

FIRST PACIFIC COMPANY LTD /FI
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 October 04, 2007

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Warrants

Soteria Imaging Services, LLC

Subordinated Debt (11.8%, Due 11/10) 14,500 13,447 13,447
 (Healthcare Services)

Equity Interests 2,153 2,308

Universal Environmental Services, LLC

Unitranche Debt (15.5%, Due 2/09) 10,900 10,862 10,862
 (Business Services)

Equity Interests 1,797 1,328 Total companies 5% to 25% owned \$168,373 \$158,806 **Companies**

Less Than 5% Owned

Advanced Circuits, Inc.

Senior Loans (10.1%, Due 9/11 3/12) \$18,732 \$18,642 \$18,642
 (Industrial Products)

Common Stock (40,000 shares) 1,000 1,000

Anthony, Inc.

(Industrial Products)

Subordinated Debt (12.9%, Due 9/11 9/12) 14,670 14,610 14,610

Benchmark Medical, Inc.

Warrants 18 190

(Healthcare Services)

BI Incorporated

Subordinated Debt (14.0%, Due 2/12) 16,203 16,133 16,133
 (Business Services)

Border Foods, Inc.

Subordinated Debt (13.0%, Due 12/10)⁽⁶⁾ 13,428 12,721
 (Consumer Products)

Preferred Stock (140,214 shares) 2,893 Common Stock (1,810 shares) 45 Warrants 910

- (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.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

December 31, 2005

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
C&K Market, Inc. (Retail)	Subordinated Debt (13.0%, Due 12/08)	\$ 14,694	\$ 14,638	\$ 14,638
Callidus Debt Partners CDO Fund I, Ltd. ⁽⁴⁾⁽⁹⁾ (Senior Debt Fund)	Class C Notes (12.9%, Due 12/13) Class D Notes (17.0%, Due 12/13)	18,800 9,400	18,973 9,487	18,973 9,487
Callidus Debt Partners CLO Fund III, Ltd. ⁽⁴⁾⁽⁹⁾ (Senior Debt Fund)	Preferred Shares (23,600,000 shares)		24,233	24,233
Callidus MAPS CLO Fund I LLC ⁽⁹⁾ (Senior Debt Fund)	Class E Notes (9.7%, Due 12/17) Income Notes	17,000	17,000 48,108	17,000 48,108
Camden Partners Strategic Fund II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,142	2,726
Catterton Partners V, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,650	2,691
CBS Personnel Holdings, Inc. (Business Services)	Subordinated Debt (14.5%, Due 12/09)	20,617	20,541	20,541
Community Education Centers, Inc. (Education Services)	Subordinated Debt (16.0%, Due 12/10)	32,852	32,738	32,738
Component Hardware Group, Inc. (Industrial Products)	Preferred Stock (18,000 shares) Common Stock (2,000 shares)		2,605 200	2,783 700
Cooper Natural Resources, Inc. (Industrial Products)	Subordinated Debt (0%, Due 11/07) Preferred Stock (6,316 shares) Warrants	840	840 1,424 830	840 20
Coverall North America, Inc. (Business Services)	Subordinated Debt (14.6%, Due 2/11) Preferred Stock (6,500 shares)	27,309	27,261 6,500	27,261 6,866

Warrants

2,950

3,100

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- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (9) The fund is managed by Callidus Capital, a portfolio company of Allied Capital.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

December 31, 2005

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
Drilltec Patents & Technologies Company, Inc. (Energy Services)	Subordinated Debt (17.0%, Due 8/06) ⁽⁶⁾	\$ 1,500	\$ 1,500	\$ 1,500
	Subordinated Debt (10.0%, Due 8/06) ⁽⁶⁾	10,994	10,918	9,792
eCentury Capital Partners, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		5,649	83
Elexis Beta GmbH ⁽⁴⁾ (Industrial Products)	Options		426	50
Event Rentals, Inc. (Consumer Services)	Senior Loans (9.9%, Due 11/11)	18,341	18,244	18,244
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	470
Garden Ridge Corporation (Retail)	Subordinated Debt (7.0%, Due 5/12) ⁽⁶⁾	22,500	22,500	22,500
Geotrace Technologies, Inc. (Energy Services)	Subordinated Debt (10.0%, Due 6/09)	25,618	23,875	23,875
	Warrants		2,350	2,500
Ginsey Industries, Inc. (Consumer Products)	Subordinated Debt (12.5%, Due 3/07)	3,680	3,680	3,680
Grant Broadcasting Systems II (Broadcasting & Cable)	Subordinated Debt (5.0%, Due 6/09)	2,756	2,756	2,756
Grotech Partners, VI, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		6,914	4,161
Havco Wood Products LLC (Industrial Products)	Unitranche Debt (10.4%, Due 8/11)	33,000	31,794	31,794
	Equity Interests		1,048	1,048
Haven Eldercare of New England, LLC ⁽¹⁰⁾	Subordinated Debt (12.0%, Due 8/09) ⁽⁶⁾	4,320	4,320	4,320

(Healthcare Services)

Haven Healthcare Management, LLC ⁽¹⁰⁾ (Healthcare Services)	Subordinated Debt (18.0% Due 4/07) ⁽⁶⁾	1,319	1,319	485
HealthASPex Services Inc. (Business Services)	Senior Loans (4.0%, Due 7/08)	500	500	500
The Hillman Companies, Inc. ⁽³⁾ (Consumer Products)	Subordinated Debt (13.5%, Due 9/11)	44,000	43,815	43,815
Homax Holdings, Inc. (Consumer Products)	Subordinated Debt (12.0%, Due 8/11)	14,000	13,039	13,039
	Preferred Stock (89 shares)		89	92
	Common Stock (28 shares)		6	6
	Warrants		1,106	1,492
Icon International, Inc. (Business Services)	Common Stock (25,707 shares)		76	16
International Fiber Corporation (Industrial Products)	Subordinated Debt (14.0%, Due 6/12)	21,546	21,460	21,460
	Preferred Stock (25,000 shares)		2,500	1,900
Line-X, Inc. (Consumer Products)	Senior Loan (8.1%, Due 8/11)	4,134	4,111	4,111
	Unitranche Debt (10.0% Due 8/11)	51,475	51,229	51,229
	Standby Letter of Credit (\$1,500)			

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- (10) Haven Eldercare of New England, LLC and Haven Healthcare Management, LLC are affiliated companies.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

December 31, 2005

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares) Warrants		\$ 2,049 136	\$ 2,893 180
Meineke Car Care Centers, Inc. (Consumer Services)	Senior Loan (8.0%, Due 6/11) Subordinated Debt (11.9%, Due 6/12 6/13) Common Stock (10,696,308 shares) ⁽¹¹⁾ Warrants	\$ 28,000 72,000	27,865 71,675 26,985	27,865 71,675 26,629
MHF Logistical Solutions, Inc. (Business Services)	Unitranche Debt (10.0%, Due 5/11) Preferred Stock (431 shares) Common Stock (1,438 shares)	22,281	22,177 431 144	22,177 455 211
Mid-Atlantic Venture Fund IV, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		6,600	3,339
Mogas Energy, LLC (Energy Services)	Subordinated Debt (9.5%, Due 3/12 4/12) Warrants	16,855	15,472 1,774	15,472 3,550
Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (10.5%, Due 12/11) Convertible Subordinated Debt (9.8%, Due 12/15)	38,500 12,000	38,743 12,076	38,743 12,076
N.E.W. Customer Service Companies, Inc. (Business Services)	Subordinated Debt (11.0%, Due 7/12)	40,000	40,016	40,016
Nobel Learning Communities, Inc. ⁽³⁾ (Education)	Preferred Stock (1,214,356 shares) Warrants		2,764 575	2,343 1,296
Norwesco, Inc. (Industrial Products)	Subordinated Debt (12.6%, Due 1/12 7/12) Common Stock (559,603 shares) ⁽¹¹⁾ Warrants	82,061	81,683 38,313	81,683 38,313
Novak Biddle Venture Partners III, L.P. ⁽⁵⁾	Limited Partnership Interest		1,669	1,809

(Private Equity Fund)

Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		239	1,000
Opinion Research Corporation ⁽³⁾ (Business Services)	Warrants		996	45
Oriental Trading Company, Inc. (Consumer Products)	Common Stock (13,820 shares)			5,200
Palm Coast Data, LLC (Business Services)	Senior Loan (7.6%, Due 8/10)	16,100	16,024	16,024
	Subordinated Debt (15.5%, Due 8/12 8/15)	29,600	29,461	29,461
	Common Stock (21,743 shares) ⁽¹¹⁾		21,743	21,743
	Warrants			
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	2,500
Pro Mach, Inc. (Industrial Products)	Subordinated Debt (13.8%, Due 6/12)	19,275	19,193	19,193
	Equity Interests		1,500	1,200

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- (11) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

December 31, 2005

Private Finance**Portfolio Company**

(in thousands, except number of shares)

	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
Promo Works, LLC (Business Services)	Senior Loan (8.5%, Due 12/11) Unitranche Debt (10.3%, Due 12/11) Guaranty (\$1,650)	\$ 900 31,000	\$ 851 30,728	\$ 851 30,728
RadioVisa Corporation (Broadcasting & Cable)	Unitranche Debt (15.5%, Due 12/08)	27,093	26,993	26,993
Red Hawk Industries, LLC (Business Services)	Unitranche Debt (11.0%, Due 4/11)	56,343	56,063	56,063
S.B. Restaurant Company (Retail)	Subordinated Debt (14.6%, Due 11/08 12/09) Preferred Stock (54,125 shares) Warrants	29,085	28,615 135 619	28,615 135 700
SBBUT, LLC (Consumer Products)	Equity Interests			
off-Cut Holdings, Inc. (Industrial Products)	Preferred Stock (300 shares) Common Stock (2,000 shares)		300 200	300 37
SPP Mezzanine Fund, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		3,007	2,969
Tradesmen International, Inc. (Business Services)	Subordinated Debt (12.0%, Due 12/09) Warrants	15,000	14,323 710	14,323 1,700
TransAmerican Auto Parts, LLC (Consumer Products)	Subordinated Debt (14.0%, Due 11/12) Equity Interests	10,000	9,951 889	9,951 889
United Site Services, Inc. (Business Services)	Subordinated Debt (12.4%, Due 8/11) Common Stock (160,588 shares)	49,712	49,503 1,000	49,503 1,200
Universal Air Filter Company (Industrial Products)	Senior Loans (7.9%, Due 11/11) Unitranche Debt (11.0%, Due 11/11)	400 19,867	390 19,768	390 19,768
Universal Tax Systems, Inc. (Business Services)	Subordinated Debt (14.5%, Due 7/11)	19,068	18,995	18,995

Updata Venture Partners II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest	4,977	4,686
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest	42	42
Venturehouse Group, LLC ⁽⁵⁾ (Private Equity Fund)	Equity Interest	598	397
VICORP Restaurants, Inc. ⁽³⁾ (Retail)	Warrants	33	691
Walker Investment Fund II, LLLP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest	1,330	676

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

December 31, 2005

Private Finance**Portfolio Company**

(in thousands, except number
of shares)

	Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
Wear Me Apparel Corporation (Consumer Products)	Subordinated Debt (15.0%, Due 12/10) Warrants	\$ 40,000	\$ 38,992 1,219	\$ 38,992 2,000
Wilshire Restaurant Group, Inc. (Retail)	Subordinated Debt (20.0%, Due 6/07) ⁽⁶⁾ Warrants	22,471	21,930 735	21,930 538
Wilton Industries, Inc. (Consumer Products)	Subordinated Debt (19.3%, Due 6/08)	4,800	4,800	4,800
Woodstream Corporation (Consumer Products)	Subordinated Debt (13.2%, Due 11/12 5/13) Common Stock (180 shares) Warrants	52,397	52,251 673	52,251 3,336 2,365
Other companies	Other debt investments Other debt investments ⁽⁶⁾ Other equity investments Guaranty (\$135)	382 470	382 470 8	382 348
Total companies less than 5% owned			\$ 1,448,268	\$ 1,432,833
Total private finance (118 portfolio companies)			\$ 3,106,423	\$ 3,479,290

