, with a total cost basis of $49.8 million for $12.5 million of new debt and a 68.5% common stock interest in Startec Global Communications Corporation (Startec) upon its emergence from bankruptcy in May 2004. The Company also

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

provided a $4.0 million term loan to Startec to make an acquisition and for working capital;

an exchange of existing loans in Gordian Group, Inc., along with accrued and unpaid interest thereon, with a total cost basis of $11.1 million for new debt with a cost basis of $9.4 million and a contribution to capital of the remaining $1.7 million;

a new equity investment of $0.8 million and an exchange of existing debt securities, along with accrued and unpaid interest thereon, with a total cost basis of $13.4 million for new debt of $11.3 million with the remaining cost basis attributed to equity, in Fairchild Industrial Products Company (Fairchild) upon its emergence from bankruptcy in July 2004. The Company now owns 100% of the common stock of Fairchild;

the repayment in kind of $10.0 million of debt in American Healthcare Services, Inc. and its affiliates (AHS) with debt in MedBridge Healthcare, LLC; the repayment in kind of $2.7 million of AHS debt with $2.5 million of equity in Maui Body Works, Inc. and $0.2 million of debt from other companies;

the sale of The Color Factory, Inc. during the third quarter of 2004; and

the exit of our investment in Ace Products, Inc. during the fourth quarter of 2004.

At December 31, 2004 and 2003, loans and debt securities at value not accruing interest were as follows:

($ in thousands)	2004	2003
Loans and debt securities in workout status (classified as Grade 4 or 5)		
Companies more than 25% owned	$34,374	$ 31,873
Companies 5% to 25% owned		2,777
Companies less than 5% owned	16,550	28,027
Loans and debt securities not in workout status		
Companies more than 25% owned	29,368	31,897
Companies 5% to 25% owned	678	
Companies less than 5% owned	15,864	16,532
Total	$96,834	$111,106

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The industry and geographic compositions of the private finance portfolio at value at December 31, 2004 and 2003, were as follows:

	2004	2003
Industry		
Business services	32%	22%
Financial services	21	19
Consumer products	20	30
Healthcare services	8	8
Industrial products	8	6
Energy services	2	4
Retail	2	4
Broadcasting and cable	2	2
Other	5	5
Total	100%	100%
Geographic Region(1)		
Mid-Atlantic	40%	40%
West	30	16
Midwest	16	26
Southeast	10	13
Northeast	4	4
International		1
Total	100%	100%

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

Commercial Real Estate Finance

At December 31, 2004 and 2003, the commercial real estate finance portfolio consisted of the following:

	2004			2003		
($ in thousands)	**Cost**	**Value**	**Yield**(1)	**Cost**	**Value**	**Yield**(1)
CMBS bonds	$383,310	$373,805	14.6%	$399,106	$393,979	14.1%
CDO bonds and preferred shares	212,590	212,573	16.8%	186,824	186,557	16.7%
Commercial mortgage loans	99,373	95,056	6.8%	87,427	83,639	8.6%
Real estate owned	16,170	16,871		15,931	12,856	
Equity interests	11,169	13,020		5,641	4,896	

Total	$722,612	$711,325	$694,929	$681,927

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Interest-bearing investments for the commercial real estate finance portfolio include all investments except for real estate owned and equity interests.

CMBS Bonds. At December 31, 2004 and 2003, CMBS bonds consisted of the following:

($ in thousands)	2004	2003
Face	$1,043,688	$1,016,533
Original issue discount	(660,378)	(617,427)
Cost	$ 383,310	$ 399,106
Value	$ 373,805	$ 393,979

The underlying rating classes of the CMBS bonds at cost and value at December 31, 2004 and 2003, were as follows:

	2004			2003		
($ in thousands)	Cost	Value	Percentage of Total Value	Cost	Value	Percentage of Total Value
AA	$ 4,669	$ 4,658	1.2%	$	$	%
A	4,549	4,539	1.2			
BBB-	9,029	9,016	2.4			
BB+	7,195	7,695	2.1	49,477	51,157	13.0
BB	5,940	5,952	1.6	22,031	23,008	5.9
BB-	7,490	7,676	2.1	13,538	14,266	3.6
B+	13,123	15,318	4.1	54,464	54,246	13.8
B	61,767	62,582	16.7	38,416	38,362	9.7
B-	89,341	88,099	23.6	84,986	83,859	21.3
CCC+	22,506	18,585	5.0	15,935	15,494	3.9
CCC	24,078	20,306	5.4	13,323	11,413	2.9
CCC-				3,133	2,410	0.6
CC	998	610	0.2			
Unrated	132,625	128,769	34.4	103,803	99,764	25.3
Total	$383,310	$373,805	100.0%	$399,106	$393,979	100.0%

The CMBS bonds in which the Company invests are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages is generally allocated first to the senior tranches in order of priority, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages or the properties securing those mortgages resulting in reduced cash flows, the most subordinate tranche will bear this loss first. At December 31, 2004, the face value of the CMBS bonds rated BBB- and below held by the Company were subordinate to 84% to 99% of the face value of the bonds issued in these various CMBS transactions. At December 31, 2003, the face value of the CMBS bonds held by the Company were subordinate to 87% to 99% of the face value of the bonds issued in these

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of interest and principal, the Company invests in these CMBS bonds at a discount from the face amount of the bonds.

At December 31, 2004 and 2003, the Company held CMBS bonds in 45 and 38 separate CMBS issuances, respectively. The underlying collateral pool, consisting of commercial mortgage loans and real estate owned (REO) properties, for these CMBS issuances consisted of the following at December 31, 2004 and 2003:

($ in millions)	2004	2003
Approximate number of loans and REO properties(1)	6,200	5,600
Total outstanding principal balance	$42,759	$38,437
Loans over 30 days delinquent or classified as REO properties(2)	1.6%(3)	1.5% (3)

(1) Includes approximately 39 and 22 REO properties obtained through the foreclosure of commercial mortgage loans at December 31, 2004 and 2003, respectively.

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

(3) At December 31, 2004 and 2003, the Company s investments included bonds in the first loss, unrated bond class in 43 and 34 separate CMBS issuances, respectively. For these issuances, loans over 30 days delinquent or classified as REO properties were 1.7% of the total outstanding principal balance at both December 31, 2004 and 2003.

The property types and the geographic composition of the underlying mortgage loans and REO properties in the underlying collateral pools for all CMBS issuances calculated using the outstanding principal balance at December 31, 2004 and 2003, were as follows:

	2004	2003
Property Type		
Retail	34%	35%
Office	26	24
Housing	24	25
Industrial	6	5
Hospitality	4	5
Other	6	6
Total	100%	100%
Geographic Region		
West	29%	31%
Mid-Atlantic	27	27
Midwest	22	21
Southeast	17	17
Northeast	5	4
Total	100%	100%

The Company s yield on its CMBS bonds is based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

include the timing and magnitude of credit losses on the mortgage loans underlying the CMBS bonds that are a result of the general condition of the real estate market, including vacancies, changes in market rental rates and tenant credit quality. The initial yield on each CMBS bond has generally been computed assuming an approximate 1% loss rate on its underlying collateral mortgage pool, with the estimated losses being assumed to occur in three equal installments in years three, six, and nine. As each CMBS bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated, and the respective yield will be adjusted as appropriate. 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. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

At December 31, 2004 and 2003, the unamortized discount related to the CMBS bond portfolio was $660.4 million and $617.4 million, respectively, and the Company had set aside $346.5 million and $295.8 million, respectively, of this unamortized discount to absorb potential future losses. The yields on the CMBS bonds of 14.6% and 14.1%, respectively, assume that this amount that has been set aside will not be amortized.

At December 31, 2004 and 2003, the Company had reduced the face amount and the original issue discount on the CMBS bonds for specifically identified losses of $110.3 million and $52.6 million, respectively, which had the effect of also reducing the amount of unamortized discount set aside to absorb potential future losses since those losses have now been recognized. The reduction of the face amount and the original issue discount on the CMBS bonds to reflect specifically identified losses will not result in a change in the cost basis of the CMBS bonds.

The Company completed a securitization of $53.7 million of commercial mortgage loans during 2004. In connection with this securitization, the Company received proceeds, net of costs, of $54.0 million, which included cash, A and AA rated bonds, and LLC interests. The bonds and LLC interests are included in the CMBS portfolio at December 31, 2004. The realized gain from this securitization was $0.3 million.

At December 31, 2004 and 2003, CMBS bonds with a value of $0.1 and $0.2 million, respectively, were not accruing interest.

Collateralized Debt Obligation Bonds and Preferred Shares (CDOs). At December 31, 2004, the Company owned BB+ rated bonds in one CDO totaling $5.9 million at value and preferred shares in nine CDOs totaling $206.7 million at value. At December 31, 2003, the Company owned BBB rated bonds in one CDO totaling $16.0 million at value, BB rated bonds in one CDO totaling $0.9 million at value and preferred shares in seven CDOs totaling $169.7 million at value.

The bonds and preferred shares of the CDOs in which the Company has invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. Cash flow from the underlying collateral generally is allocated first to the senior bond tranches in order of priority, with the most senior tranches having a

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

priority right to the cash flow. Then, any remaining cash flow is generally distributed to the preferred shareholders. To the extent there are defaults and unrecoverable losses on the underlying collateral that result in reduced cash flows, the preferred shares will bear this loss first and then the bonds would bear any loss after the preferred shares. At December 31, 2004, the Company s bonds and preferred shares in the CDOs were subordinate to 70% to 98% of the more senior tranches of debt issued in the various CDO transactions. At December 31, 2003, the Company s bonds in the CDO were subordinate to 61% to 93% of the more senior tranches of debt issued in the various CDO transactions and the preferred shares in the CDOs were subordinate to 84% to 98% of the more senior tranches of debt issued in the various CDO transactions. In addition, included in the CMBS collateral for the CDOs at December 31, 2004 and 2003, were certain CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held directly by the Company.

At December 31, 2004 and 2003, the underlying collateral for the Company s investment in the outstanding CDO issuances had balances as follows:

($ in millions)	2004	2003
Investment grade REIT debt[(1)]	$1,532.5	$1,338.0
Investment grade CMBS bonds[(2)]	918.8	662.3
Non-investment grade CMBS bonds[(3)]	1,636.4	1,133.7
Other collateral	355.8	32.4
Total collateral	$4,443.5	$3,166.4

(1) Issued by 44 REITs for both periods presented.
(2) Issued in 121 and 78 transactions, respectively, for the periods presented.
(3) Issued in 109 and 68 transactions, respectively, for the periods presented.

The initial yields on the CDO bonds and preferred shares are based on the estimated future cash flows from the assets in the underlying collateral pool to be paid to these CDO classes. As each CDO bond and preferred share ages, the estimated future cash flows will be updated based on the estimated performance of the collateral, and the respective yield will be adjusted as necessary. As future cash flows are subject to uncertainties and contingencies that are difficult to predict and are subject to future events which may alter current assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

As of December 31, 2004, 2003, and 2002, the Company acted as the disposition consultant with respect to six, five, and three, respectively, of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. For these services, the Company collects annual fees based on the outstanding collateral pool balance, and for the years ended December 31, 2004, 2003, and 2002, these fees totaled $1.7 million, $1.2 million, and $0.5 million, respectively.

Loans and Equity Interests. The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At December 31, 2004, approximately 94% and 6% of the Company s commercial mortgage

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

loan portfolio was composed of fixed and adjustable interest rate loans, respectively. At December 31, 2003, approximately 92% and 8% of the Company s commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of December 31, 2004 and 2003, loans with a value of $18.0 million and $6.8 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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

The property types and the geographic composition securing the commercial mortgage loans and equity interests at value at December 31, 2004 and 2003, were as follows:

	2004	2003
Property Type		
Hospitality	49%	41%
Retail	21	21
Office	17	22
Housing	5	4
Healthcare		7
Other	8	5
Total	100%	100%
Geographic Region		
Midwest	30%	30%
Southeast	26	34
Mid-Atlantic	20	9
West	16	20
Northeast	8	7
Total	100%	100%

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt

At December 31, 2004 and 2003, the Company had the following debt:

($ in thousands)	2004 Facility Amount	2004 Amount Drawn	2004 Annual Interest Cost(1)	2003 Facility Amount	2003 Amount Drawn	2003 Annual Interest Cost(1)
Notes payable and debentures:						
Unsecured notes payable	$ 981,368	$ 981,368	6.5%	$ 854,000	$ 854,000	7.2%
SBA debentures	84,800	77,500	8.2%	101,800	94,500	8.1%
OPIC loan	5,700	5,700	6.6%	5,700	5,700	6.6%
Total notes payable and debentures	1,071,868	1,064,568	6.6%	961,500	954,200	7.3%
Revolving line of credit	552,500	112,000	6.3%(2)	532,500		(2)
Total debt	$ 1,624,368	$ 1,176,568	6.6%(2)	$ 1,494,000	$ 954,200	7.5%(2)

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

(2) The stated interest rate payable on the revolving line of credit was 4.7% at December 31, 2004, which excluded the annual cost of commitment fees and other facility fees of $1.8 million. There were no amounts drawn on the revolving line of credit at December 31, 2003. The annual cost of commitment fees and other facility fees was $2.7 million at December 31, 2003. The annual interest cost for total debt includes the annual cost of commitment fees and other facility fees on the revolving line of credit regardless of the amount drawn on the facility as of the balance sheet date.

Notes Payable and Debentures

Unsecured Notes Payable. The Company has issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At December 31, 2004, the notes had remaining maturities of five months to seven years. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

On November 15, 2004, the Company issued $252.5 million of five-year and $72.5 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 5.53% and 5.99%, respectively, and have substantially the same terms as the Company s existing unsecured long-term notes. In addition, on November 15, 2004, $102.0 million of the Company s existing unsecured long-term notes matured and the Company used the proceeds from the new long-term note issuance to repay this debt.

During 2004, the Company also repaid $112.0 million of the unsecured notes payable that matured on May 1, 2004.

On March 25, 2004, the Company issued five-year unsecured long-term notes denominated in Euros and Sterling for a total U.S. dollar equivalent of $15.2 million. The notes have fixed interest rates and have substantially the same terms as the Company s existing unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. Simultaneous with issuing the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

notes, the Company entered into a cross-currency swap with a financial institution which fixed the Company s interest and principal payments in U.S. dollars for the life of the debt.

SBA Debentures. At December 31, 2004 and 2003, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 7.6% and 5.9% to 8.2%, respectively. During the year ended December 31, 2004, the Company repaid $17.0 million of the SBA debentures. At December 31, 2004, the debentures had remaining maturities of nine months to seven years. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to the fifth anniversary date of the notes.

At December 31, 2004, the Company had a commitment from the SBA to borrow up to an additional $7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

Scheduled Maturities. Scheduled future maturities of notes payable and debentures at December 31, 2004, were as follows:

Year	Amount Maturing
	($ in thousands)
2005	$ 169,000
2006	180,700
2007	
2008	153,000
2009	268,868
Thereafter	293,000
Total	$1,064,568

Revolving Line of Credit

The committed amount under the unsecured revolving credit facility is $552.5 million and may be further expanded through new or additional commitments up to $600 million at the Company s option. The facility generally bears interest at a rate, at the Company s option, equal to (i) the one-month LIBOR plus 1.50%, (ii) the Bank of America, N.A. cost of funds plus 1.50% or (iii) the higher of the Bank of America, N.A. prime rate or the Federal Funds rate plus 0.50%. The interest rate adjusts at the beginning of each new interest period, usually every 30 days. The facility requires an annual commitment fee equal to 0.25% of the committed amount. The annual cost of commitment fees and other facility fees was $1.8 million and $2.7 million at December 31, 2004 and 2003, respectively. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity. The line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at the Company s option. An extension of the facility would require payment of an extension fee of 0.3% on existing

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

commitments and the interest rate on outstanding borrowings would increase by 0.5% during the extension period.

The average debt outstanding on the revolving line of credit was $75.2 million and $41.5 million for the years ended December 31, 2004 and 2003, respectively. The maximum amount borrowed under this facility and the weighted average stated interest rate for the years ended December 31, 2004 and 2003, were $353.0 million and 3.1%, and $208.8 million and 2.0%, respectively. As of December 31, 2004, the amount available under the revolving line of credit was $396.4 million, net of amounts committed for standby letters of credit of $44.1 million issued under the credit facility. As of December 31, 2003, the amount available under the revolving line of credit was $487.0 million, net of amounts committed for standby letters of credit of $45.5 million issued under the credit facility.

Fair Value of Debt

The Company records debt at cost. The fair value of the Company s outstanding debt was approximately $1.2 billion and $1.0 billion at December 31, 2004 and 2003, respectively. The fair value of the Company s debt was determined using market interest rates as of the balance sheet date for similar instruments.

Covenant Compliance

The Company has various financial and operating covenants required by the notes payable and debentures and the revolving line of credit. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company s credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of December 31, 2004 and 2003, the Company was in compliance with these covenants.

Note 5. Guarantees and Other Commitments

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. All standby letters of credit have been issued through Bank of America, N.A. As of December 31, 2004 and 2003, the Company had issued guarantees of debt, rental obligations, lease obligations and severance obligations aggregating $100.2 million and $83.4 million, respectively, and had extended standby letters of credit aggregating $44.1 million and $45.5 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of potential future payments was $144.3 million and $128.9 million at December 31, 2004 and 2003, respectively. At December 31, 2004, $0.8 million had been recorded as a liability for the Company s guarantees and no amounts had been recorded as a liability for the Company s standby letters of credit. At December 31, 2003, no amounts had been recorded as a liability for the Company s guarantees or standby letters of credit.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 5. Guarantees and Other Commitments, continued

As of December 31, 2004, the guarantees and standby letters of credit expire as follows:

($ in millions)	Total	2005	2006	2007	2008	2009	After 2009
Guarantees	$100.2	$0.6	$ 1.1	$94.8	$0.1	$2.5	$1.1
Standby letters of credit[1]	44.1		44.1				
Total	$144.3	$0.6	$45.2	$94.8	$0.1	$2.5	$1.1

(1) Standby letters of credit are issued under the Company s revolving line of credit that expires in April 2005 and may be extended under substantially similar terms for one additional year at the Company s option, for an assumed maturity of April 2006. Therefore, unless a standby letter of credit is set to expire at an earlier date, it is assumed that the standby letters of credit will expire contemporaneously with the expiration of the Company s line of credit in April 2006.

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

At December 31, 2004, the Company had outstanding commitments to fund investments totaling $330.2 million. In addition, during the fourth quarter of 2004, the Company sold certain commercial mortgage loans that the Company may be required to repurchase under certain circumstances. These recourse provisions expire by January 2006. The aggregate outstanding principal balance of these sold loans was $11.7 million at December 31, 2004.

Note 6. Preferred Stock

At December 31, 2003, Allied Investment had outstanding a total of 60,000 shares of $100 par value, 3% cumulative preferred stock and 10,000 shares of $100 par value, 4% redeemable cumulative preferred stock issued to the SBA pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended. In April 2004, Allied Investment redeemed the preferred stock by paying the SBA the par value of such securities plus any dividends accumulated and unpaid to the date of redemption. Accordingly, there were no amounts outstanding at December 31, 2004.

Note 7. Shareholders Equity

Sales of common stock for the years ended December 31, 2004, 2003, and 2002, were as follows:

(in thousands)	2004	2003	2002
Number of common shares	3,000	18,700	8,047
Gross proceeds	$75,000	$442,680	$177,345
Less costs, including underwriting fees	(4,749)	(20,675)	(4,498)
Net proceeds	$70,251	$422,005	$172,847

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Shareholders Equity, continued

In addition, the Company issued 123,814 shares of common stock with a value of $3.2 million to acquire one portfolio investment during 2004, and 32,266 shares of common stock with a value of $0.9 million to acquire one portfolio investment during 2003.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company s common stock for the five consecutive trading days immediately prior to the dividend payment date. For the years ended December 31, 2004, 2003, and 2002, the Company issued new shares in order to satisfy dividend reinvestment requests.