- (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.
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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Commercial Real Estate Finance
(in thousands, except number of loans)

	Interest Rate Ranges	Number of Loans	December 31, 2005		
			Cost	Value	
Commercial Mortgage Loans					
	Up to 6.99%	5	\$ 23,121	\$ 21,844	
	7.00% 8.99%	24	48,156	48,156	
	9.00% 10.99%	5	25,999	25,967	
	11.00% 12.99%	1	338	338	
	13.00% 14.99%	1	2,294	2,294	
	15.00% and above	2	3,970	3,970	
Total commercial mortgage loans ⁽¹²⁾		38	\$ 103,878	\$ 102,569	
Real Estate Owned			\$ 14,240	\$ 13,932	
Equity Interests⁽²⁾ Companies more than 25% owned (Guarantees \$7,054)			\$ 13,577	\$ 10,564	
Total commercial real estate finance			\$ 131,695	\$ 127,065	
Total portfolio			\$ 3,238,118	\$ 3,606,355	
			Yield	Cost	Value
Liquidity Portfolio					
	U.S. Treasury bills (Due June 2006)		4.25%	\$ 100,000	\$ 100,305
	SEI Daily Income Tr Prime Obligation Fund ⁽¹³⁾		4.11%	100,000	100,000
Total liquidity portfolio				\$ 200,000	\$ 200,305
Other Investments in Money Market Securities⁽¹³⁾					
	PNC Bank Corporate Money Market Deposit Account		4.15%	\$ 21,967	\$ 21,967

(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.
- (12) Commercial mortgage loans totaling \$20.8 million at value were on non-accrual status and therefore were considered non-income producing.
- (13) Included in investments in money market securities on the accompanying Consolidated Balance Sheet.

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

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

Note 1. Organization

Allied Capital Corporation, a Maryland corporation, is a closed-end, non-diversified 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 real estate investment trust subsidiary, Allied Capital REIT, Inc. (Allied REIT), and several subsidiaries that are single member limited liability companies established for specific purposes including holding real estate properties. ACC also has a subsidiary, A.C. Corporation (AC Corp), that generally provides diligence and structuring services, as well as transaction, management, consulting, and other services, including underwriting and arranging senior loans, to the Company and its portfolio companies.

In addition, ACC had a subsidiary, Allied Investments L.P. (Allied Investments), which was licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company (SBIC). As of September 30, 2006, Allied Investments surrendered its SBIC license and on October 1, 2006, Allied Investments was merged into ACC.

ACC and its subsidiaries, collectively, are referred to as the Company. The Company consolidates the results of its subsidiaries for financial reporting purposes.

Pursuant to Article 6 of Regulation S-X, the financial results of the Company s portfolio investments are not consolidated in the Company s financial statements. Portfolio investments are held for purposes of deriving investment income and future capital gains.

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company has primarily invested in debt and equity securities of private companies in a variety of industries.

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2005 and 2004 balances to conform with the 2006 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

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 2. Summary of Significant Accounting Policies, continued

where the Company directly or indirectly owns less than 5% of the outstanding voting 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 that may be considered related party transactions.

Valuation Of Portfolio Investments

The Company, as a BDC, has invested in illiquid securities including debt and equity securities of companies and CDO and CLO bonds and preferred shares/income notes. The Company's investments may be subject to certain 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/or 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. The value of loan and debt securities may be greater than the Company's cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than the Company's cost basis.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. In general, interest is not accrued on loans and debt securities if the Company has doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by the Company depending on such company's capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. 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 on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Equity Securities

The Company's equity securities 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, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. The determined equity values are generally discounted when the company has a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

The value of the Company's equity securities 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 on preferred equity securities is recorded as dividend income on an accrual basis to the extent that such amounts are expected to be collected and to the

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

extent that the Company has the option to receive the dividend in cash. Dividend income on common equity securities is recorded on the record date for private companies or on the ex-dividend date for publicly traded companies.

Commercial Mortgage-Backed Securities (CMBS), Collateralized Debt Obligations (CDO) and Collateralized Loan Obligations (CLO)

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

The Company recognizes interest income on the preferred shares/income notes using the effective interest method, based on the anticipated yield and the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred share/income note from the date the estimated yield was changed. CDO and CLO bonds have stated interest rates.

Net Realized Gains or Losses and Net Change in Unrealized Appreciation or Depreciation

Realized gains or losses are measured by the difference between the net proceeds from the repayment or sale and the cost basis of the investment without regard to unrealized appreciation or depreciation previously recognized, and include investments charged off during the year, net of recoveries. Net change in unrealized appreciation or depreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

Fee Income

Fee income includes fees for loan prepayment premiums, guarantees, commitments, and services rendered by the Company to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Loan prepayment premiums are recognized at the time of prepayment. Guaranty and commitment fees are generally recognized as income over the related period

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 2. Summary of Significant Accounting Policies, continued

of the guaranty or commitment, respectively. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management, consulting and other services fees are generally recognized as income as the services are rendered.

Guarantees

Guarantees meeting the characteristics described in FASB Interpretation No. 45, *Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (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.

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 using a method that approximates the effective interest method. Costs associated with the issuance of common stock, such as underwriting, accounting and legal fees, and printing costs are recorded as a reduction to the proceeds from the sale of common stock.

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company has a stock-based employee compensation plan. See Note 9. Effective January 1, 2006, the Company adopted the provisions of FASB Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement). The Statement was adopted using the modified prospective method of application, which required the Company to recognize compensation costs on a prospective basis beginning January 1, 2006. Accordingly, the prior year financial statements have not been restated. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006, using the fair value amounts determined for pro forma disclosure under Statement No. 123. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized over the related

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

service period in the statement of operations. The effect of this adoption for the year ended December 31, 2006, was as follows:

(\$ in millions, except per share amounts)	2006
Employee Stock Option Expense:	
Previously awarded, unvested options as of January 1, 2006	\$ 13.2
Options granted on or after January 1, 2006	2.4
Total employee stock option expense	\$ 15.6
Per basic share	\$ 0.11
Per diluted share	\$ 0.11

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

Prior to January 1, 2006, the Company accounted for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Prior to January 1, 2006, no stock-based compensation cost was 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 compensation for the years ended December 31, 2005 and 2004.

(\$ in millions, except per share amounts)	2005	2004
Net increase in net assets resulting from operations as reported	\$ 872.8	\$ 249.5
Less total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(12.7)	(16.9)
Pro forma net increase in net assets resulting from operations	860.1	232.6
Less preferred stock dividends		(0.1)
Pro forma net income available to common shareholders	\$ 860.1	\$ 232.5
Basic earnings per common share:		
As reported	\$ 6.48	\$ 1.92
Pro forma	\$ 6.39	\$ 1.79
Diluted earnings per common share:		
As reported	\$ 6.36	\$ 1.88
Pro forma	\$ 6.27	\$ 1.76

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

The stock option expense for 2006 and the pro forma expenses for 2005 and 2004 shown in the tables above were based on the underlying value of the options granted by the Company. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following weighted average assumptions were used to calculate the fair value of options granted during the years ended December 31, 2006, 2005, and 2004:

	2006	2005	2004
Expected term (in years)	5.0	5.0	5.0
Risk-free interest rate	4.8%	4.1%	2.9%
Expected volatility	29.1%	35.1%	37.0%
Dividend yield	9.0%	9.0%	8.8%
Weighted average fair value per option	\$ 3.47	\$ 3.94	\$ 4.17

The expected term of the options granted represents the period of time that such options are expected to be outstanding. To determine the expected term of the options, the Company used historical data to estimate option exercise time frames, including considering employee terminations. The risk free rate was based on the U.S. Treasury bond yield curve at the date of grant. Expected volatilities were determined based on the historical volatility of the Company's common stock over a historical time period consistent with the expected term. The dividend yield was determined based on the Company's historical dividend yield over a historical time period consistent with the expected term.

To determine the stock options expense, the calculated fair value of the options granted is applied to the options granted, net of assumed future option forfeitures. The Company estimates that the employee-related stock option expense under the Statement that will be recorded in the Company's statement of operations will be approximately \$11.3 million, \$3.7 million, and \$0.1 million for the years ended December 31, 2007, 2008, and 2009, respectively, which includes approximately \$1.9 million, \$1.0 million, and \$0.1 million, respectively, related to options granted during the year ended December 31, 2006. This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant. The aggregate total stock option expense remaining as of December 31, 2006, is expected to be recognized over an estimated weighted-average period of 1.08 years.

Federal and State Income Taxes and Excise Tax

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). ACC and any 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 income taxes for these entities.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 2. Summary of Significant Accounting Policies, continued

If the Company does not distribute at least 98% of its annual taxable income in the year earned, the Company will generally be required to pay an excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions from such taxable income for the year. To the extent that the Company determines that its estimated current year annual taxable income will be in excess of estimated current year dividend distributions, from such taxable income, the Company accrues excise taxes, if any, on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

Per Share Information

Basic earnings per common share is calculated using the weighted average number of common shares outstanding for the year 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, if any.

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 \$4.5 billion and \$3.6 billion at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, 92% and 90%, 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.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 2. Summary of Significant Accounting Policies, continued

Recent Accounting Pronouncements

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

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of this statement to have a significant effect on the Company's consolidated financial position or its results of operations.

In September 2006, the SEC released SEC Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which addresses how uncorrected errors in previous years should be considered when quantifying errors in current year financial statements and requires registrants to consider the effect of all carry over and reversing effects of prior year misstatements when quantifying errors in current year financial statements. The SAB allows registrants to record the effects of adopting the guidance as a cumulative effect adjustment which must be reported as of the beginning of the first fiscal year ending after November 15, 2006. The adoption of the SAB had no effect on the Company's consolidated financial position or its results of operations.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio**Private Finance**

At December 31, 2006 and 2005, the private finance portfolio consisted of the following:

	2006			2005		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 450.0	\$ 405.2	8.4%	\$ 284.7	\$ 239.8	9.5%
Unitranche debt ⁽²⁾	800.0	799.2	11.2%	294.2	294.2	11.4%
Subordinated debt	2,038.3	1,980.8	12.9%	1,610.2	1,560.9	13.8%
Total loans and debt securities ⁽³⁾	3,288.3	3,185.2	11.9%	2,189.1	2,094.9	13.0%
Equity securities	1,209.1	1,192.7		917.3	1,384.4	
Total	\$ 4,497.4	\$ 4,377.9		\$ 3,106.4	\$ 3,479.3	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At December 31, 2006 and 2005, the cost and value of subordinated debt included the Class A equity interests in BLX and the guaranteed dividend yield on these equity interests was included in interest income. During the fourth quarter of 2006, the Class A equity interests were placed on non-accrual status. The weighted average yield is computed as of the balance sheet date.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms.

(3) The total principal balance outstanding on loans and debt securities was \$3,322.3 million and \$2,216.3 million at December 31, 2006 and 2005, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$34.0 million and \$27.2 million at December 31, 2006 and 2005, 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 debt and equity investments are generally issued by private companies and are generally illiquid and may be subject to certain restrictions on resale.

The Company's private finance debt 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 the Company's 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.

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Table of Contents**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 3. Portfolio, continued**

At December 31, 2006 and 2005, 86% and 87%, respectively, of the private finance loans and debt securities had a fixed rate of interest and 14% and 13%, respectively, had a floating rate of interest. Senior loans generally carry a floating rate of interest, usually set as a spread over LIBOR, and generally require payments of both principal and interest throughout the life of the loan. Senior loans generally have contractual maturities of three to six years and interest is generally paid to the Company monthly or quarterly. Unitranche debt generally carries a fixed rate of interest and may require payments of both principal and interest throughout the life of the loan. However, unitranche instruments generally allow for principal to be repaid at a slower rate than would generally be allowed under a more traditional senior loan/subordinated debt structure. Unitranche debt generally has contractual maturities of five to six years and interest is generally paid to the Company quarterly. Subordinated debt generally carries a fixed rate of interest generally with contractual maturities of five to ten years and generally has interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest is generally paid to the Company quarterly.