Dividend reinvestment plan activity for the years ended December 31, 2004, 2003, and 2002, was as follows:

(in thousands, except per share amounts)	2004	2003	2002
Shares issued	222	279	275
Average price per share	$26.34	$23.60	$22.78

Note 8. Earnings Per Common Share

Earnings per common share for the years ended December 31, 2004, 2003, and 2002, were as follows:

(in thousands, except per share amounts)	2004	2003	2002
Net increase in net assets resulting from operations	$249,486	$192,011	$228,291
Less preferred stock dividends	(62)	(210)	(230)
Income available to common shareholders	$249,424	$191,801	$228,061
Weighted average common shares outstanding basic	129,828	116,747	102,107
Dilutive options outstanding to officers	2,630	1,604	1,467
Weighted average common shares outstanding diluted	132,458	118,351	103,574
Basic earnings per common share	$ 1.92	$ 1.64	$ 2.23
Diluted earnings per common share	$ 1.88	$ 1.62	$ 2.20

Note 9. 401(k) Plan and Deferred Compensation Plans

The Company s 401(k) retirement investment plan is open to all of its full-time employees who are at least 21 years of age. The employees may elect voluntary pre-tax wage deferrals ranging from 0% to 100% of eligible compensation for the year up to $13 thousand annually for the 2004 plan year. Plan participants who reached the age of 50

F-40

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. 401(k) Plan and Deferred Compensation Plans, continued

during the 2004 plan year were eligible to defer an additional $3 thousand during the year. The Company makes contributions to the 401(k) plan of up to 5% of each participant s eligible compensation for the year up to a maximum compensation permitted by the IRS, which fully vests at the time of contribution. For the year ended December 31, 2004, the maximum compensation was $0.2 million. Employer contributions that exceed the IRS limitation are directed to the participant s deferred compensation plan account. Total 401(k) contribution expense for the years ended December 31, 2004, 2003, and 2002, was $0.9 million, $0.7 million, and $0.6 million, respectively.

The Company also has a deferred compensation plan. Eligible participants in the deferred compensation plan may elect to defer some of their compensation and have such compensation credited to a participant account. In addition, the Company makes contributions to the deferred compensation plan on compensation deemed ineligible for a 401(k) contribution. Contribution expense for the deferred compensation plan for the years ended December 31, 2004, 2003, and 2002, was $0.7 million, $0.4 million, and $0.3 million, respectively. All amounts credited to a participant s account are credited solely for purposes of accounting and computation and remain assets of the Company and subject to the claims of the Company s general creditors. Amounts credited to participants under the deferred compensation plan are at all times 100% vested and non-forfeitable. A participant s account shall become distributable upon his or her separation from service, retirement, disability, death, or at a future determined date. All deferred compensation plan accounts will be distributed in the event of a change of control of the Company or in the event of the Company s insolvency. Amounts deferred by participants under the deferred compensation plan are funded to a trust, which is administered by trustees. The accounts of the deferred compensation trust are consolidated with the Company s accounts. The assets of the trust are classified as other assets and the liability to the plan participants is included in other liabilities in the accompanying financial statements. The deferred compensation plan accounts at December 31, 2004 and 2003, totaled $16.1 million and $13.0 million, respectively.

In the first quarter of 2004, the Company established the Individual Performance Award (IPA) as a long-term incentive compensation program for certain officers. In conjunction with the program, the Board of Directors has approved a non-qualified deferred compensation plan (DCP II), which is administered through a trust by an independent third-party trustee. The administrator of the DCP II is the Compensation Committee of the Company s Board of Directors (DCP II Administrator).

The IPA, which will generally be determined annually at the beginning of each year, is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the DCP II to require the trustee to use the cash to purchase shares of the Company s common stock in the open market. During 2004, 0.5 million shares were purchased in the DCP II.

All amounts deposited and then credited to a participant s account in the trust, based on the amount of the IPA received by such participant, are credited solely for purposes of accounting and computation and remain assets of the Company and subject to the claims

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. 401(k) Plan and Deferred Compensation Plans, continued

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

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

For the year ended December 31, 2004, the Company recorded $13.4 million in IPA expense. These amounts were contributed into the DCP II trust and invested in the Company s common stock. The accounts of the DCP II are consolidated with the Company s accounts. The common stock is classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represents the amount owed to the employees, is included in other liabilities. Changes in the value of the Company s common stock are not recognized in the common stock held in deferred compensation trust. However, the obligation is adjusted with a corresponding charge or credit to compensation expense. The effect of this adjustment for the year ended December 31, 2004, was to reduce the individual performance award expense by $0.4 million. This resulted in a total IPA expense of $13.0 million for the year ended December 31, 2004.

Note 10. Stock Option Plan

The Option Plan

The purpose of the stock option plan (Option Plan) is to provide officers and non-officer directors of the Company with additional incentives. Options are exercisable at a price equal to the fair market value of the shares on the day the option is granted. Each option states the period or periods of time within which the option may be exercised by

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Stock Option Plan, continued

the optionee, which may not exceed ten years from the date the option is granted. The options granted vest ratably over a three- or five-year period.

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

At December 31, 2004, there were 32.2 million shares authorized under the Option Plan and the number of shares available to be granted under the Option Plan was 7.9 million. At December 31, 2003, there were 26.0 million shares authorized under the Option Plan and the number of shares available to be granted under the Option Plan was 8.8 million.

Information with respect to options granted, exercised and forfeited under the Option Plan for the years ended December 31, 2004, 2003, and 2002, is as follows:

(in thousands, except per share amounts)	Shares	Weighted Average Exercise Price Per Share
Options outstanding at January 1, 2002	10,480	$19.63
Granted	6,162	$22.07
Exercised	(769)	$18.85
Forfeited	(1,184)	$21.09
Options outstanding at December 31, 2002	14,689	$20.57
Granted	1,045	$22.74
Exercised	(408)	$21.01
Forfeited	(442)	$21.66
Options outstanding at December 31, 2003	14,884	$20.68
Granted	8,170	$28.34
Exercised	(1,635)	$19.73
Forfeited	(1,059)	$26.07
Options outstanding at December 31, 2004	20,360	$23.55

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Stock Option Plan, continued

The following table summarizes information about stock options outstanding at December 31, 2004:

	Outstanding			Exercisable	
Range of Exercise Prices	**Total Number Outstanding**	**Weighted Average Remaining Contractual Life (Years)**	**Weighted Average Exercise Price**	**Total Number Exercisable**	**Weighted Average Exercise Price**
(in thousands, except per share amounts and years)					
$16.81 $21.38	4,978	4.41	$18.75	4,962	$18.74
$21.52	4,488	7.95	$21.52	2,982	$21.52
$21.59 $26.29	4,389	7.78	$23.18	2,818	$22.58
$26.73 $27.38	315	8.68	$27.06	104	$27.24
$28.98	6,190	9.19	$28.98	1,547	$28.98
$16.81 $28.98	20,360	7.44	$23.55	12,413	$21.63

The Company accounts for its stock options as required by APB Opinion No. 25, *Accounting for Stock Issued to Employees,* and accordingly no compensation cost has been recognized as the exercise price equals the market price on the date of grant.

Notes Receivable from the Sale of Common Stock

As a business development company under the Investment Company Act of 1940, the Company is entitled to provide and has provided loans to the Company s officers in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, the Company is prohibited from making new loans to its executive officers in the future. The outstanding loans are full recourse, have varying terms not exceeding ten years, bear interest at the applicable federal interest rate in effect at the date of issue and have been recorded as a reduction to shareholders equity. At December 31, 2004 and 2003, the Company had outstanding loans to officers of $5.5 million, and $18.6 million, respectively. Officers with outstanding loans repaid principal of $13.2 million, $6.1 million, and $3.7 million, for the years ended December 31, 2004, 2003, and 2002, respectively. The Company recognized interest income from these loans of $0.5 million, $1.3 million, and $1.5 million, respectively, during these same periods. This interest income is included in interest and dividends for companies less than 5% owned.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Dividends and Distributions

For the years ended December 31, 2004, 2003, and 2002, the Company declared the following distributions:

	2004		2003		2002	
	Total Amount	Total Per Share	Total Amount	Total Per Share	Total Amount	Total Per Share
($ in thousands, except per share amounts)						
First quarter	$ 73,357	$0.57	$ 62,971	$0.57	$ 53,259	$0.53
Second quarter	73,465	0.57	64,503	0.57	56,224	0.55
Third quarter	74,010	0.57	68,685	0.57	57,340	0.56
Fourth quarter	75,833	0.57	71,679	0.57	59,851	0.56
Extra dividend	2,661	0.02			3,261	0.03
Total distributions to common shareholders	$299,326	$2.30	$267,838	$2.28	$229,935	$2.23

For income tax purposes, distributions for 2004, 2003, and 2002, were composed of the following:

	2004		2003		2002	
	Total Amount	Total Per Share	Total Amount	Total Per Share	Total Amount	Total Per Share
($ in thousands, except per share amounts)						
Ordinary income(1)	$145,365	$1.12	$212,272	$1.81	$178,246	$1.73
Long-term capital gains	153,961	1.18	55,566	0.47	51,689	0.50
Total distributions to common shareholders(2)	$299,326	$2.30	$267,838	$2.28	$229,935	$2.23

(1) For the years ended December 31, 2004 and 2003, ordinary income included dividend income of approximately $0.04 per share and $0.05 per share, respectively, that qualified to be taxed at the 15% maximum capital gains rate.

(2) For certain eligible corporate shareholders, the dividend received deduction for 2004 and 2003 was $0.038 per share and $0.044 per share, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Dividends and Distributions, continued

The following table summarizes the differences between financial statement net increase in net assets resulting from operations and taxable income available for distribution to shareholders for the years ended December 31, 2004, 2003, and 2002:

($ in thousands)	2004 (ESTIMATED)	2003	2002
Financial statement net increase in net assets resulting from operations	$249,486	$192,011	$228,291
Adjustments:			
Net change in unrealized appreciation or depreciation	68,712	78,466	571
Amortization of discounts and fees	(10,396)	948	(10,097)
Interest- and dividend-related items	3,630	(2,400)	8,787
Employee compensation-related items	6,381	2,902	867
Net income (loss) from partnerships and limited liability companies(1)	5,624	(1,316)	(3,822)
Realized gains deferred through installment treatment (2)	(29,339)		
Income (loss) from securitized commercial mortgage loans		(251)	1,258
Net loss from consolidated SBIC subsidiary(3)	15,615		
Net (income) loss from consolidated taxable subsidiary, net of tax	(1,008)	3,864	(1,160)
Other	15,413	(7,947)	4,740
Taxable income	$324,118	$266,277	$229,435

(1) Includes taxable income passed through to the Company from Business Loan Express, LLC in excess of interest and related portfolio income from BLX included in the financial statements totaling $10.0 million and $3.4 million for the years ended December 31, 2004 and 2003, respectively. See Note 3 for additional related disclosure.

(2) Includes the deferral of long-term capital gains through installment treatment related to the Company s sale of its control equity investment in Hillman.

(3) 2004 includes estimated capital loss carryforwards of $8.7 million.

The Company must distribute at least 90% of its investment company taxable income to qualify for pass-through tax treatment and maintain its RIC status. The Company has distributed and currently intends to distribute or retain through a deemed distribution sufficient dividends to eliminate taxable income. Dividends declared and paid by the Company in a year generally differ from taxable income for that year as such dividends may include the distribution of current year taxable income, less amounts carried forward into the following year, and the distribution of prior year taxable income carried forward into and distributed in the current year. Estimated taxable income for 2004 includes undistributed income of $27.5 million that is being carried forward for distribution in 2005, which includes $7.1 million of ordinary income and $20.4 million of net long-term capital gains.

The Company s undistributed book earnings of $12.1 million as of December 31, 2004, substantially relate to undistributed long-term capital gains.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Dividends and Distributions, continued

At December 31, 2004 and 2003, the aggregate gross unrealized appreciation of the Company s investments above cost for federal income tax purposes was $323.3 million (estimated) and $429.8 million, respectively. At December 31, 2004 and 2003, the aggregate gross unrealized depreciation of the Company s investments below cost for federal income tax purposes was $265.0 million (estimated) and $319.2 million, respectively. The aggregate net unrealized appreciation of the Company s investments over cost for federal income tax purposes was $58.3 million (estimated) and $110.6 million at December 31, 2004 and 2003, respectively. At December 31, 2004 and 2003, the aggregate cost of securities, for federal income tax purposes was $3.0 billion (estimated) and $2.5 billion, respectively.

The Company s consolidated subsidiary, AC Corp, is subject to federal and state income taxes. The Company recorded tax provisions of $1.1 million and $0.9 million for the years ended December 31, 2004 and 2002, respectively, and a tax benefit of $2.5 million for the year ended December 31, 2003. At December 31, 2004, 2003, and 2002, the Company had a net deferred tax asset of $6.0 million, $3.1 million, and $0.4 million, respectively, which was composed primarily of net operating loss carry forwards. Management believes that the realization of the net deferred tax asset is more likely than not based on expectations as to future taxable income and scheduled reversals of temporary differences. Accordingly, the Company did not record a valuation allowance at December 31, 2004, 2003, or 2002.

Note 12. Cash and Cash Equivalents

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

At December 31, 2004 and 2003, cash and cash equivalents consisted of the following:

($ in thousands)	2004	2003
Cash and cash equivalents	$57,576	$218,160
Less escrows held	(416)	(3,993)
Total cash and cash equivalents	$57,160	$214,167

Note 13. Supplemental Disclosure of Cash Flow Information

For the years ended December 31, 2004, 2003, and 2002, the Company paid interest of $74.6 million, $73.8 million, and $69.1 million, respectively.

Principal collections related to investment repayments or sales include the collection of discounts previously amortized into interest income and added to the cost basis of a loan or debt security totaling $11.4 million, $17.6 million, and $6.8 million, for the years ended December 31, 2004, 2003, and 2002, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 13. Supplemental Disclosure of Cash Flow Information, continued

Non-cash operating activities for the year ended December 31, 2004, included notes or other securities received as consideration from the sale of investments of $56.6 million. The notes received for the year ended December 31, 2004, included a note received for $47.5 million in conjunction with the sale of the Company s investment in Hillman. During the second quarter of 2004, the Company sold a $5.0 million participation in its subordinated debt in Hillman to a third party, which reduced its investment, and no gain or loss resulted from the transaction.

Non-cash operating activities for the year ended December 31, 2004, also included an exchange of $93.7 million of subordinated debt in certain predecessor companies of Advantage Sales & Marketing, Inc. for new subordinated debt in Advantage; an exchange of existing debt securities with a cost basis of $46.4 million for new debt and common stock in Startec Global Communications Corporation; an exchange of existing debt securities with a cost basis of $13.1 million for new debt of $11.3 million with the remaining cost basis attributed to equity in Fairchild Industrial Products Company; an exchange of existing loans with a cost basis of $11.1 million for a new loan and equity in Gordian Group, Inc.; the repayment in kind of $12.7 million of existing debt in AHS with $10.0 million of debt in MedBridge Healthcare, LLC and $2.7 million of debt and equity from other companies; and an exchange of existing subordinated debt with a cost basis of $7.3 million for equity interests in an affiliate of Impact Innovations Group, LLC. In addition, GACI acquired certain assets of Galaxy out of bankruptcy during the third quarter of 2004. The Company exchanged its $50.7 million outstanding debt in Galaxy for debt and equity in GACI to facilitate the asset acquisition. See Note 3 for related disclosures.

Finally, non-cash operating activities for the year ended December 31, 2004, included $25.5 million of CMBS bonds and LLC interests received from the securitization of commercial mortgage loans.

Non-cash operating activities for the year ended December 31, 2003, included transfers of commercial mortgage loans and real estate owned in the repayment of the Company s residual interest totaling $69.3 million, real estate owned received in connection with foreclosure on commercial mortgage loans of $9.1 million, receipt of commercial mortgage loans in satisfaction of private finance loans and debt securities of $9.1 million and receipt of a note as consideration from the sale of real estate owned of $3.0 million. Non-cash operating activities for the year ended December 31, 2002, included real estate owned received in connection with foreclosure on commercial mortgage loans of $2.5 million.

For the years ended December 31, 2004, 2003, and 2002, the Company s non-cash financing activities included stock option exercises and dividend reinvestment totaling $5.8 million, $6.6 million and $8.6 million, respectively. The non-cash financing activities for the years ended December 31, 2004 and 2003, also included the issuance of $3.2 million and $0.9 million, respectively, of the Company s common stock as consideration to acquire portfolio investments.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 14. Hedging Activities

The Company invests in CMBS and CDO bonds, which are purchased at prices that are based in part on comparable Treasury rates. The Company has entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of the higher rated CMBS and CDO bonds. These transactions, referred to as short sales, involve the Company receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities at value, including accrued interest payable on the obligations, as of December 31, 2004 and 2003, consisted of the following:

($ in thousands) Description of Issue	2004	2003
5-year Treasury securities, due November 2007	$	$ 7,185
5-year Treasury securities, due February 2008		5,977
5-year Treasury securities, due December 2009	533	
10-year Treasury securities, due November 2012		9,357
10-year Treasury securities, due February 2013	3,908	32,226
10-year Treasury securities, due May 2013		5,281
10-year Treasury securities, due August 2013		23,666
10-year Treasury securities, due November 2013		14,833
10-year Treasury securities, due February 2014	4,709	
10-year Treasury securities, due August 2014	14,743	
10-year Treasury securities, due November 2014	14,333	
Total	$38,226	$98,525

As of December 31, 2004 and 2003, the total obligations to replenish borrowed Treasury securities had decreased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized appreciation on the obligations of $0.3 million and $0.6 million, respectively.

The net proceeds related to the sales of the borrowed Treasury securities were $38.5 million and $98.5 million at December 31, 2004 and 2003, respectively. Under the terms of the transactions, the Company had received cash payments of $0.3 million at December 31, 2004, and had provided additional cash collateral of $18 thousand at December 31, 2003, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities.

The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with Wachovia Capital Markets, LLC under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of December 31, 2004, the repurchase agreements were due on January 5, 2005, and had a weighted average interest rate of 1.3%. The weighted average interest rate on the repurchase agreements as of December 31, 2003 was 0.3%.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 15. Financial Highlights

	At and for the Years Ended December 31,		
	2004	**2003**	**2002**
Per Common Share Data(1)			
Net asset value, beginning of year	$ 14.94	$ 14.22	$ 13.57
Net investment income	1.52	1.65	1.77
Net realized gains[2]	0.88	0.63	0.44
Net investment income plus net realized gains	2.40	2.28	2.21
Net change in unrealized appreciation or depreciation [2]	(0.52)	(0.66)	(0.01)
Net increase in net assets resulting from operations	1.88	1.62	2.20
Net decrease in net assets from shareholder distributions	(2.30)	(2.28)	(2.23)
Net increase in net assets from capital share transactions	0.35	1.38	0.68
Net asset value, end of year	$ 14.87	$ 14.94	$ 14.22
Market value, end of year	$ 25.84	$ 27.88	$ 21.83
Total return[3]	1%	41%	(7)%
Ratios and Supplemental Data			
($ and shares in thousands, except per share amounts)			
Ending net assets	$1,979,778	$1,914,577	$1,546,071
Common shares outstanding at end of year	133,099	128,118	108,698
Diluted weighted average common shares outstanding	132,458	118,351	103,574
Employee and administrative expenses/average net assets [4]	4.65%	3.50%	3.82%
Total expenses/average net assets	8.58%	8.06%	8.75%
Net investment income/average net assets	10.45%	11.51%	12.94%
Net increase in net assets resulting from operations/ average net assets	12.97%	11.33%	15.98%
Portfolio turnover rate	32.97%	31.12%	15.12%
Average debt outstanding	$ 985,616	$ 943,507	$ 938,148
Average debt per share[1]	$ 7.44	$ 7.97	$ 9.06

(1) Based on diluted weighted average number of common shares outstanding for the year.

(2) Net realized gains and net change in unrealized appreciation or depreciation can fluctuate significantly from year to year.

(3) Total return assumes the reinvestment of all dividends paid for the periods presented.