Equity securities consist primarily of securities issued by private companies and may be subject to certain restrictions on their resale and are generally illiquid. The Company may make equity investments for minority stakes in portfolio companies or may receive equity features, such as nominal cost warrants, in conjunction with its debt investments. The Company may also invest in the equity (preferred and/or voting or non-voting common) of a portfolio company where the Company's equity ownership may represent a significant portion of the equity, but may or may not represent a controlling interest. If the Company invests in non-voting equity in a buyout investment, the Company generally has the option to acquire a controlling stake in the voting securities of the portfolio company at fair market value. The Company may incur costs associated with making buyout investments that will be included in the cost basis of the Company's equity investment. These include costs such as legal, accounting and other professional fees associated with diligence, referral and investment banking fees, and other costs. Equity securities generally do not produce a current return, but are held with the potential for investment appreciation and ultimate gain on sale.

Mercury Air Centers, Inc. At December 31, 2006, the Company's investment in Mercury Air Centers, Inc. (Mercury) totaled \$84.3 million at cost and \$244.2 million at value, which included unrealized appreciation of \$159.9 million. At December 31, 2005, the Company's investment in Mercury totaled \$113.3 million at cost and \$167.1 million at value, which included unrealized appreciation of \$53.8 million. The Company completed the purchase of a majority ownership in Mercury in April 2004.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Total interest and related portfolio income earned from the Company's investment in Mercury for the years ended December 31, 2006, 2005, and 2004, was as follows:

(\$ in millions)	2006	2005	2004
Interest income	\$ 9.3	\$ 8.8	\$ 5.5
Fees and other income	0.6	0.7	1.9
Total interest and related portfolio income	\$ 9.9	\$ 9.5	\$ 7.4

Interest income from Mercury for the years ended December 31, 2006, 2005, and 2004, included interest income of \$2.0 million, \$1.6 million, and \$1.0 million, respectively, which was paid in kind. The interest paid in kind was paid to the Company through the issuance of additional debt.

Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on the Company's investment in Mercury of \$106.1 million, \$53.8 million, and zero for the years ended December 31, 2006, 2005, and 2004, respectively.

Mercury owns and operates fixed base operations generally under long-term leases from local airport authorities, which consist of terminal and hangar complexes that service the needs of the general aviation community. Mercury is headquartered in Richmond Heights, OH.

Business Loan Express, LLC. BLX originates, sells, and services primarily real estate secured loans, including real estate secured conventional small business loans, Small Business Administration's 7(a) loans and small investment real estate loans. BLX is headquartered in New York, NY.

The Company's investment in BLX totaled \$295.3 million at cost and \$210.7 million at value, which included unrealized depreciation of \$84.6 million, at December 31, 2006, and \$299.4 million at cost and \$357.1 million at value, which included unrealized appreciation of \$57.7 million, at December 31, 2005. At December 31, 2006 and 2005, the Company owned 94.9% of the voting Class C equity interests. BLX has an equity appreciation rights plan for management that will dilute the value available to the Class C equity interest holders. Subsequent to December 31, 2006, in the first quarter of 2007 the Company increased its investment in BLX by \$12 million by acquiring additional Class A equity interests.

At December 31, 2005, the Company had a commitment to BLX of \$30.0 million in the form of a subordinated revolving credit facility to provide working capital to BLX. There was \$10.0 million outstanding under this facility at December 31, 2005. Outstanding borrowings under this facility were repaid in full and this facility matured on April 30, 2006.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Total interest and related portfolio income earned from the Company's investment in BLX for the years ended December 31, 2006, 2005, and 2004, was as follows:

(\$ in millions)	2006	2005	2004
Interest income on subordinated debt and Class A equity interests	\$ 11.9	\$ 14.3	\$ 23.2
Dividend income on Class B equity interests		14.0	14.8
Fees and other income	7.8	9.2	12.0
 Total interest and related portfolio income	 \$ 19.7	 \$ 37.5	 \$ 50.0

Interest and dividend income from BLX for the years ended December 31, 2006, 2005, and 2004, included interest and dividend income of \$5.7 million, \$8.9 million, and \$25.4 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. In the fourth quarter of 2006, the Company placed its \$66.6 million investment in BLX's 25% Class A equity interests on non-accrual status, which resulted in lower interest income from its investment in BLX for 2006 as compared to 2005.

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 equity interests, and 94.9% of the Class C equity interests. BLX's taxable income is first allocated to the Class A equity interests to the extent that guaranteed dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and C equity interests. BLX may declare dividends on its Class B equity interests. If declared, BLX would determine the amount of such dividends considering its estimated annual taxable income allocable to such interests. There were no dividends declared or paid in 2006.

Net change in unrealized appreciation or depreciation included a net decrease on the Company's investment in BLX of \$142.3 million and \$32.3 million for the years ended December 31, 2006 and 2004, respectively, and a net increase of \$2.9 million for the year ended December 31, 2005.

BLX is a national, non-bank lender that participates in the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the SBA and the United States Secret Service have announced an ongoing investigation of allegedly fraudulently obtained SBA-guaranteed loans issued by BLX. Specifically, on or about January 9, 2007, BLX became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleges that a former BLX employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. The Company understands that BLX is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. The Company understands that BLX is also working cooperatively with the SBA so that it may remain a preferred lender in the

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

SBA 7(a) program and retain the ability to sell loans into the secondary market. The ultimate resolution of these matters could have a material adverse impact on BLX's financial condition, and, as a result, the Company's financial results could be negatively affected. The Company is monitoring the situation and has retained a third party to work with BLX to conduct a review of BLX's current internal control systems, with a focus on preventing fraud and further strengthening the company's operations.

Further, on or about January 16, 2007, BLX and Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC), that is pending in the United States District Court for the Northern District of Georgia. The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans made by BLX and BLC. The Company understands that BLX and BLC plan to vigorously contest the lawsuit. The Company is monitoring the litigation.

As an SBA lender, BLX is also subject to other SBA and OIG audits, investigations, and reviews. The Company has considered these matters in performing the valuation of BLX at December 31, 2006.

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. At the date of BLX's reorganization, the Company estimated that its future tax liability resulting from the built-in gains may total up to a maximum of \$40 million. 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 or its interests in BLX 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 or its interests in BLX within the 10-year period. At December 31, 2006 and 2005, 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.

At December 31, 2006, BLX had a three-year \$500.0 million revolving credit facility provided by third party lenders that matures in March 2009. The revolving credit facility may be expanded through new or additional commitments up to \$600.0 million at BLX's option. This facility provides for a sub-facility for the issuance of letters of credit for up to

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

an amount equal to 25% of the committed facility. The Company has provided an unconditional guaranty to these 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 this facility. The total obligation guaranteed by the Company at December 31, 2006, was \$189.7 million.

This guaranty can be called by the lenders in the event of a default under the BLX credit facility, which includes certain defaults under the Company's revolving credit facility. Among other requirements, the BLX facility requires that BLX maintain compliance with certain financial covenants such as interest coverage, maximum debt to net worth, asset coverage, and maintenance of certain asset quality metrics. In addition, BLX would have an event of default if BLX failed to maintain its lending status with the SBA and such failure could reasonably be expected to result in a material adverse effect on BLX, or if BLX failed to maintain certain financing programs for the sale or long-term funding of BLX's loans. At December 31, 2006, BLX would not have met the required maximum debt to net worth covenant requirement had the Company not made the additional \$12 million investment in BLX in the first quarter of 2007 discussed above. Under the terms of the facility, the \$12 million investment in BLX caused BLX to satisfy the leverage covenant requirement and BLX has determined that it was in compliance with the terms of this facility at December 31, 2006.

At December 31, 2005, BLX had a \$275 million revolving credit facility, which was replaced by the current facility discussed above. The Company had provided a similar unconditional guaranty to this facility's lenders in an amount equal to 50% of BLX's total obligations under the facility. The total obligation guaranteed by the Company at December 31, 2005, was \$135.4 million.

At December 31, 2006 and 2005, the Company had also provided four standby letters of credit totaling \$25.0 million and \$34.1 million, respectively, in connection with four term securitization transactions completed by BLX. In consideration for providing the revolving credit facility guaranty and the standby letters of credit, the Company earned fees of \$6.1 million, \$6.3 million, and \$6.0 million for the years ended December 31, 2006, 2005, and 2004, respectively, which were included in fees and other income above. The remaining fees and other income relate to management fees from BLX. The Company did not charge a management fee to BLX in the fourth quarter of 2006.

Advantage Sales and Marketing, Inc. In June 2004, the Company completed the purchase of a majority voting ownership in Advantage, which was subject to dilution by a management option pool. Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

At December 31, 2005, the Company's investment in Advantage totaled \$257.7 million at cost and \$660.4 million at value, which included unrealized appreciation of \$402.7 million.

On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company was repaid its \$184 million in subordinated debt outstanding and realized a gain

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

at closing on its equity investment sold of \$433.1 million, subject to post-closing adjustments. Subsequent to closing on this sale, the Company realized additional gains resulting from post-closing adjustments totaling \$1.3 million in 2006. In addition, there is potential for the Company to receive additional consideration through an earn-out payment that would be based on Advantage's 2006 audited results. The Company's realized gain of \$434.4 million as of December 31, 2006, subject to post-closing adjustments, excludes any earn-out amounts.

As consideration for the common stock sold in the transaction, the Company received a \$150 million subordinated note, with the balance of the consideration paid in cash. In addition, a portion of the Company's cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. At December 31, 2006, the amount of the escrow included in other assets in the accompanying consolidated balance sheet was approximately \$24 million.

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

The Company's investment in Advantage at December 31, 2006, which was composed of subordinated debt and a minority equity interest, totaled \$151.6 million at cost and \$162.6 million at value. This investment was included in companies 5% to 25% owned in the consolidated financial statements as the Company continues to hold a seat on Advantage's board of directors.

Total interest and related portfolio income earned from the Company's investment in Advantage while the Company held a majority equity interest for the years ended December 31, 2006, 2005, and 2004, was \$14.1 million, \$37.4 million, and \$21.3 million, respectively.

Net change in unrealized appreciation or depreciation for the year ended December 31, 2006, included the reversal of \$389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of the Company's majority equity interest in Advantage and for the years ended December 31, 2005 and 2004, included an increase in unrealized appreciation of \$378.4 million and \$24.3 million, respectively, related to the Company's majority equity interest investment in Advantage.

The Hillman Companies, Inc. On March 31, 2004, the Company sold its control investment in Hillman, which was one of the Company's largest investments, 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 \$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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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 a gain of \$1.3 million realized after closing, resulting from post-closing adjustments, which provided additional cash consideration to the Company in the same amount.

Collateralized Loan Obligations (CLOs) and Collateralized Debt Obligations (CDOs). At December 31, 2006 and 2005, the Company owned bonds and preferred shares/income notes in collateralized loan obligations (CLOs) and a collateralized debt obligation (CDO) as follows:

	2006		2005	
	Cost	Value	Cost	Value
(\$ in millions)				
Callidus Debt Partners CDO Fund I, Ltd.	\$ 28.4	\$ 28.4	\$ 28.5	\$ 28.5
Callidus Debt Partners CLO Fund III, Ltd.	23.3	23.0	24.2	24.2
Callidus Debt Partners CLO Fund IV, Ltd.	13.0	13.0		
Callidus MAPS CLO Fund I LLC	68.0	64.6	65.1	65.1
Callidus Debt Partners CLO Fund V, Ltd.	13.8	13.8		
 Total	 \$ 146.5	 \$ 142.8	 \$ 117.8	 \$ 117.8

These CLO and CDO investments are managed by Callidus Capital, a portfolio company controlled by the Company.

The bonds, preferred shares and income notes of the CLOs and CDO in which the Company has invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes will bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes.