(4) Employee expenses for the year ended December 31, 2004, include the expense related to the individual performance award totaling $13.0 million.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 16. Selected Quarterly Data (Unaudited)

	2004			
($ in thousands, except per share amounts)	Qtr. 1	Qtr. 2	Qtr. 3	Qtr. 4
Total interest and related portfolio income	$81,765	$87,500	$96,863	$100,962
Net investment income	$44,545	$48,990	$52,745	$ 54,678
Net increase in net assets resulting from operations	$20,308	$95,342	$85,999	$ 47,837
Basic earnings per common share	$ 0.16	$ 0.74	$ 0.67	$ 0.36
Diluted earnings per common share	$ 0.15	$ 0.73	$ 0.66	$ 0.35

	2003			
	Qtr. 1	Qtr. 2	Qtr. 3	Qtr. 4
Total interest and related portfolio income	$73,130	$77,214	$88,870	$90,015
Net investment income	$42,670	$44,598	$53,608	$54,254
Net increase in net assets resulting from operations	$19,873	$59,940	$33,744	$78,454
Basic earnings per common share	$ 0.18	$ 0.53	$ 0.28	$ 0.63
Diluted earnings per common share	$ 0.18	$ 0.52	$ 0.28	$ 0.62

Note 17. Litigation

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATING BALANCE SHEET

(in thousands)	December 31, 2004 Allied Capital	Allied Investment	Others	Eliminations	Consolidated Total
ASSETS					
Portfolio at value:					
Private finance	$2,179,798	$100,769	$ 21,519	$	$2,302,086
Commercial real estate finance	649,587	599	61,139		711,325
Investments in subsidiaries	136,681		5,768	(142,449)	
Total portfolio at value	2,966,066	101,368	88,426	(142,449)	3,013,411
Deposits of proceeds from sales of borrowed Treasury securities	38,226				38,226
Accrued interest and dividends receivable	76,995	2,172	322		79,489
Other assets	33,927	3,023	35,762		72,712
Intercompany notes and receivables	68,444	5,727	15,338	(89,509)	
Cash and cash equivalents		46,184	10,976		57,160
Total assets	$3,183,658	$158,474	$150,824	$(231,958)	$3,260,998
LIABILITIES AND SHAREHOLDERS EQUITY					
Liabilities:					
Notes payable and debentures	$ 987,068	$ 77,500	$	$	$1,064,568
Revolving line of credit	112,000				112,000
Obligations to replenish borrowed Treasury securities	38,226				38,226
Accounts payable and other liabilities	40,107	2,117	24,202		66,426
Intercompany notes and payables	26,479	25,085	37,945	(89,509)	
Total liabilities	1,203,880	104,702	62,147	(89,509)	1,281,220
Commitments and contingencies					
Shareholders equity:					
Common stock	13		1	(1)	13
Additional paid-in capital	2,094,421	36,712	93,377	(130,089)	2,094,421
Common stock held in deferred compensation trust	(13,503)				(13,503)
Notes receivable from sale of common stock	(5,470)				(5,470)
Net unrealized appreciation (depreciation) on portfolio	(107,767)	(2,775)	1,258	1,517	(107,767)
Undistributed (distributions in excess of) earnings	12,084	19,835	(5,959)	(13,876)	12,084
Total shareholders equity	1,979,778	53,772	88,677	(142,449)	1,979,778
Total liabilities and shareholders equity	$3,183,658	$158,474	$150,824	$(231,958)	$3,260,998

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATING STATEMENT OF OPERATIONS

	For the Year Ended December 31, 2004				
(in thousands)	**Allied Capital**	**Allied Investment**	**Others**	**Eliminations**	**Consolidated Total**
Interest and Related Portfolio Income					
Interest and dividends	$304,395	$ 10,551	$ 4,696	$	$319,642
Intercompany interest	5,076			(5,076)	
Loan prepayment premiums	4,834	528	140		5,502
Income from investments in wholly owned subsidiaries	(13,185)			13,185	
Fees and other income	19,824	356	50,366	(28,600)	41,946
Total interest and related portfolio income	320,944	11,435	55,202	(20,491)	367,090
Expenses					
Interest	68,628	7,015	7		75,650
Intercompany interest		190	4,886	(5,076)	
Employee	17,293		23,435		40,728
Individual performance award	7,417		5,594		13,011
Administrative	47,129	112	17,045	(28,600)	35,686
Total operating expenses	140,467	7,317	50,967	(33,676)	165,075
Net investment income before income taxes	180,477	4,118	4,235	13,185	202,015
Income tax expense	72	1	984		1,057
Net investment income	180,405	4,117	3,251	13,185	200,958
Net Realized and Unrealized Gains (Losses)					
Net realized gains (losses)	137,793	(20,990)	437		117,240
Net change in unrealized appreciation or depreciation	(68,712)	33,749	8,030	(41,779)	(68,712)
Total net gains (losses)	69,081	12,759	8,467	(41,779)	48,528
Net increase in net assets resulting from operations	$249,486	$ 16,876	$11,718	$(28,594)	$249,486

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATING STATEMENT OF CASH FLOWS

	For the Year Ended December 31, 2004				
(in thousands)	**Allied Capital**	**Allied Investment**	**Others**	**Eliminations**	**Consolidated Total**
Cash flows from operating activities					
Net increase in net assets resulting from operations	$ 249,486	$ 16,876	$ 11,718	$ (28,594)	$ 249,486
Adjustments					
Portfolio investments	(1,438,867)	(19,978)	(13,551)		(1,472,396)
Principal collections related to investment repayments or sales	868,496	33,816	6,877		909,189
Change in accrued or reinvested interest and dividends	(54,289)	2,095	1		(52,193)
Net change in intercompany investments	(7,891)	20,415	661	(13,185)	
Amortization of discounts and fees	(4,651)	(523)	(61)		(5,235)
Changes in other assets and liabilities	22,904	375	(4,563)		18,716
Depreciation and amortization			1,433		1,433
Notes or other securities received as consideration from sale of investments	(45,460)	(2,037)			(47,497)
Realized losses	123,818	26,631	13		150,462
Net change in unrealized appreciation or depreciation	68,712	(33,749)	(8,030)	41,779	68,712
Net cash provided by (used in) operating activities	(217,742)	43,921	(5,502)		(179,323)
Cash flows from financing activities					
Sale of common stock	70,251				70,251
Sale of common stock upon the exercise of stock options	32,274				32,274
Collections of notes receivable from sale of common stock	13,162				13,162
Borrowings under notes payable and debentures	340,212				340,212
Repayments on notes payable and debentures	(214,000)	(17,000)			(231,000)
Net borrowings under (repayments on) revolving line of credit	112,000				112,000
Redemption of preferred stock		(7,000)			(7,000)
Purchase of common stock held in deferred compensation trust	(13,687)				(13,687)
Other financing activities	(3,004)				(3,004)
Common stock dividends and distributions paid	(290,830)				(290,830)
Preferred stock dividends paid		(52)	(10)		(62)
Net cash provided by (used in) financing activities	46,378	(24,052)	(10)		22,316

Net increase (decrease) in cash and cash equivalents	(171,364)	19,869	(5,512)		(157,007)
Cash and cash equivalents at beginning of year	171,364	26,315	16,488		214,167
Cash and cash equivalents at end of year	$	$ 46,184	$ 10,976	$	$ 57,160

Schedule 12-14

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

SCHEDULE OF INVESTMENTS IN AND ADVANCES TO AFFILIATES

PRIVATE FINANCE Portfolio Company (in thousands)	Investment(1)	Amount of Interest or Dividends Credited to Income(7)	Amount of Interest or Dividends Other(2)	December 31, 2003 Value	Gross Additions(3)	Gross Reductions(4)	December 31, 2004 Value
Companies More Than 25% Owned							
ACE Products, Inc. (Industrial Products)	Loan	$ 245		$ 50	$	$ (50)	$
	Common Stock						
Acme Paging, L.P. (Telecommunications)	Loan(5)			4,496	135	(4,631)	
	Equity Interests			2,586		(1,356)	1,230
	Common Stock						
Advantage Sales Marketing, Inc. (Business Services)	Loan	3,724			59,729		59,729
	Debt Securities	11,844			125,498		125,498
	Common Stock				97,724		97,724
Alaris Consulting, LLC (Business Services)	Loan(5)	(64)		8,160	4,310	(7,807)	4,663
	Equity Interests						
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Loan(5)			23,501	5,744	(25,020)	4,225
	Debt Securities			8,684		(8,684)	
	Common Stock						
Avborne, Inc. (Business Services)	Loan	272	177	2,863		(1,771)	1,092
	Preferred Stock			2,300	5,020		7,320
	Common Stock						
Avborne Heavy Maintenance, Inc. (Business Services)	Preferred Stock						
	Common Stock						
Business Loan Express, LLC (Financial Services)	Loan	2			10,000	(10,000)	
	Debt Securities	10,577		40,044	4,571		44,615
	Class A Equity Interests	12,676		47,800	6,062		53,862
	Class B Equity Interests*	14,750		99,386	14,750	(15,395)	98,741
	Class C Equity Interests		39	154,960		(16,972)	137,988
Callidus Capital Corporation (Financial Services)	Loan	273			42,213		42,213
	Loan	63			1,391	(1,325)	66
	Debt Securities	734		3,500	551		4,051
	Common Stock			1,768	1,832		3,600

Chickasaw Sales & Marketing, Inc.	Preferred Stock			1,000	(1,000)	
(Consumer Services)	Common Stock			2,812	(2,812)	
The Color Factory, Inc.	Loan		6,952	1,812	(8,764)	
(Consumer Products)	Preferred Stock					
	Common Stock					
Fairchild Industrial Products Company	Loan	261	7,166	264	(392)	7,038
(Industrial Products)	Debt Securities	198	3,534	2,420	(2,121)	3,833
	Common Stock			2,841	(718)	2,123
Financial Pacific Company	Loan	4,987		68,473		68,473
(Financial Services)	Preferred Stock*	327		10,448		10,448
	Common Stock			14,819		14,819
ForeSite Towers, LLC	Equity Interests*	366	17,638	3,873		21,511
(Tower Leasing)						
GAC Investments, Inc.	Loan(5)			11,000	(3,483)	7,517
(Broadcasting & Cable)	Common Stock			43,353	(43,353)	
Global Communications, LLC	Loan	507	2,350	3,919		6,269
(Business Services)	Debt Securities	2,842	17,247	946		18,193
	Preferred Equity Interest		18,351		(3,742)	14,609
	Options		1,639	522		2,161