At both December 31, 2006 and 2005, the face value of the CLO and CDO bonds held by the Company were subordinate to approximately 82% to 85% of the face value of the securities issued in these CLOs and CDO. At December 31, 2006 and 2005, the face value of the CLO preferred shares/income notes held by the Company were subordinate to approximately 86% to 92% and 86% to 91%, respectively, of the face value of the securities issued in these CLOs.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

At December 31, 2006 and 2005, the underlying collateral assets of these CLO and CDO investments, consisting primarily of senior debt, were issued by 465 issuers and 336 issuers, respectively, and had balances as follows:

	2006	2005
(\$ in millions)		
Bonds	\$ 245.4	\$ 230.7
Syndicated loans	1,769.9	704.0
Cash ⁽¹⁾	59.5	238.4
 Total underlying collateral assets	 \$ 2,074.8	 \$ 1,173.1

⁽¹⁾ Includes undrawn liability amounts.

At December 31, 2006, there was one defaulted obligor in the underlying collateral assets of Callidus MAPS CLO Fund I, LLC. There were no other delinquencies in the underlying collateral assets in the other CLO and CDO issuances owned by the Company. At December 31, 2006, the total face value of defaulted obligations was \$9.6 million, or approximately 0.5% of the total underlying collateral assets. At December 31, 2005, there were no delinquencies in the underlying collateral assets.

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

Loans and Debt Securities on Non-Accrual Status. At December 31, 2006 and 2005, private finance loans and debt securities at value not accruing interest were as follows:

	2006	2005
(\$ in millions)		
Loans and debt securities in workout status		
Companies more than 25% owned	\$ 51.1	\$ 15.6
Companies 5% to 25% owned	4.0	
Companies less than 5% owned	31.6	11.4
Loans and debt securities not in workout status		
Companies more than 25% owned	87.1	58.0
Companies 5% to 25% owned	7.2	0.5
Companies less than 5% owned	38.9	49.5
 Total	 \$ 219.9	 \$ 135.0

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Industry and Geographic Compositions. The industry and geographic compositions of the private finance portfolio at value at December 31, 2006 and 2005, were as follows:

	2006	2005
Industry		
Business services	39%	42%
Consumer products	20	14
Financial services	9	14
Industrial products	9	10
Consumer services	6	6
Retail	6	3
Healthcare services	3	2
Energy services	2	2
Other ⁽¹⁾	6	7
Total	100%	100%
Geographic Region⁽²⁾		
Mid-Atlantic	31%	29%
Midwest	30	21
Southeast	18	12
West	17	34
Northeast	4	4
Total	100%	100%

(1) Includes investments in senior debt CDO and CLO funds which represented 3% of the private finance portfolio at both December 31, 2006 and 2005. These funds invest in senior debt representing a variety of industries.

(2) 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 in other geographic regions.

Commercial Real Estate Finance

At December 31, 2006 and 2005, the commercial real estate finance portfolio consisted of the following:

	2006			2005		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in millions)						
Commercial mortgage loans	\$ 72.6	\$ 71.9	7.5%	\$ 103.9	\$ 102.6	7.6%
Real estate owned	15.7	19.6		14.2	13.9	
Equity interests	15.2	26.7		13.6	10.6	

Total	\$ 103.5	\$ 118.2	\$ 131.7	\$ 127.1
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(1) The weighted average yield on the commercial mortgage loans is computed as the (a) annual stated interest on accruing loans plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans 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.

Commercial Mortgage Loans and Equity Interests. The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

party sellers. At December 31, 2006, approximately 96% and 4% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. At December 31, 2005, approximately 97% and 3% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. At December 31, 2006 and 2005, loans with a value of \$18.9 million and \$20.8 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 certain 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, 2006 and 2005, were as follows:

	2006	2005
Property Type		
Hospitality	45%	37%
Office	20	11
Retail	19	16
Housing	13	30
Other	3	6
Total	100%	100%
Geographic Region		
Southeast	36%	25%
Mid-Atlantic	35	31
Midwest	21	21
Northeast	8	5
West		18
Total	100%	100%

CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares (CDOs). On May 3, 2005, the Company completed the sale of its portfolio of CMBS bonds and CDO bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of \$976.0 million and realized a net gain of \$227.7 million, after transaction and other costs of \$7.8 million. Transaction costs included investment banking fees, legal and other professional fees, and other transaction costs. Upon the closing of the sale, the Company settled all the hedge positions relating to these assets, which resulted in a net realized loss of \$0.7 million, which has been included in the net realized gain on the sale. The value of these assets prior to their sale was determined on an individual security-by-security basis. The net gain realized upon the sale of \$227.7 million reflects the total value received for the portfolio as a whole. Simultaneous with the sale of the Company's CMBS and CDO portfolio, the Company entered into certain agreements with affiliates of the Caisse, including a platform assets purchase

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

agreement, pursuant to which the Company agreed to sell certain additional commercial real estate-related assets to the Caisse, subject to certain adjustments and closing conditions.

The platform assets purchase agreement was completed on July 13, 2005, and the Company received total cash proceeds from the sale of the platform assets of approximately \$5.3 million. No gain or loss resulted from the transaction. Under this agreement, the Company agreed not to primarily invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008, subject to certain limitations and excluding the Company's existing portfolio and related activities.

Note 4. Debt

At December 31, 2006 and 2005, the Company had the following debt:

	2006			2005		
	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾
(\$ in millions)						
Notes payable and debentures:						
Privately issued unsecured notes payable	\$1,041.4	\$1,041.4	6.1%	\$ 1,164.5	\$ 1,164.5	6.2%
Publicly issued unsecured notes payable	650.0	650.0	6.6%			
SBA debentures ⁽²⁾			%	28.5	28.5	7.5%
Total notes payable and debentures	1,691.4	1,691.4	6.3%	1,193.0	1,193.0	6.3%
Revolving line of credit ⁽⁵⁾	922.5	207.7	6.4% ⁽³⁾	772.5	91.8	5.6% ⁽³⁾
Total debt	\$2,613.9	\$1,899.1	6.5% ⁽⁴⁾	\$ 1,965.5	\$ 1,284.8	6.5% ⁽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, other facility fees and amortization of debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.

(2) The SBA debentures were repaid in full during 2006.

(3) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$3.9 million and \$3.3 million at December 31, 2006 and 2005, respectively.

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

(5) At December 31, 2006, \$673.8 million remained unused and available on the revolving line of credit, net of amounts committed for standby letters of credit of \$41.0 million issued under the credit facility.

Notes Payable and Debentures

Privately Issued Unsecured Notes Payable. The Company has privately issued unsecured long-term notes to institutional investors. The notes have five- or seven-year maturities and have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity. At December 31, 2006, the

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

notes had maturities from May 2008 to May 2013. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreements.

The Company has also privately 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 other unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. Simultaneous with issuing the 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.

On October 16, 2006, the Company repaid \$150.0 million of unsecured long-term debt that matured. This debt had a fixed interest rate of 7.2%.

On May 1, 2006, the Company issued \$50.0 million of seven-year, unsecured notes with a fixed interest rate of 6.8%. This debt matures in May 2013. The proceeds from the issuance of the notes were used in part to repay \$25 million of 7.5% unsecured long-term notes that matured on May 1, 2006.

On October 13, 2005, the Company issued \$261.0 million of five-year and \$89.0 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 6.2% and 6.3%, respectively, and have substantially the same terms as the Company's existing unsecured long-term notes. The Company used a portion of the proceeds from the new long-term note issuance to repay \$125.0 million of existing unsecured long-term notes that matured on October 15, 2005, and had an annual weighted average interest cost of 8.3%.

Publicly Issued Unsecured Notes Payable. During 2006, the Company completed public issuances of unsecured notes as follows:

(\$ in millions)	Amount	Coupon	Maturity Date
July 25, 2006	\$ 400.0	6.625%	July 15, 2011
December 8, 2006	250.0	6.000%	April 1, 2012
Total	\$ 650.0		

The notes require payment of interest only semi-annually, and all principal is due upon maturity. The Company has the option to redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes.

SBA Debentures. At December 31, 2005, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 6.4%. The debentures required semi-annual interest-only payments with all principal due upon maturity. During the years ended December 31, 2006 and 2005, the Company repaid \$28.5 million and \$49.0 million, respectively, of the SBA debentures. At December 31, 2006, the Company had no debentures payable to the SBA.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

Scheduled Maturities. Scheduled future maturities of notes payable at December 31, 2006, were as follows:

Year	Amount Maturing (\$ in millions)
2007	\$
2008	153.0
2009	268.9
2010	408.0
2011	472.5
Thereafter	389.0
Total	\$ 1,691.4

Revolving Line of Credit

At December 31, 2006, the Company had an unsecured revolving line of credit with a committed amount of \$922.5 million that expires on September 30, 2008. At December 31, 2005, the commitments under the facility were \$772.5 million. At the Company's option, borrowings under the revolving line of credit generally bear interest at a rate equal to (i) LIBOR (for the period the Company selects) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America, N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

The annual cost of commitment fees, other facility fees and amortization of debt financing costs was \$3.9 million and \$3.3 million at December 31, 2006 and 2005, respectively.

The revolving credit facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 16.66% of the committed facility or \$153.7 million. The letter of credit fee is 1.05% per annum on letters of credit issued, which is payable quarterly.

The average debt outstanding on the revolving line of credit was \$142.1 million and \$33.3 million, respectively, for the years ended December 31, 2006 and 2005. The maximum amount borrowed under this facility and the weighted average stated interest rate for the years ended December 31, 2006 and 2005, were \$540.3 million and 6.3%, respectively, and \$263.3 million and 4.4%, respectively. At December 31, 2006, the amount available under the revolving line of credit was \$673.8 million, net of amounts committed for standby letters of credit of \$41.0 million issued under the credit facility.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 4. Debt, continued

Fair Value of Debt

The Company records debt at cost. The fair value of the Company's outstanding debt was approximately \$1.9 billion and \$1.3 billion at December 31, 2006 and 2005, 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 privately issued unsecured notes payable and the revolving line of credit outstanding at December 31, 2006. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of the Company's assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of December 31, 2006 and 2005, the Company was in compliance with these covenants.

The Company has certain financial and operating covenants that are required by the publicly issued unsecured notes payable, including that the Company will maintain a minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding. As of December 31, 2006, the Company was in compliance with these covenants.

Note 5. Guarantees and 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, 2006 and 2005, the Company had issued guarantees of debt, rental obligations, and lease obligations aggregating \$202.1 million and \$148.6 million, respectively, and had extended standby letters of credit aggregating \$41.0 million and \$37.1 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 \$243.1 million and \$185.7 million at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, \$2.4 million and \$2.5 million, respectively, 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.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 5. Guarantees and Commitments, continued

As of December 31, 2006, the guarantees and standby letters of credit expired as follows:

	Total	2007	2008	2009	2010	2011	After 2011
(in millions)							
Guarantees	\$ 202.1	\$ 0.6	\$ 3.0	\$ 192.2	\$	\$ 4.4	\$ 1.9
Standby letters of credit ⁽¹⁾	41.0	4.0	37.0				
Total⁽²⁾	\$ 243.1	\$ 4.6	\$ 40.0	\$ 192.2	\$	\$ 4.4	\$ 1.9

(1) Standby letters of credit are issued under the Company's revolving line of credit that expires in September 2008. 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 September 2008.

(2) The Company's most significant commitments relate to its investment in Business Loan Express, LLC (BLX), which commitments totaled \$214.7 million at December 31, 2006. At December 31, 2006, the Company guaranteed 50% of the outstanding total obligations on BLX's revolving line of credit for a total guaranteed amount of \$189.7 million and had also provided four standby letters of credit totaling \$25.0 million in connection with four term securitizations completed by BLX. See Note 3.

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, 2006, the Company had outstanding commitments to fund investments totaling \$435.0 million, including \$426.0 million related to private finance investments and \$9.0 related to commercial real estate finance investments. In addition, during the fourth quarter of 2004 and the first quarter of 2005, the Company sold certain commercial mortgage loans that the Company may be required to repurchase under certain circumstances. These recourse provisions expire by April 2007. The aggregate outstanding principal balance of these sold loans was \$4.2 million at December 31, 2006.