		Amount of Interest or Dividends					
PRIVATE FINANCE Portfolio Company (in thousands)	**Investment[1]**	**Credited to Income[7]**	**Other[2]**	**December 31, 2003 Value**	**Gross Additions[3]**	**Gross Reductions[4]**	**December 31, 2004 Value**
Gordian Group, Inc.	Loan[5]	(19)	664	9,382	3,080	(5,081)	7,381
(Business Services)	Common Stock			4,000	3,435	(7,435)	
HealthASPex, Inc.	Preferred Stock			700			700
(Business Services)	Preferred Stock			2,650		(897)	1,753
	Common Stock						
The Hillman Companies,		2,091		43,965	604	(44,569)	
Inc.	Debt Securities						
(Consumer Products)	Common Stock			190,577		(190,577)	
HMT, Inc.	Debt Securities	1,478		9,186	128		9,314
(Energy Services)	Preferred Stock*	150		2,303	234		2,537
	Common Stock			4,264		(654)	3,610
	Warrants			1,641		(251)	1,390
Housecall Medical		2,668		15,242	368		15,610
Resources, Inc.	Loan						
(Healthcare Services)	Preferred Stock		3,889	3,889		(3,889)	
	Common Stock			23,000	8,898		31,898
Impact Innovations	Equity Interests				15,528	(14,756)	772
Group, LLC	in Affiliate						
(Business Services)	Warrants						
Insight Pharmaceuticals		21			66,115		66,115
Corporation	Senior Loan						
(Consumer Products)	Loan	18			57,213		57,213
	Preferred Stock				25,000		25,000
	Common Stock				6,325		6,325

This schedule should be read in conjunction with the Company s consolidated financial statements as of and for the year ended December 31, 2004, including the consolidated statement of investments and Note 3 to the consolidated financial statements. Note 3 includes additional information regarding activities in the private finance portfolio for the year ended December 31, 2004.

(1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of December 31, 2004.
(2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.
(3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, and the exchange of one or more existing securities for one or more new securities. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.
(4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales and the exchange of one or more existing securities for one or more new securities. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.
(5)

Loan or debt security is on non-accrual status at December 31, 2004, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the year may or may not have been on non-accrual status for the full year ended December 31, 2004.

(6) Data is included for these companies less than 5% owned at December 31, 2004, as these companies were included in the companies 5% to 25% owned category during the past year, however, due to changes in affiliation status were classified in the less than 5% owned category at December 31, 2004.

(7) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.

* All or a portion of the dividend income on this investment was or will be paid in the form of additional securities. Dividends paid-in-kind are also included in the Gross Additions for the investment, as applicable.

PRIVATE FINANCE Portfolio Company (in thousands)	Investment[1]	Amount of Interest or Dividends Credited to Income[7]	Other[2]	December 31, 2003 Value	Gross Additions[3]	Gross Reductions[4]	December 31, 2004 Value
Jakel, Inc.	Loan[5]	$ 461		$ 2,062	$ 3,350	$	$ 5,412
(Industrial Products)	Debt Securities[5]	1,007		7,770	560		8,330
	Preferred Stock			4,069		(3,233)	836
	Common Stock						
Legacy Partners Group, LLC	Loan[5]	147			6,647		6,647
(Financial Service)	Debt Securities[5]	152			2,952	(1,056)	1,896
	Equity Interests				2,729	(2,729)	
Litterer Beteiligungs-GmbH	Debt Securities	31		1,379	52	(716)	715
(Business Service)	Equity Interest				2,656	(60)	2,596
Maui Body Works, Inc.	Common Stock				2,500	(1,420)	1,080
(Healthcare Services)							
Mercury Air Centers, Inc.	Senior Loan	1,470			20,000		20,000
(Business Services)	Loan	4,020			34,613		34,613
	Common Stock				31,214		31,214
MVL Group, Inc.	Loan	2,517		19,075	54	(3,473)	15,656
(Business Services)	Debt Securities	2,681		16,787	739		17,526
	Common Stock			643	9,157		9,800
Pennsylvania Avenue					1,027	(235)	792
Investors, L.P.	Equity Interests						
(Private Equity Fund)							
Powell Plant Farms, Inc.	Loan	4,290		21,542	11,500	(9,850)	23,192
(Consumer Products)	Debt Securities[5]			11,692		(1,104)	10,588
	Preferred Stock						
	Warrants						
Redox Brands, Inc.	Loan	627		3,127	198		3,325
(Consumer Products)	Debt Securities	1,887		10,243	429		10,672
	Preferred Stock	458		6,965	4,699		11,664
	Warrants			584			584
Staffing Partners Holding					1,000		1,000
Company, Inc.	Loan[5]						
(Business Services)	Debt Securities[5]	216		5,794	290		6,084
	Preferred Stock			2,018		(57)	1,961
	Common Stock						
	Warrants						
Startec Global		992		22,170	4,022	(9,671)	16,521
Communications	Loan						
Corporation	Debt Securities	(649)					
(Telecommunications)	Common Stock				37,255	(29,455)	7,800
STS Operating, Inc.	Preferred Stock	412		6,473	576	(773)	6,276
(Industrial Products)	Common Stock			3,700	5,932		9,632
	Options						

Sure-Tel, Inc.	Preferred Stock		1,000		(1,000)	
(Consumer Services)	Common Stock		320		(320)	
Total companies more than 25% owned		**$91,710**				**$1,359,641**
Companies 5% to 25% Owned						
Air Evac Lifeteam	Debt Securities	$ 2,455	$	$39,964	$	$ 39,964
(Healthcare Services)	Equity Interests			3,000	(1,908)	1,092
Aspen Pet Products, Inc.	Loans	3,558	17,675	1,109		18,784
(Consumer Products)	Preferred Stock		845	79	(27)	897
	Common Stock					
	Warrants					
Becker Underwood, Inc.	Loan	1,144		22,939		22,939
(Industrial Products)	Common Stock			5,000		5,000
Border Foods, Inc.	Loan	396	3,000			3,000
(Consumer Products)	Debt Securities	1,375	9,454	56		9,510
	Preferred Stock		2,000			2,000
	Common Stock		71		(71)	
	Warrants		1,059		(1,059)	

PRIVATE FINANCE Portfolio Company (in thousands)	Investment[1]	Amount of Interest or Dividends Credited to Income[7]	Other[2]	December 31, 2003 Value	Gross Additions[3]	Gross Reductions[4]	December 31, 2004 Value
CBA-Mezzanine Capital Finance, LLC (Financial Services)	Loan	467		16,185	1,028	(17,213)	
CorrFlex Graphics, LLC (Business Services)	Debt Securities	952		12,699	419	(13,118)	
	Warrants			18,411		(18,411)	
	Options			1,589		(1,589)	
The Debt Exchange Inc. (Business Services)	Preferred Stock	75		1,250	207		1,457
GFC Holdings, LLC (Business Services)	Warrants				800	(800)	
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities			2,454	658	(3,112)	
	Common Stock						
MasterPlan, Inc. (Business Services)	Loan	147		959	245		1,204
	Common Stock			200	3,100		3,300
MedBridge Healthcare, LLC (Healthcare Services)	Loan	208			11,311		11,311
	Convertible Debenture[5]				1,015	(337)	678
MortgageRamp, Inc. (Business Services)	Common Stock			2,084		(1,181)	903

This schedule should be read in conjunction with the Company s consolidated financial statements as of and for the year ended December 31, 2004, including the consolidated statement of investments and Note 3 to the consolidated financial statements. Note 3 includes additional information regarding activities in the private finance portfolio for the year ended December 31, 2004.

(1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of December 31, 2004.
(2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.
(3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, and the exchange of one or more existing securities for one or more new securities. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.
(4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales and the exchange of one or more existing securities for one or more new securities. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.
(5) Loan or debt security is on non-accrual status at December 31, 2004, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the year may or may not have been on non-accrual status for the full year ended December 31, 2004.
(6) Data is included for these companies less than 5% owned at December 31, 2004, as these companies were included in the companies 5% to 25% owned category during the past year, however, due to changes in affiliation status were classified in the less than 5% owned category at December 31, 2004.

(7) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.

* All or a portion of the dividend income on this investment was or will be paid in the form of additional securities. Dividends paid-in-kind are also included in the Gross Additions for the investment, as applicable.

PRIVATE FINANCE Portfolio Company (in thousands)	Investment[1]	Amount of Interest or Dividends Credited to Income[7]	Amount of Interest or Dividends Other[2]	December 31, 2003 Value	Gross Additions[3]	Gross Reductions[4]	December 31, 2004 Value
Nexcel Synthetics, LLC	Loan	$ 2,158		$	$ 10,211	$	$ 10,211
(Consumer Products)	Equity Interests				1,690	(1,003)	687
Packaging Advantage Corporation	Debt Securities	1,800	75	14,350	456	(75)	14,731
(Business Services)	Common Stock			1,069	410		1,479
	Warrants			431	166		597
Pres Air Trol LLC	Debt Securities	582			6,521	(500)	6,021
(Industrial Products)	Equity Interests				1,323	(423)	900
Professional Paint, Inc.	Loan	736		4,976	346	(5,322)	
(Consumer Products)	Debt Securities	3,428		24,258	1,566	(25,824)	
	Preferred Stock	2,257		22,156	2,955	(25,111)	
	Common Stock			5,500		(5,500)	
Progressive International Corporation	Debt Securities	678		3,977	23	(4,000)	
(Consumer Products)	Loan	658			7,221		7,221
	Preferred Stock			707		(121)	586
	Common Stock			668		(655)	13
	Warrants						
Soteria Imaging Services, LLC	Loan	168			8,340		8,340
(Healthcare Services)	Equity Interests				2,114		2,114
Total Foam, Inc.	Debt Securities		52	105		(105)	
(Industrial Products)	Common Stock						
Universal Environmental Services, LLC	Loan	670			12,099		12,099
(Business Services)	Equity Interests				1,864		1,864
Total companies 5% to 25% owned							$ 188,902
Companies less than 5% owned [6]							
Apogen Technologies Inc. (f/k/a	Debt Securities	90		4,978	4		4,982
Sidarus Holdings, Inc.)	Preferred Stock			980	2,175		3,155
(Business Services)	Common Stock			896	1,399		2,295
	Warrants			5	443		448
EDM Consulting, LLC	Debt Securities		1	218		(218)	
(Business Services)	Equity Interests						
	Loan				100		100
International Fiber Corporation	Debt Securities	1,502		22,828	510	(23,338)	

(Industrial Products)	Common Stock		6,816		(6,816)	
	Warrants		684		(684)	
	Debt Securities			21,016		21,016
	Preferred Stock			2,500		2,500
Nobel Learning		172	9,838	162	(10,000)	
Communities, Inc.	Debt Securities					
(Education)	Preferred Stock*	26	2,764			2,764
	Warrants		166	142		308
Total		$25,702				

This schedule should be read in conjunction with the Company s consolidated financial statements as of and for the year ended December 31, 2004, including the consolidated statement of investments and Note 3 to the consolidated financial statements. Note 3 includes additional information regarding activities in the private finance portfolio for the year ended December 31, 2004.

(1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of December 31, 2004.

(2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.

(3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, and the exchange of one or more existing securities for one or more new securities. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.

(4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales and the exchange of one or more existing securities for one or more new securities. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.

(5) Loan or debt security is on non-accrual status at December 31, 2004, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the year may or may not have been on non-accrual status for the full year ended December 31, 2004.

(6) Data is included for these companies less than 5% owned at December 31, 2004, as these companies were included in the companies 5% to 25% owned category during the past year, however, due to changes in affiliation status were classified in the less than 5% owned category at December 31, 2004.

(7) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.

* All or a portion of the dividend income on this investment was or will be paid in the form of additional securities. Dividends paid-in-kind are also included in the Gross Additions for the investment, as applicable.

PART C

OTHER INFORMATION

Item 25. Financial Statements and Exhibits

1. Financial Statements.

The following financial statements of Allied Capital Corporation are included in this registration statement in Part A: Information Required in a Prospectus :

2. Exhibits

Exhibit Number	Description
a.1	Restated Articles of Incorporation. *(Incorporated by reference to Exhibit a.1 filed with Allied Capital s Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).*
b.	Amended and Restated Bylaws. *(Incorporated by reference to Exhibit 3.1 filed with Allied Capital s Form 8-K on December 15, 2004).*
c.	Not applicable.
d.	Specimen Certificate of Allied Capital s Common Stock, par value $0.0001 per share. *(Incorporated by reference to Exhibit d. filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
e.	Dividend Reinvestment Plan, as amended. *(Incorporated by reference to Exhibit e. filed with Allied Capital s registration statement on Form N-2 (File No. 333-87862) filed on May 8, 2002).*
f.1	Form of debenture between certain subsidiaries of Allied Capital and the U.S. Small Business Administration. *(Incorporated by reference to Exhibit 4.2 filed by a predecessor entity to Allied Capital on Form 10-K for the year ended December 31, 1996).*
f.2	Third Amended and Restated Credit Agreement, dated April 18, 2003. *(Incorporated by reference to Exhibit 10.2 filed with Allied Capital s Form 10-Q for the period ended March 31, 2003).*
f.2(a)	First Amendment to Credit Agreement, dated as of October 6, 2003. *(Incorporated by reference to Exhibit 10.2(a) filed with Allied Capital s Form 10-Q for the period ended September 30, 2003).*

Exhibit Number	Description
f.2(b)	Second Amendment to Credit Agreement, dated as of December 17, 2003. *(Incorporated by reference to Exhibit 10.2(b) filed with Allied Capital s Form 10-K for the year ended December 31, 2003).*
f.2(c)	Third Amendment to Credit Agreement, dated May 28, 2004.*(Incorporated by reference to Exhibit 10.2(c) filed with Allied Capital s Form 10-Q for the period ended June 30, 2004).*
f.2(d)*	Fourth Amendment to Credit Agreement, dated March 29, 2005.
f.3	Note Agreement, dated as of April 30, 1998. *(Incorporated by reference to Exhibit 10.2 filed with Allied Capital s Form 10-Q for the period ended June 30, 1998).*
f.4	Loan Agreement between a predecessor entity to Allied Capital and Overseas Private Investment Corporation, dated April 10, 1995. *(Incorporated by reference to Exhibit f.7 filed by a predecessor entity to Allied Capital to Pre-Effective Amendment No. 2 to the registration statement on Form N-2 (File No. 33-64629) filed on January 24, 1996).* Letter, dated December 11, 1997, evidencing assignment of Loan Agreement from the predecessor entity of Allied Capital to Allied Capital. *(Incorporated by reference to Exhibit 10.3 of Allied Capital s Form 10-K for the year ended December 31, 1997).*
f.5	Note Agreement, dated as of May 1, 1999. *(Incorporated by reference to Exhibit 10.5 filed with Allied Capital s Form 10-Q for the period ended June 30, 1999).*
f.12	Note Agreement, dated as of October 15, 2000. *(Incorporated by reference to Exhibit 10.4b filed with Allied Capital s Form 10-Q for the period ended September 30, 2000).*
f.13	Note Agreement, dated as of October 15, 2001. *(Incorporated by reference to Exhibit f.10 filed with Allied Capital s Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).*
f.15	Control Investor Guaranty Agreement, dated as of March 28, 2001, between Allied Capital and Fleet National Bank and Business Loan Express, Inc. *(Incorporated by reference to Exhibit f.14 filed with Allied Capital s Post-Effective Amendment No. 3 to registration statement on Form N-2 (File No. 333-43534) filed on May 15, 2001).*
f.19	Note Agreement, dated as of May 14, 2003. *(Incorporated by reference to Exhibit 10.31 filed with Allied Capital s Form 10-Q for the quarter ended March 31, 2003).*
f.20	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of April 30, 1998. *(Incorporated by reference to Exhibit 10.32 filed with Allied Capital s Form 10-Q for the period ended March 31, 2003).*
f.21	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of May 1, 1999. *(Incorporated by reference to Exhibit 10.33 filed with Allied Capital s Form 10-Q for the period ended March 31, 2003).*
f.23	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2000. *(Incorporated by reference to Exhibit 10.35 filed with Allied Capital s Form 10-Q for the period ended March 31, 2003).*

Exhibit Number	Description
f.24	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2001. *(Incorporated by reference to Exhibit 10.36 filed with Allied Capital s Form 10-Q for the period ended March 31, 2003).*
f.25	Note Agreement, dated as of March 25, 2004. *(Incorporated by reference to Exhibit 10.38 filed with Allied Capital s Form 10-Q for the period ended March 31,2004.)*
f.26	Note Agreement, dated as of November 15, 2004. *(Incorporated by reference to Exhibit 99.1 filed with Allied Capital s current report on Form 8-K filed on November 18, 2004).*
g.	Not applicable.
h.**	Form of Underwriting Agreement.
i.2	Non-Qualified Deferred Compensation Plan II. *(Incorporated by reference to Exhibit A filed with Allied Capital s Proxy Statement filed on March 30, 2004).*
i.3	Amended and Restated Deferred Compensation Plan, dated January 30, 2004. *(Incorporated by reference to Exhibit 10.16 filed with Allied Capital s Form 10-K for the year ended December 31, 2003).*
i.4	Amended Stock Option Plan. *(Incorporated by reference to Exhibit B of Allied Capital s definitive proxy statement for Allied Capital s 2004 Annual Meeting of Stockholders filed on March 30, 2004).*
i.5	Allied Capital Corporation 401(k) Plan, dated September 1, 1999. *(Incorporated by reference to Exhibit 4.4 filed with Allied Capital s registration statement on Form S-8 (File No. 333-88681) filed on October 8, 1999).*
i.5(a)	Amendment to Allied Capital Corporation 401(k) Plan, dated April 15, 2004. *(Incorporated by reference to Exhibit 10.20(b) filed with Allied Capital s Form 10-Q for the period ended June 30, 2004).*
i.6	Employment Agreement, dated January 1, 2004, between Allied Capital and William L. Walton. *(Incorporated by reference to Exhibit 10.21 filed with Allied Capital s Form 10-K for the year ended December 31, 2003).*
i.7	Employment Agreement, dated January 1, 2004, between Allied Capital and Joan M. Sweeney. *(Incorporated by reference to Exhibit 10.22 filed with Allied Capital s Form 10-K for the year ended December 31, 2003).*
i.8	Retention Agreement, dated March 21, 2005, between Allied Capital and John M. Scheurer, *(Incorporated by reference to Exhibit 99.1 filed with Allied Capital s current report on Form 8-K filed on March 24, 2005).*
j.1	Form of Custody Agreement with Riggs Bank N.A. *(Incorporated by reference to Exhibit j.1 filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
j.2	Form of Custody Agreement with LaSalle National Bank. *(Incorporated by reference to Exhibit j.2 filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
j.3	Custodian Agreement with LaSalle National Bank Association dated July 9, 2001. *(Incorporated by reference to Exhibit j.3 filed with Allied Capital s registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).*

Exhibit Number	Description
k.1	Agreement and Plan of Merger by and among Allied Capital, Allied Capital Lock Acquisition Corporation, and Sunsource, Inc dated June 18, 2001. *(Incorporated by reference to Exhibit k.1 filed with Allied Capital s registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).*
k.2	Form of Indemnification Agreement between Allied Capital and its directors and certain officers. *(Incorporated by reference to Exhibit 10.37 filed with Allied Capital s Form 10-K for the year ended December 31, 2003).*
l.**	Opinion of counsel and consent to its use.
m.	Not applicable.
n.1**	Consent of Sutherland Asbill & Brennan LLP. *(Contained in exhibit l).*
n.2.a*	Consent of KPMG LLP, independent registered public accounting firm.
n.3.a*	Opinion of KPMG LLP, independent registered public accounting firm, regarding Senior Securities table contained herein.
n.3.b*	Opinion of KPMG LLP, independent registered public accounting firm, regarding financial statement schedule contained herein.
o.	Not applicable.
p.	Not applicable.
q.	Not applicable.
r.	Code of Ethics. *(Incorporated by reference to Exhibit 10.28 filed with Allied Capital s Form 10-K for the year ended December 31, 2003.)*

* Filed herewith.