Note 6. Shareholders' Equity

Sales of common stock for the years ended December 31, 2006, 2005, and 2004, were as follows:

	2006	2005 ⁽¹⁾	2004
(in millions)			
Number of common shares	10.9		3.0
Gross proceeds	\$ 310.2	\$	\$ 75.0
Less costs, including underwriting fees	(14.4)		(4.7)
Net proceeds	\$ 295.8	\$	\$ 70.3

(1) The Company did not sell any common stock during the year ended December 31, 2005.

The Company issued 0.3 million shares of common stock with a value of \$7.2 million as consideration for an additional investment in Mercury Air Centers, Inc. during the year ended December 31, 2005, and 0.1 million shares

of common stock with a value of \$3.2 million as consideration for an investment in Legacy Partners Group, LLC during the year ended December 31, 2004.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6. Shareholders Equity, continued

The Company issued 0.5 million shares, 3.0 million shares, and 1.6 million shares of common stock upon the exercise of stock options during the years ended December 31, 2006, 2005, and 2004, respectively.

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, 2006, 2005, and 2004, the Company issued new shares in order to satisfy dividend reinvestment requests. Dividend reinvestment plan activity for the years ended December 31, 2006, 2005, and 2004, was as follows:

	2006	2005	2004
(in millions, except per share amounts)			
Shares issued	0.5	0.3	0.2
Average price per share	\$ 30.58	\$ 28.00	\$ 26.34

Note 7. Earnings Per Common Share

Earnings per common share for the years ended December 31, 2006, 2005, and 2004, were as follows:

	2006	2005	2004
(in millions, except per share amounts)			
Net increase in net assets resulting from operations	\$ 245.1	\$ 872.8	\$ 249.5
Less preferred stock dividends			(0.1)
Income available to common shareholders	\$ 245.1	\$ 872.8	\$ 249.4
Weighted average common shares outstanding basic	142.4	134.7	129.8
Dilutive options outstanding	3.2	2.6	2.7
Weighted average common shares outstanding diluted	145.6	137.3	132.5
Basic earnings per common share	\$ 1.72	\$ 6.48	\$ 1.92
Diluted earnings per common share	\$ 1.68	\$ 6.36	\$ 1.88

Note 8. Employee 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 \$15 thousand annually for the 2006 plan year. Plan participants who were age 50 or older during the 2006 plan year were eligible to defer an additional \$5 thousand during the year. The Company makes contributions to the 401(k) plan of up to 5% of each participant's

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8. Employee Compensation Plans, continued

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, 2006, the maximum compensation was \$0.2 million. Employer contributions that exceed the IRS limitation are directed to the participant's deferred compensation plan account as discussed below. Total 401(k) contribution expense for the years ended December 31, 2006, 2005, and 2004, was \$1.2 million, \$1.0 million, and \$0.9 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, 2006, 2005, and 2004, was \$1.5 million, \$0.7 million, and \$0.7 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, 2006 and 2005, totaled \$18.6 million and \$16.6 million, respectively.

The Company has an Individual Performance Award (IPA), which was established 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 a 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 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 the years ended December 31, 2006, 2005, and 2004, 0.3 million shares, 0.3 million shares, and 0.5 million shares, respectively, 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 of the Company's general creditors. Amounts credited to participants under the DCP II are immediately vested and generally non-forfeitable once deposited by the Company into

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8. Employee Compensation Plans, continued

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 in accordance with the plan, 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. 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.

The IPA amounts are 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 held in the deferred compensation trust are not recognized. However, the liability is marked to market with a corresponding charge or credit to employee compensation expense. At December 31, 2006 and 2005, common stock held in DCP II was \$28.3 million and \$19.5 million, respectively, and the IPA liability was \$33.9 million and \$22.3 million, respectively. At December 31, 2006 and 2005, the DCP II held 1.0 million shares and 0.7 million shares, respectively, of the Company's common stock.

The IPA expense for the years ended December 31, 2006, 2005, and 2004, were as follows:

	2006	2005	2004
(\$ in millions)			
IPA contributions	\$ 8.1	\$ 7.0	\$ 13.4
IPA mark to market expense (benefit)	2.9	2.0	(0.4)
Total IPA expense	\$ 11.0	\$ 9.0	\$ 13.0

The Company also has an individual performance bonus (IPB) which was established in 2005. The IPB is distributed in cash to award recipients equally throughout the year as long as the recipient remains employed by the Company. If a recipient terminated employment during the year, any remaining cash payments under the IPB were

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 8. Employee Compensation Plans, continued

forfeited. For the years ended December 31, 2006 and 2005, the IPB expense was \$8.1 million and \$6.9 million, respectively. The IPA and IPB expenses are included in employee expenses.

Note 9. Stock 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 the optionee, which may not exceed ten years from the date the option is granted. The options granted to officers generally vest ratably over a three year period. Options granted to non-officer directors vest on the grant date.

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 both December 31, 2006 and 2005, there were 32.2 million shares authorized under the Option Plan. At December 31, 2006 and 2005, the number of shares available to be granted under the Option Plan was 1.6 million and 3.0 million, respectively.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Stock Option Plan, continued

Information with respect to options granted, exercised and forfeited under the Option Plan for the years ended December 31, 2006, 2005, and 2004, was as follows:

	Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Remaining Term (Years)	Aggregate Intrinsic Value at December 31, 2006 ⁽¹⁾
(in millions, except per share amounts)				
Options outstanding at January 1, 2004	14.9	\$ 20.68		
Granted	8.2	\$ 28.34		
Exercised	(1.6)	\$ 19.73		
Forfeited	(1.1)	\$ 26.07		
Options outstanding at December 31, 2004	20.4	\$ 23.55		
Granted	6.8	\$ 27.37		
Exercised	(3.0)	\$ 22.32		
Forfeited	(1.9)	\$ 27.83		
Options outstanding at December 31, 2005	22.3	\$ 24.52		
Granted	1.8	\$ 29.88		
Exercised	(0.5)	\$ 22.99		
Forfeited	(0.4)	\$ 27.67		
Options outstanding at December 31, 2006	23.2	\$ 24.92	6.27	\$ 180.1
Exercisable at December 31, 2006	16.7	\$ 23.70	5.60	\$ 150.2
Exercisable and expected to be exercisable at December 31, 2006 ⁽²⁾	22.7	\$ 24.85	6.24	\$ 178.0

⁽¹⁾ Represents the difference between the market value of the options at December 31, 2006, and the cost for the option holders to exercise the options.

⁽²⁾ The amount of options expected to be exercisable at December 31, 2006, is calculated based on an estimate of expected forfeitures.

The fair value of the shares vested during the years ended December 31, 2006, 2005, and 2004, was \$16.1 million, \$16.2 million, and \$18.7 million, respectively. The total intrinsic value of the options exercised during the years ended December 31, 2006, 2005, and 2004, was \$3.6 million, \$18.4 million, and \$12.2 million, respectively.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Stock Option Plan, continued

The following table summarizes information about stock options outstanding at December 31, 2006:

Range of Exercise Prices	Total Number Outstanding	Outstanding	Weighted Average Contractual Life (Years)	Weighted Average Exercise Price	Exercisable	Weighted Average Exercise Price
		Total			Total	
					Number	
					Exercisable	
(in millions, except per share amounts and years)						
\$16.81 - \$17.88	2.4	3.28	\$ 16.97	2.4	\$ 16.97	
\$19.00 - \$21.38	1.8	1.04	\$ 21.30	1.8	\$ 21.30	
\$21.52	3.3	5.95	\$ 21.52	3.3	\$ 21.52	
\$21.59 - \$24.98	2.6	5.49	\$ 22.43	2.4	\$ 22.23	
\$25.50 - \$27.38	1.8	7.35	\$ 26.49	1.4	\$ 26.47	
\$27.51	5.2	8.59	\$ 27.51	1.7	\$ 27.51	
\$28.98	4.3	7.19	\$ 28.98	3.2	\$ 28.98	
\$29.23 - \$30.52	1.8	7.18	\$ 29.88	0.5	\$ 29.77	
	23.2	6.27	\$ 24.92	16.7	\$ 23.70	

Notes Receivable from the Sale of Common Stock

As a business development company under the 1940 Act, 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. 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, 2006 and 2005, the Company had outstanding loans to officers of \$2.9 million and \$3.9 million, respectively. Officers with outstanding loans repaid principal of \$1.0 million, \$1.6 million, and \$13.2 million, for the years ended December 31, 2006, 2005, and 2004, respectively. The Company recognized interest income from these loans of \$0.2 million, \$0.2 million, and \$0.5 million, respectively, during these same periods. This interest income is included in interest and dividends for companies less than 5% owned.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Dividends and Distributions and Taxes

For the years ended December 31, 2006, 2005, and 2004, the Company's Board of Directors declared the following distributions:

	2006		2005		2004	
	Total Amount	Total Per Share	Total Amount	Total Per Share	Total Amount	Total Per Share
(in millions, except per share amounts)						
First quarter	\$ 82.5	\$ 0.59	\$ 76.1	\$ 0.57	\$ 73.3	\$ 0.57
Second quarter	84.1	0.60	76.2	0.57	73.5	0.57
Third quarter	88.8	0.61	78.8	0.58	74.0	0.57
Fourth quarter	92.0	0.62	79.3	0.58	75.8	0.57
Extra dividend	7.5	0.05	4.1	0.03	2.7	0.02
Total distributions to common shareholders	\$ 354.9	\$ 2.47	\$ 314.5	\$ 2.33	\$ 299.3	\$ 2.30

For income tax purposes, distributions for 2006, 2005, and 2004, were composed of the following:

	2006		2005		2004	
	Total Amount	Total Per Share	Total Amount	Total Per Share	Total Amount	Total Per Share
(in millions, except per share amounts)						
Ordinary income	\$ 177.4	\$ 1.23	\$ 157.3	\$ 1.17	\$ 145.3	\$ 1.12
Long-term capital gains	177.5	1.24	157.2	1.16	154.0	1.18
Total distributions to common shareholders ⁽¹⁾	\$ 354.9	\$ 2.47	\$ 314.5	\$ 2.33	\$ 299.3	\$ 2.30

⁽¹⁾ For the years ended December 31, 2006, 2005 and 2004, ordinary income included dividend income of approximately \$0.04 per share, \$0.03 per share, and \$0.04 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 2006, 2005, and 2004, was \$0.042 per share, \$0.034 per share, and \$0.038 per share, respectively.

The Company's Board of Directors also declared a dividend of \$0.63 per common share for the first quarter of 2007.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Dividends and Distributions and Taxes, 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, 2006, 2005, and 2004:

	2006	2005	2004
	(ESTIMATED) ⁽¹⁾		
(\$ in millions)			
Financial statement net increase in net assets resulting from operations	\$ 245.1	\$ 872.8	\$ 249.5
Adjustments:			
Net change in unrealized appreciation or depreciation	477.4	(462.1)	68.7
Amortization of discounts and fees	(0.3)	4.7	(5.4)
Interest- and dividend-related items	7.3	5.5	6.3
Employee compensation-related items	18.1	3.0	7.7
Nondeductible excise tax	15.1	6.2	1.0
Realized gains recognized (deferred) through installment treatment ⁽²⁾	(181.1)	(5.9)	(33.7)
Other realized gain or loss related items	11.5	18.6	5.5
Net income (loss) from partnerships and limited liability companies ⁽³⁾	(1.9)	18.0	8.6
Net loss from consolidated SBIC subsidiary		(8.4)	15.2
Net (income) loss from consolidated taxable subsidiary, net of tax	3.9	(5.0)	(1.0)
Other	0.4	(2.4)	0.8
Taxable income	\$ 595.5	\$ 445.0	\$ 323.2

⁽¹⁾ The Company's taxable income for 2006 is an estimate and will not be finally determined until the Company files its 2006 tax return in September 2007. Therefore, the final taxable income may be different than this estimate.

⁽²⁾ 2006 includes the deferral of long-term capital gains through installment treatment related to the Company's sale of its control equity investment in Advantage and certain other portfolio companies.

⁽³⁾ Includes taxable income passed through to the Company from BLX in excess of interest and related portfolio income from BLX included in the financial statements totaling \$3.7 million, \$15.4 million, and \$10.0 million for the years ended December 31, 2006, 2005 and 2004, respectively. See Note 3 for additional related disclosure.

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.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Dividends and Distributions and Taxes, continued

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 over into the following year, and the distribution of prior year taxable income carried over into and distributed in the current year. For income tax purposes, distributions for 2006, 2005, and 2004, were made from taxable income as follows:

	2006	2005	2004
	(ESTIMATED) ⁽¹⁾		
(\$ in millions)			
Taxable income	\$ 595.5	\$ 445.0	\$ 323.2
Taxable income earned in current year and carried forward for distribution in next year ⁽²⁾	(397.1)	(156.5)	(26.0)
Taxable income earned in prior year and carried forward and distributed in current year	156.5	26.0	2.1
Total distributions to common shareholders	\$ 354.9	\$ 314.5	\$ 299.3

⁽¹⁾ The Company's taxable income for 2006 is an estimate and will not be finally determined until the Company files its 2006 tax return in September 2007. Therefore, the final taxable income and the taxable income earned in 2006 and carried forward for distribution in 2007 may be different than this estimate.

⁽²⁾ Estimated taxable income for 2006 includes undistributed income of \$397.1 million that is being carried over for distribution in 2007, which represents approximately \$120.6 million of ordinary income and approximately \$276.5 million of net long-term capital gains.

The Company will generally be required to pay an excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions for the year. The Company's 2006 (estimated), 2005, and 2004, annual taxable income were in excess of its dividend distributions from such taxable income in 2006, 2005, and 2004, and accordingly, the Company accrued an excise tax of \$15.4 million, \$6.2 million, and \$1.0 million, respectively, on the excess taxable income carried forward. In 2006, the Company reversed \$0.3 million of excise tax which was over accrued in 2005, resulting in excise tax expense of \$15.1 million for the year ended December 31, 2006.

In addition to excess taxable income carried forward, the Company currently estimates that it has cumulative deferred taxable income related to installment sale gains of approximately \$220.7 million as of December 31, 2006, which is composed of cumulative deferred taxable income of \$39.6 million as of December 31, 2005, and approximately \$181.1 million for the year ended December 31, 2006. These gains have been recognized for financial reporting purposes in the respective years they were realized, but are generally deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. The realized gains deferred through installment treatment for 2006 are estimates and will not be finally determined until the Company files its 2006 tax return in September 2007.

The Company's undistributed book earnings of \$502.2 million as of December 31, 2006, resulted from undistributed ordinary income and long-term capital gains. The

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Dividends and Distributions and Taxes, continued

difference between undistributed book earnings at the end of the year and taxable income carried over from the current year into the next year relates to a variety of timing and permanent differences in the recognition of income and expenses for book and tax purposes as discussed above.

At December 31, 2006 and 2005, the aggregate gross unrealized appreciation of the Company's investments above cost for federal income tax purposes was \$613.1 million (estimated) and \$789.1 million, respectively. At December 31, 2006 and 2005, the aggregate gross unrealized depreciation of the Company's investments below cost for federal income tax purposes was \$418.8 million (estimated) and \$308.8 million, respectively. The aggregate net unrealized appreciation of the Company's investments over cost for federal income tax purposes was \$194.3 million (estimated) and \$480.3 million at December 31, 2006 and 2005, respectively. At December 31, 2006 and 2005, the aggregate cost of securities, for federal income tax purposes was \$4.3 billion (estimated) and \$3.1 billion, respectively.

The Company's consolidated subsidiary, AC Corp, is subject to federal and state income taxes. For the years ended December 31, 2006, 2005, and 2004, AC Corp's income tax expense (benefit) was \$(0.1) million, \$5.3 million, and \$1.0 million, respectively. For the years ended December 31, 2005, and 2004, paid in capital was increased for the tax benefit of amounts deducted for tax purposes but not for financial reporting purposes primarily related to stock-based compensation by \$3.7 million and \$3.8 million, respectively.

The net deferred tax asset at December 31, 2006, was \$6.9 million, consisting of deferred tax assets of \$13.7 million and deferred tax liabilities of \$6.8 million. The net deferred tax asset at December 31, 2005, was \$4.1 million, consisting of deferred tax assets of \$8.9 million and deferred tax liabilities of \$4.8 million. At December 31, 2006, the deferred tax assets primarily related to compensation-related items and the deferred tax liabilities primarily related to depreciation. 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, 2006, 2005, or 2004.

Note 11. Cash

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, 2006 and 2005, cash consisted of the following:

(\$ in millions)	2006	2005
Cash	\$ 2.3	\$ 33.4
Less escrows held	(0.6)	(2.0)
Total cash	\$ 1.7	\$ 31.4

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 12. Supplemental Disclosure of Cash Flow Information

The Company paid interest of \$90.6 million, \$75.2 million, and \$74.6 million, respectively, for the years ended December 31, 2006, 2005, and 2004.

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 \$0.2 million, \$8.4 million, and \$11.4 million, for the years ended December 31, 2006, 2005, and 2004, respectively.

Non-cash operating activities for the year ended December 31, 2006, included the following:

a note received as consideration from the sale of the Company's equity investment in Advantage of \$150.0 million;

a note received as consideration from the sale of the Company's equity investment in STS Operating, Inc. of \$30.0 million;

the exchange of existing debt securities and accrued interest of S.B. Restaurant Company with a cost basis of \$29.2 million for new debt securities;

the exchange of existing debt securities, preferred stock and common stock of Border Foods, Inc. with a cost basis of \$16.6 million for new preferred and common equity securities; and

the exchange of existing preferred stock and common stock of Redox Brands, Inc. with a cost basis of \$10.2 million for common stock in CR Brands, Inc.

Non-cash operating activities for the year ended December 31, 2005, included the following:

the exchange of existing subordinated debt securities and accrued interest of BLX with a cost basis of \$44.8 million for additional Class B equity interests (see Note 3);

the exchange of debt securities and accrued interest of Coverall North America, Inc. with a cost basis of \$24.2 million for new debt securities and warrants with a total cost basis of \$26.8 million;

the exchange of debt securities of Garden Ridge Corporation with a cost basis of \$25.0 million for a new loan with a cost basis of \$22.5 million; and

the contribution to capital of existing debt securities of GAC Investments, Inc. (GAC) with a cost basis of \$11.0 million, resulting in a decrease in the Company's debt cost basis and an increase in the Company's common stock cost basis in GAC. During the third quarter of 2005, GAC changed its name to Triview Investments, Inc.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 12. Supplemental Disclosure of Cash Flow Information, continued

Non-cash operating activities for the year ended December 31, 2004, included the following:

notes or other securities received as consideration from the sale of investments of \$56.6 million. Notes received 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;

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 American Healthcare Services, Inc. with \$10.0 million of debt in MedBridge Healthcare, LLC and \$2.7 million of debt and equity from other companies;

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;

GAC 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 GAC to facilitate the asset acquisition; and

\$25.5 million of CMBS bonds and LLC interests received from the securitization of commercial mortgage loans.

Non-cash financing activities included the issuance of common stock in lieu of cash distributions totaling \$15.0 million, \$9.3 million, and \$5.8 million, for the years ended December 31, 2006, 2005, and 2004, respectively. In addition, the non-cash financing activities included the issuance of \$7.2 million of the Company's common stock as consideration for an additional investment in Mercury Air Centers, Inc. for the year ended December 31, 2005, and the issuance of \$3.2 million of the Company's common stock as consideration for an investment in Legacy Partners Group, LLC for the year ended December 31, 2004.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 13. Hedging Activities

At December 31, 2005, the Company had invested in commercial mortgage loans that were purchased at prices that were based in part on comparable Treasury rates and the Company had entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of these commercial mortgage loans. These transactions, referred to as short sales, involved 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, 2005, consisted of the following:

(\$ in millions)

Description of Issue	2005
5-year Treasury securities, due April 2010	\$ 17.7

During the fourth quarter of 2006, the Company sold commercial mortgage loans with a total outstanding principal balance of \$21.1 million and realized a gain of \$0.7 million. As these loans were purchased at prices that were based in part on comparable Treasury rates, the Company had a related hedge in place to protect against movements in Treasury rates. Upon the loan sale, the Company settled the related hedge, which resulted in a realized gain of \$0.5 million, which was included in the realized gain on the sale of \$0.7 million. At December 31, 2006, the Company did not have any similar hedges in place.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 14. Financial Highlights

	At and for the Years Ended December 31,		
	2006	2005	2004
Per Common Share Data			
Net asset value, beginning of year	\$ 19.17	\$ 14.87	\$ 14.94
Net investment income ⁽¹⁾	1.30	1.00	1.52
Net realized gains ⁽¹⁾⁽²⁾	3.66	1.99	0.88
Net investment income plus net realized gains ⁽¹⁾	4.96	2.99	2.40
Net change in unrealized appreciation or depreciation ⁽¹⁾⁽²⁾	(3.28)	3.37	(0.52)
Net increase in net assets resulting from operations ⁽¹⁾	1.68	6.36	1.88
Net decrease in net assets from shareholder distributions	(2.47)	(2.33)	(2.30)
Net increase in net assets from capital share transactions ⁽¹⁾	0.74	0.27	0.35
Net asset value, end of year	\$ 19.12	\$ 19.17	\$ 14.87
Market value, end of year	\$ 32.68	\$ 29.37	\$ 25.84
Total return ⁽³⁾	20.6%	23.5%	1.1%
Ratios and Supplemental Data			
(\$ and shares in millions, except per share amounts)			
Ending net assets	\$ 2,841.2	\$ 2,620.5	\$ 1,979.8
Common shares outstanding at end of year	148.6	136.7	133.1
Diluted weighted average common shares outstanding	145.6	137.3	132.5
Employee, employee stock option and administrative expenses/average net assets	5.38%	6.56%	4.65%
Total operating expenses/average net assets	9.05%	9.99%	8.53%
Net investment income/average net assets	6.90%	6.08%	10.45%
Net increase in net assets resulting from operations/ average net assets	8.94%	38.68%	12.97%
Portfolio turnover rate	27.05%	47.72%	32.97%
Average debt outstanding	\$ 1,491.0	\$ 1,087.1	\$ 985.6
Average debt per share ⁽¹⁾	\$ 10.24	\$ 7.92	\$ 7.44

(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.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 15. Selected Quarterly Data (Unaudited)

(\$ in millions, except per share amounts)	2006			
	Qtr. 1	Qtr. 2	Qtr. 3	Qtr. 4
Total interest and related portfolio income	\$ 111.0	\$ 110.5	\$ 113.4	\$ 117.7
Net investment income	\$ 41.3	\$ 50.2	\$ 48.7	\$ 49.1
Net increase in net assets resulting from operations	\$ 99.6	\$ 33.7	\$ 77.9	\$ 33.9
Basic earnings per common share	\$ 0.72	\$ 0.24	\$ 0.54	\$ 0.23
Diluted earnings per common share	\$ 0.70	\$ 0.24	\$ 0.53	\$ 0.23

(\$ in millions, except per share amounts)	2005			
	Qtr. 1	Qtr. 2	Qtr. 3	Qtr. 4
Total interest and related portfolio income	\$ 94.9	\$ 86.2	\$ 94.9	\$ 98.2
Net investment income	\$ 38.8	\$ 15.3	\$ 46.1	\$ 37.1
Net increase in net assets resulting from operations	\$ 119.6	\$ 311.9	\$ 113.2	\$ 328.1
Basic earnings per common share	\$ 0.90	\$ 2.33	\$ 0.84	\$ 2.40
Diluted earnings per common share	\$ 0.88	\$ 2.29	\$ 0.82	\$ 2.36

Note 16. Litigation

On June 23, 2004, the Company was notified by the SEC that the SEC is conducting an informal investigation of the Company. On December 22, 2004, the Company received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding the Company and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to the Company at this time, the inquiries appear to primarily pertain to matters related to portfolio valuation and the Company's portfolio company, Business Loan Express, LLC. To date, the Company has produced materials in response to requests from both the SEC and the U.S. Attorney's office, and a director and certain current and former employees have provided testimony and have been interviewed by the staff of the SEC and, in some cases, the U.S. Attorney's Office. The Company is voluntarily cooperating with these investigations.