** To be filed by amendment.

Item 26. Marketing Arrangements

The information contained under the heading Plan of Distribution of the prospectus is incorporated herein by reference, and any information concerning any underwriters will be contained in the accompanying prospectus supplement, if any.

Item 27. Other Expenses of Issuance and Distribution*

SEC registration fee	$ 9,362
NASD filing fee	75,500
New York Stock Exchange Additional Listing Fee	**
Accounting fees and expenses	200,000
Legal fees and expenses	350,000
Printing and engraving	135,000
Miscellaneous fees and expenses	**
Total	$ **

* Estimated for filing purposes and excludes fees previously paid.

** To be provided by amendment.

All of the expenses set forth above shall be borne by us.

Item 28. Persons Controlled by or Under Common Control

Direct Subsidiaries

The following list sets forth each of our subsidiaries, the state or country under whose laws the subsidiary is organized, and the percentage of voting securities or membership interests owned by us in such subsidiary:

Allied Investment Corporation (Maryland)	100%
Allied Capital REIT, Inc. (Allied REIT) (Maryland)	100%
A.C. Corporation (Delaware)	100%
Allied Capital Holdings, LLC (Delaware)	100%
Allied Capital Beteiligungsberatung GmbH (Germany) (inactive)	100%

Each of our subsidiaries is consolidated for financial reporting purposes, except as noted below.

Indirect Subsidiaries

We indirectly control the entities set forth below through Allied REIT. Allied REIT owns either all of the membership interests (in the case of a limited liability company, LLC) or all of the outstanding voting stock (in the case of a corporation) of each entity. The following list sets forth each of Allied REIT s subsidiaries, the state under whose laws the subsidiary is organized, and the percentage of voting securities or membership interests owned by Allied REIT of such subsidiary:

Allied Capital Property LLC (Delaware)	100%
Allied Capital Equity LLC (Delaware)	100%
9586 I-25 East Frontage Road, Longmont, CO 80504 LLC (Delaware)	100%

We indirectly control Allied Investment Holdings LLC (Delaware) through Allied Investment Corporation, which owns 100% of the membership interests. We indirectly control AC Management Services, Inc. (Delaware) through A.C. Corporation, which owns 100% of the common stock. We indirectly control Allied Capital Investors, LLC (Delaware) through A.C. Corporation, which is the sole member and manager. We indirectly control A.C. Management Services, LLC (Delaware) through A.C. Corporation, which is the sole member and manager.

Other Entities Deemed to be Controlled by the Company

We have also established certain limited purpose entities in order to facilitate certain portfolio transactions. In addition, we may be deemed to control certain portfolio companies. See Portfolio Companies in the prospectus.

Item 29. Number of Holders of Securities

The following table sets forth the approximate number of record holders of our common stock at March 21, 2005.

Title of Class	Number of Record Holders
Common stock, $0.0001 par value	4,700

We have privately issued long-term debt securities to 28 institutional lenders, primarily insurance companies.

Item 30. Indemnification

Section 2-418 of the Maryland General Corporation Law provides that a Maryland corporation may indemnify any director of the corporation and any person who, while a director of the corporation, is or was serving at the request of the corporation as a director, officer, partner, trustee, employee, or agent of another foreign or domestic corporation, partnership, joint venture, trust, other enterprise or employee benefit plan, made a party to any proceeding by reason of service in that capacity unless it is established that the act or omission of the director was material to the matter giving rise to the proceeding and was committed in bad faith or was the result of active and deliberate dishonesty; or the director actually received an improper personal benefit in money, property or services; or, in the case of any criminal proceeding, the director had reasonable cause to believe that the act or omission was unlawful. Indemnification may be made against judgments, penalties, fines, settlements, and reasonable expenses actually incurred by the director in connection with the proceeding, but if the proceeding was one by or in the right of the corporation, indemnification may not be made in respect of any proceeding in which the director shall have been adjudged to be liable to the corporation. Such indemnification may not be made unless authorized for a specific proceeding after a determination has been made, in the manner prescribed by the law, that indemnification is permissible in the circumstances because the director has met the applicable standard of conduct. On the other hand, the director must be indemnified for expenses if he or she has been successful in the defense of the proceeding or as otherwise ordered by a court. The law also prescribes the circumstances under which the corporation may advance expenses to, or obtain insurance or similar cover for, directors.

The law also provides for comparable indemnification for corporate officers and agents.

The Restated Articles of Incorporation of Allied Capital provide that its directors and officers shall, and its agents in the discretion of the board of directors may be indemnified to the fullest extent permitted from time to time by the laws of Maryland (with such power to indemnify officers and directors limited to the scope provided for in Section 2-418 as currently in force), provided, however, that such indemnification is limited by the Investment Company Act of 1940 or by any valid rule, regulation or order of the Securities and Exchange Commission thereunder. Allied Capital s bylaws, however, provide that Allied Capital may not indemnify any director or officer against liability to Allied Capital or its security holders to which he or she might otherwise be subject by reason of such person s willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office unless a determination is made by final decision of a court, by vote of a majority of a quorum of directors who are disinterested, non-party directors or by independent legal counsel that the liability for which indemnification is sought did not arise out of such disabling conduct.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of Allied Capital pursuant to the provisions described above, or otherwise, Allied Capital has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by Allied Capital of expenses incurred or paid by a director, officer or controlling person in the successful defense of an action, suit or proceeding) is asserted by a director, officer or controlling person in connection with the securities being registered, Allied Capital will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of the court of the issue.

Allied Capital carries liability insurance for the benefit of its directors and officers on a claims-made basis of up to $50,000,000, subject to a $1,000,000 retention and the other terms thereof. Allied Capital also maintains an additional $10,000,000 of insurance coverage for the benefit of its directors and officers.

As of March 21, 2005, we have entered into indemnification agreements with our directors and 16 senior officers. The indemnification agreements attempt to provide these directors and senior officers the maximum indemnification permitted under Maryland law and the Investment Company Act of 1940. Each indemnification agreement provides that Allied Capital shall indemnify the director or senior officer who is a party to the agreement (an Indemnitee) if, by reason of his corporate status, the Indemnitee is, or is threatened to be, made a party to or a witness in any threatened, pending, or completed proceeding, other than a proceeding by or in the right of Allied Capital.

At present, these is no pending litigation or proceeding involving an Indemnitee where indemnification would be required or permitted under the indemnification agreement.

Item 31. Business and Other Connections of Investment Adviser

Not applicable.

Item 32. Location of Accounts and Records

We maintain at our principal office physical possession of each account, book or other document required to be maintained by Section 31(a) of the 1940 Act and the rules thereunder.

Item 33. Management Services

Not applicable.

Item 34. Undertakings

We hereby undertake:

(1) to suspend the offering of shares until the prospectus is amended if subsequent to the effective date of this registration statement, our net asset value declines more than ten percent from our net asset value as of the effective date of this registration statement or (2) our net asset value increases to an amount greater than our net proceeds as stated in the prospectus;

(2) to file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:

(i) to include any prospectus required by Section 10(a)(3) of the Securities Act of 1933;

(ii) to reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the SEC pursuant to Rule 424(b) under the Securities Act of 1933 if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement; and

(iii) to include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.

(3) that, for the purpose of determining any liability under the Securities Act of 1933, the information omitted from the form of prospectus filed as part of this registration statement in reliance upon Rule 430A and contained in a form of prospectus filed by us under Rule 497(h) under the Securities Act of 1933 shall be deemed to be part of this registration statement as of the time it was declared effective;

(4) to remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering; and

(5) that, for the purpose of determining any liability under the Securities Act of 1933, each post effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of the securities at that time shall be deemed to be the initial bona fide offering thereof.

SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the Registrant has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Washington, in the District of Columbia, on the 7th day of April, 2005.

ALLIED CAPITAL CORPORATION

By: /s/ WILLIAM L. WALTON

William L. Walton,
Chairman of the Board, Chief
Executive Officer and President

KNOW ALL MEN BY THESE PRESENT, each person whose signature appears below hereby constitutes and appoints William L. Walton and Joan M. Sweeney and each of them, his or her true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him or her and in his or her name, place, and stead, in any and all capacities, to sign any and all amendments to this Registration Statement, and to file the same, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he or she might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or their substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed by the following persons in the capacities indicated on April 7, 2005.

Signature	Title
/s/ WILLIAM L. WALTON William L. Walton	Chairman of the Board, Chief Executive Officer, and President
/s/ BROOKS H. BROWNE Brooks H. Browne	Director
/s/ JOHN D. FIRESTONE John D. Firestone	Director
/s/ ANTHONY T. GARCIA Anthony T. Garcia	Director
/s/ ANN TORRE GRANT Ann Torre Grant	Director
/s/ LAWRENCE I. HEBERT Lawrence I. Hebert	Director
/s/ JOHN I. LEAHY John I. Leahy	Director

Signature	Title
/s/ ROBERT E. LONG Robert E. Long	Director
/s/ ALEX J. POLLOCK Alex J. Pollock	Director
/s/ MARC F. RACICOT Marc F. Racicot	Director
/s/ GUY T. STEUART II Guy T. Steuart II	Director
/s/ JOAN M. SWEENEY Joan M. Sweeney	Director
/s/ LAURA W. VAN ROIJEN Laura W. van Roijen	Director
/s/ PENNI F. ROLL Penni F. Roll	Chief Financial Officer (Principal Financial and Accounting Officer)

INDEX TO EXHIBITS

Exhibit Number	Description
Ex - f.2(d)	Fourth Amendment to Credit Agreement, dated March 29, 2005.
Ex - 99.n.2.a	Consent of KPMG LLP, independent registered public accounting firm.
Ex - 99.n.3.a	Opinion of KPMG LLP, independent registered public accounting firm, regarding Senior Securities table contained herein.
Ex - 99.n.3.b	Opinion of KPMG LLP, independent registered public accounting firm, regarding financial statement schedule contained herein.