In late December 2006, the Company received a subpoena from the U.S. Attorney for the District of Columbia requesting, among other things, the production of records regarding the use of private investigators by the Company or its agents. The Board established a committee, which was advised by its own counsel, to review this matter. In the course of gathering documents responsive to the subpoena, the Company became aware that an agent of the Company obtained what were represented to be telephone records of David Einhorn and which purport to be records of calls from Greenlight Capital during a period of time in 2005. Also, while the Company was gathering documents responsive to the subpoena, allegations were made that the Company's management had authorized the acquisition of these records and that management was subsequently advised

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 16. Litigation, continued

that these records had been obtained. The Company's management has stated that these allegations are not true. The Company is cooperating fully with the inquiry by the United States Attorney's office.

On February 13, 2007, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned Rena Nadoff v. Walton, et al., CA 001060-07, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. Ms. Nadoff's complaint names as defendants the members of Allied Capital's Board of Directors; Allied Capital is a nominal defendant for purposes of the derivative action. The complaint alleges breach of fiduciary duty by the Board of Directors arising from internal controls failures and mismanagement of Business Loan Express, LLC, an Allied Capital portfolio company. The Company believes the lawsuit is without merit, and intends to defend the lawsuit vigorously.

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The complaint is captioned Dana Ross v. Walton, et al., CV 00402. Dana Ross claims that, between March 1, 2006, and January 10, 2007, Allied Capital either failed to disclose or misrepresented information concerning the loan origination practices of Business Loan Express, LLC, an Allied Capital portfolio company. Dana Ross seeks unspecified compensatory and other damages, as well as other relief. The Company believes the lawsuit is without merit, and intends to defend the lawsuit vigorously.

In addition, the Company is party to certain lawsuits in the normal course of business.

While the outcome of any of the legal proceedings described above cannot at this time be predicted with certainty, the Company does not expect these matters will materially affect its financial condition or results of operations.

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Report of Independent Registered Public Accounting Firm

The Board of Directors

Allied Capital Corporation:

Under date of February 28, 2007, we reported on the consolidated balance sheet of Allied Capital Corporation and subsidiaries as of December 31, 2006 and 2005, including the consolidated statements of investments as of December 31, 2006 and 2005, and the related consolidated statements of operations, changes in net assets and cash flows, and the financial highlights (included in Note 14), for each of the years in the three-year period ended December 31, 2006, which are included in the registration statement on Form N-2. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related financial statement schedule as of and for the year ended December 31, 2006. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audit.

In our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects the information set forth therein.

Washington, D.C.

February 28, 2007

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Schedule 12-14

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
SCHEDULE OF INVESTMENTS IN AND ADVANCES TO AFFILIATES

PRIVATE FINANCE		Amount of Interest or Dividends		December 31, 2005	Gross	Gross	December 31, 2006
Portfolio Company	Investment(1)	to	Other(2)	Value	Additions(3)	Reductions(4)	Value
(in thousands)		Income(6)					
Companies More Than 25% Owned							
Acme Paging, L.P. (Telecommunications)	Senior Loan(5) Subordinated Debt(5) Common Stock	\$ (176) (3)		\$	\$ 3,750 881 27	\$ (3,750) (881) (27)	\$
Advantage Sales & Marketing, Inc.(7) (Business Services)	Subordinated Debt Subordinated Debt Common Stock	1,712 5,555		59,787 124,000 476,578	213 374	(60,000) (124,374) (476,578)	
Alaris Consulting, LLC (Business Services)	Senior Loan(5) Equity Interests	(63)					
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Senior Loan(5)		\$ 1	4,097	502	(4,599)	
Avborne, Inc. (Business Services)	Preferred Stock Common Stock			892	73	(47)	918
Avborne Heavy Maintenance, Inc. (Business Services)	Preferred Stock Common Stock						
Border Foods, Inc. (Consumer Products)	Preferred Stock Common Stock						
Business Loan Express, LLC (Financial Services)	Subordinated Debt Class A Equity Interests(5)	38 11,889		10,000 60,693	15,000 5,929	(25,000)	66,622

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	Class B Equity Interests		146,910		(67,771)	79,139
	Class C Equity Interests		139,521		(74,545)	64,976
Calder Capital Partners, LLC (Financial Services)	Senior Loan(5) Equity Interests			975	2,076	975 2,076
Callidus Capital Corporation (Financial Services)	Senior Loan	441	600	8,705	(9,305)	
	Subordinated Debt	972	4,832	930		5,762
	Common Stock		7,968	14,582		22,550
Coverall North America, Inc. (Business Services)	Unitranche Debt	1,926		36,333		36,333
	Subordinated Debt	395		5,972		5,972
	Common Stock Warrants			19,729	(110)	19,619
CR Brands, Inc. (Consumer Products)	Senior Loan	1,109		37,219	(37,219)	
	Subordinated Debt	5,700		39,401		39,401
	Common Stock			33,321	(7,583)	25,738
Diversified Group Administrators, Inc. (Business Services)	Preferred Stock	87	728		(728)	
	Preferred Stock		841		(841)	
	Common Stock	68	502		(502)	
Financial Pacific Company (Financial Services)	Subordinated Debt	12,415	69,904	1,458		71,362
	Preferred Stock		13,116	2,826		15,942
	Common Stock		44,180	21,006		65,186
ForeSite Towers, LLC (Tower Leasing)	Equity Interests	329	9,750	2,540		12,290
Global Communications, LLC (Business Services)	Senior Loan(5)		15,957			15,957
	Subordinated Debt(5)		11,198	138	(99)	11,237
	Preferred Equity Interest		4,303		(4,303)	
	Options					
Gordian Group, Inc. (Business Services)	Senior Loan(5)	(18)	4,161	392	(4,553)	
	Common Stock			220	(220)	
Healthy Pet Corp.	Senior Loan	1,746	4,086	24,252	(1,300)	27,038

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(Consumer Services)	Subordinated Debt	6,549	38,535	5,230	(186)	43,579
	Common Stock		25,766	4,500	(1,345)	28,921
HMT, Inc.	Preferred Stock		2,637			2,637
(Energy Services)	Common Stock		5,343	3,321		8,664
	Warrants		2,057	1,279		3,336

See related footnotes at the end of this schedule.

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PRIVATE FINANCE		Amount of Interest or Dividends		December 31, 2005	Gross Additions(3)	Gross Reductions(4)	December 31, 2006
		Credited to Income(6)	Other(2)				
Portfolio Company	Investment(1)						
(in thousands)							
Huddle House, Inc. (Retail)	Senior Loan	\$ 59	\$	\$ 19,950	\$	\$ 19,950	
	Subordinated Debt	296		58,196		58,196	
	Common Stock			41,662		41,662	
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			742	131		873
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt	9,724		58,298	1,552		59,850
	Preferred Stock			26,791		(18,946)	7,845
	Common Stock			236		(236)	
Jakel, Inc. (Industrial Products)	Subordinated Debt(5)				6,655		6,655
	Preferred Stock						
	Common Stock						
Legacy Partners Group, LLC (Financial Services)	Senior Loan (5)			5,029		(186)	4,843
	Subordinated Debt(5)						
	Equity Interests				18	(18)	
Litterer Beteiligungs-GmbH (Business Services)	Subordinated Debt	43		621	71		692
	Equity Interest			2,226		(1,027)	1,199
Mercury Air Centers, Inc. (Business Services)	Senior Loan	1,231		31,720	4,000	(35,720)	
	Subordinated Debt	8,076		46,519	5,698	(3,000)	49,217

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	Common Stock		88,898	106,121		195,019
MVL Group, Inc. (Business Services)	Senior Loan	3,605	27,218	1,000	(973)	27,245
	Subordinated Debt	5,052	32,417	3,061		35,478
	Common Stock		3,211		(3,211)	
Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt	2,473		37,994		37,994
	Equity Interests			25,949		25,949
Pennsylvania Avenue Investors, L.P. (Private Equity Fund)	Equity Interests		1,864	1,193	(3,057)	
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan(5)	2,394	23,792	10,625	(8,225)	26,192
	Subordinated Debt(5)		7,364		(6,402)	962
	Preferred Stock Warrants					
Redox Brands, Inc. (Consumer Products)	Preferred Stock Warrants	363	12,097 500	1,708 84	(13,805) (584)	
Service Champ, Inc. (Business Services)	Subordinated Debt	4,339	26,906	713		27,619
	Common Stock		13,319	3,467		16,786
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt(5)	\$355	6,343		(5,857)	486
	Preferred Stock		1,812	3,156	(4,968)	
	Common Stock Warrants			60	(60)	
Startec Global Communications Corporation (Telecommunications)	Senior Loan	2,165	21,685	3,540	(9,260)	15,965
	Common Stock			11,232		11,232
STS Operating, Inc.		328	6,593	123	(6,716)	

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(Industrial Products)	Subordinated Debt Common Stock Options		64,963 560		(64,963) (560)	
Sweet Traditions, LLC (Consumer Products)	Senior Loan Equity Interests	1,755		36,150 450	(978)	35,172 450
Triview Investments, Inc. (Broadcasting & Cable/ Consumer Products/ Business Services)	Senior Loan Subordinated Debt Subordinated Debt(5) Common Stock	1,302 8,692 68	7,449 30,845 19,520 29,171	7,298 25,163 742 11,516	(15,920)	14,747 56,008 4,342 31,322
Total companies more than 25% owned		\$102,636	\$1,887,651			\$1,490,180
Companies 5% to 25% Owned						
Advantage Sales & Marketing, Inc.(7) (Business Services)	Subordinated Debt Equity Interests	\$ 14,050	\$	\$151,648 15,272	\$ (4,272)	\$ 151,648 11,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan Subordinated Debt Equity Interests	3,298 2,145 1,694		8,097 42,267 4,025	(6,334) (35,488) (1,468)	1,763 35,128 5,950
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock Common Stock			622 14	(20) (14)	602

See related footnotes at the end of this schedule.

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PRIVATE FINANCE Portfolio Company (in thousands)	Investment(1)	Amount of Interest or Dividends		December 31, 2005 Value	Gross Additions(3)	Gross Reductions(4)	December 31, 2006 Value
		Credited to Income(6)	Other(2)				
Amerex Group, LLC (Consumer Products)	Subordinated Debt	\$ 669		\$	\$ 8,400	\$	\$ 8,400
	Equity Interests				13,860	(37)	13,823
Aspen Pet Products, Inc. (Consumer Products)	Subordinated Debt	1,130		19,959	399	(20,358)	
	Preferred Stock	29		1,638	516	(2,154)	
	Common Stock Warrants			17	123	(140)	
BB&T Capital Partners/Windsor Mezzanine Fund, LLC (Private Equity Fund)	Equity Interests				5,867	(313)	5,554
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt	3,545		23,543	620		24,163
	Common Stock			2,200	1,500		3,700
BI Incorporated (Business Services)	Senior Loan	125			15,000	(15,000)	
	Subordinated Debt	3,484			30,135		30,135
	Common Stock				4,100		4,100
CitiPostal, Inc. and Affiliates (Business Services)	Senior Loan	1,061			20,689	(120)	20,569
	Common Stock				4,700		4,700
Creative Group, Inc. (Business Services)	Subordinated Debt	583			13,656		13,656
	Warrants				1,387		1,387

Drew Foam Companies, Inc. (Business Services)	Preferred Stock			722		722
	Common Stock			7		7
The Debt Exchange Inc. (Business Services)	Preferred Stock		3,219		(3,219)	
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan(5)		7,093	71		7,164
	Subordinated Debt(5)		534	1,279		1,813
	Convertible Subordinated Debt(5)					
	Equity Interests			501	(501)	
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt	348		19,879		19,879
	Equity Interests			2,000		2,000
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt	1,604	10,588	390		10,978
	Equity Interests		1,367	119		1,486
PresAir LLC (Industrial Products)	Senior Loan(5)	\$261		5,492	(3,286)	2,206
	Unitranche Debt(5)		5,820	328	(6,148)	
	Equity Interests		318	5	(323)	
Progressive International Corporation (Consumer Products)	Subordinated Debt	1,223	7,376	157		7,533
	Preferred Stock		884	140		1,024
	Common Stock Warrants		13	2,287		2,300
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan	72		1,232		1,232
	Unitranche Debt	1,152		19,908		19,908
	Equity Interests			1,616		1,616

SGT India Private Limited (Business Services)	Common Stock			3,944	(598)	3,346
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt	2,013	13,447	4,122		17,569
	Equity Interests		2,308	233		2,541
Universal Environmental Services, LLC (Business Services)	Unitranche Debt	1,529	10,862	101	(752)	10,211
	Equity Interests		1,328	13	(1,341)	
Total companies 5% to 25% owned		\$39,754	\$158,806			\$449,813

This schedule should be read in conjunction with the Company's consolidated financial statements, 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.

- (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, 2006 and 2005.

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- (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 increased in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company into this category from a different category. 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, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company out of this category into a different category. 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, 2006, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the period may or may not have been on non-accrual status for the full period.
- (6) 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.
- (7) Included in the companies more than 25% owned category while the Company held a majority equity interest. On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company's investment in Advantage after the sale transaction is included in the companies 5% to 25% owned category. See Note 3 to the consolidated financial statements for further information.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Allied Capital Corporation:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of June 30, 2007, the related consolidated statements of operations, for the three- and six-month periods ended June 30, 2007 and 2006, and the consolidated statements of changes in net assets and cash flows and the financial highlights (included in Note 12) for the six-month periods ended June 30, 2007 and 2006. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the consolidated financial statements and financial highlights referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of December 31, 2006, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights, for the year then ended; and in our report dated February 28, 2007, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet including the consolidated statement of investments as of December 31, 2006, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Washington, D.C.

August 8, 2007

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET**

(in thousands, except per share amounts)	June 30, 2007	December 31, 2006
	(unaudited)	
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2007-\$1,775,496; 2006-\$1,578,822)	\$ 1,709,770	\$ 1,490,180
Companies 5% to 25% owned (cost: 2007-\$446,746; 2006-\$438,560)	418,647	449,813
Companies less than 5% owned (cost: 2007-\$2,197,112; 2006-\$2,479,981)	2,219,839	2,437,908
Total private finance (cost: 2007-\$4,419,354; 2006-\$4,497,363)	4,348,256	4,377,901
Commercial real estate finance (cost: 2007-\$100,805; 2006-\$103,546)	122,804	118,183
Total portfolio at value (cost: 2007-\$4,520,159; 2006-\$4,600,909)	4,471,060	4,496,084
Investments in money market and other securities	304,407	202,210
Accrued interest and dividends receivable	70,933	64,566
Other assets	153,514	122,958
Cash	45,574	1,687
Total assets	\$ 5,045,488	\$ 4,887,505
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures (maturing within one year: 2007-\$153,000; 2006-\$)	\$ 1,921,815	\$ 1,691,394
Revolving line of credit		207,750
Accounts payable and other liabilities	132,539	147,117
Total liabilities	2,054,354	2,046,261
Commitments and contingencies		
Shareholders equity:		
Common stock, \$0.0001 par value, 400,000 shares authorized; 152,652 and 148,575 shares issued and outstanding at June 30, 2007, and December 31, 2006, respectively	15	15
Additional paid-in capital	2,620,247	2,493,335
Common stock held in deferred compensation trust	(34,374)	(28,335)
Notes receivable from sale of common stock	(2,709)	(2,850)
Net unrealized appreciation (depreciation)	(68,060)	(123,084)
Undistributed earnings	476,015	502,163
Total shareholders equity	2,991,134	2,841,244

Total liabilities and shareholders equity	\$ 5,045,488	\$ 4,887,505
Net asset value per common share	\$ 19.59	\$ 19.12

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

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Table of Contents**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF OPERATIONS**

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
(in thousands, except per share amounts)				
	(unaudited)		(unaudited)	
Interest and Related Portfolio Income:				
Interest and dividends				
Companies more than 25% owned	\$ 28,540	\$ 23,419	\$ 55,697	\$ 53,565
Companies 5% to 25% owned	10,876	11,419	22,737	17,069
Companies less than 5% owned	63,398	60,595	126,363	113,680
Total interest and dividends	102,814	95,433	204,797	184,314
Fees and other income				
Companies more than 25% owned	5,417	5,649	9,406	17,736
Companies 5% to 25% owned	471	1,282	499	3,998
Companies less than 5% owned	8,974	8,092	10,926	15,419
Total fees and other income	14,862	15,023	20,831	37,153
Total interest and related portfolio income	117,676	110,456	225,628	221,467
Expenses:				
Interest	34,336	21,861	64,624	46,346
Employee	28,611	20,398	50,539	41,826
Employee stock options	9,519	4,597	13,180	8,203
Administrative	14,505	9,861	27,729	21,195
Total operating expenses	86,971	56,717	156,072	117,570
Net investment income before income taxes	30,705	53,739	69,556	103,897
Income tax expense (benefit), including excise tax	5,530	3,544	4,881	12,402
Net investment income	25,175	50,195	64,675	91,495
Net Realized and Unrealized Gains (Losses):				
Net realized gains (losses)				
Companies more than 25% owned	67,127	95,212	65,777	528,399
Companies 5% to 25% owned	138	(74)	304	(417)
Companies less than 5% owned	7,614	5,102	36,464	5,093
Total net realized gains	74,879	100,240	102,545	533,075
Net change in unrealized appreciation or depreciation	(10,896)	(116,706)	55,024	(491,254)
Total net gains (losses)	63,983	(16,466)	157,569	41,821

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Net increase in net assets resulting from operations	\$ 89,158	\$ 33,729	\$ 222,244	\$ 133,316
Basic earnings per common share	\$ 0.59	\$ 0.24	\$ 1.47	\$ 0.96
Diluted earnings per common share	\$ 0.57	\$ 0.24	\$ 1.44	\$ 0.94
Weighted average common shares outstanding basic	152,361	140,024	150,940	139,395
Weighted average common shares outstanding diluted	156,051	143,213	154,446	142,466

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

	For the Six Months Ended June 30,	
	2007	2006
(in thousands, except per share amounts)		
	(unaudited)	
Operations:		
Net investment income	\$ 64,675	\$ 91,495
Net realized gains	102,545	533,075
Net change in unrealized appreciation or depreciation	55,024	(491,254)
Net increase in net assets resulting from operations	222,244	133,316
Shareholder distributions:		
Common stock dividends	(193,368)	(166,632)
Net decrease in net assets resulting from shareholder distributions	(193,368)	(166,632)
Capital share transactions:		
Sale of common stock	93,784	82,970
Issuance of common stock in lieu of cash distributions	8,279	7,199
Issuance of common stock upon the exercise of stock options	11,967	8,226
Stock option expense	13,358	8,439
Net decrease in notes receivable from sale of common stock	141	498
Purchase of common stock held in deferred compensation trust	(6,166)	(4,649)
Distribution of common stock held in deferred compensation trust	127	106
Other	(476)	
Net increase in net assets resulting from capital share transactions	121,014	102,789
Total increase in net assets	149,890	69,473
Net assets at beginning of period	2,841,244	2,620,546
Net assets at end of period	\$ 2,991,134	\$ 2,690,019
Net asset value per common share	\$ 19.59	\$ 19.17
Common shares outstanding at end of period	152,652	140,312

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Six Months Ended June 30,	
	2007	2006
(in thousands)	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$ 222,244	\$ 133,316
Adjustments:		
Portfolio investments	(659,141)	(1,071,243)
Principal collections related to investment repayments or sales	735,441	769,598
Change in accrued or reinvested interest and dividends	(17,714)	9,064
Net collection (amortization) of discounts and fees	(425)	(3,094)
Redemption of (investments in) U.S. Treasury bills		(22,875)
Redemption of (investments in) money market securities	(97,478)	25,581
Stock option expense	13,358	8,439
Changes in other assets and liabilities	(28,354)	(1,410)
Depreciation and amortization	1,022	870
Realized gains from the receipt of notes and other consideration from sale of investments, net of collections	(9,201)	(217,086)
Realized losses	18,057	4,405
Net change in unrealized (appreciation) or depreciation	(55,024)	491,254
 Net cash provided by (used in) operating activities	 122,785	 126,819
Cash flows from financing activities:		
Sale of common stock	93,784	82,970
Sale of common stock upon the exercise of stock options	11,967	8,226
Collections of notes receivable from sale of common stock	141	498
Borrowings under notes payable	230,000	50,000
Repayments on notes payable and debentures		(37,000)
Net borrowings under (repayments on) revolving line of credit	(207,750)	(90,000)
Purchase of common stock held in deferred compensation trust	(6,166)	(4,649)
Other financing activities	(8,362)	(1,590)
Common stock dividends and distributions paid	(192,512)	(163,531)
 Net cash provided by (used in) financing activities	 (78,898)	 (155,076)
 Net increase (decrease) in cash	 43,887	 (28,257)
Cash at beginning of period	1,687	31,363
 Cash at end of period	 \$ 45,574	 \$ 3,106

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

Table of Contents**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS****June 30, 2007****Private Finance****Portfolio Company****(in thousands, except number of shares)****(unaudited)****Investment⁽¹⁾⁽²⁾****Principal****Cost****Value****Companies More Than 25% Owned**

Alaris Consulting, LLC (Business Services)	Senior Loan (16.5%, Due 12/05 12/07) ⁽⁶⁾ Equity Interests Guaranty (\$1,100)	\$ 27,055	\$ 26,987 5,189	\$
AllBridge Financial, LLC (Financial Services)	Equity Interests		800	800
Allied Capital Senior Debt Fund, L.P. ⁽⁵⁾ (Private Debt Fund)	Equity Interests (See Note 3)		19,080	19,252
Avborne, Inc. ⁽⁷⁾ (Business Services)	Preferred Stock (12,500 shares) Common Stock (27,500 shares)		611	927
Avborne Heavy Maintenance, Inc. ⁽⁷⁾ (Business Services)	Preferred Stock (1,568 shares) Common Stock (2,750 shares) Guaranty (\$2,401)		2,401	
Border Foods, Inc. (Consumer Products)	Preferred Stock (100,000 shares) Common Stock (148,838 shares)		12,721 3,847	
Business Loan Express, LLC (Financial Services)	Class A Equity Interests (25.0% See Note 3) ⁽⁶⁾ Class B Equity Interests Class C Equity Interests Guaranty (\$208,821 See Note 3) Standby Letters of Credit (\$20,000 See Note 3)	95,822	95,822 119,436 109,301	95,822 70,023 54,948
Calder Capital Partners, LLC ⁽⁵⁾ (Financial Services)	Senior Loan (8.0%, Due 5/09) ⁽⁶⁾ Equity Interests	1,952	1,952 2,154	1,952 538
Callidus Capital Corporation (Financial Services)	Senior Loan (12.0%, Due 12/08) Subordinated Debt (18.0%, Due 10/08) Common Stock (100 shares)	700 6,292	700 6,292 2,067	700 6,292 48,341

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Coverall North America, Inc. (Business Services)	Unitranche Debt (12.0%, Due 7/11)	35,054	34,905	34,905
	Subordinated Debt (15.0%, Due 7/11)	6,000	5,976	5,976
	Common Stock (884,880 shares)		16,648	22,510
CR Holding, Inc. (Consumer Products)	Subordinated Debt (16.6%, Due 2/13)	40,256	40,099	40,099
	Common Stock (37,200,551 shares)		33,321	38,522
Direct Capital Corporation (Financial Services)	Subordinated Debt (16.0%, Due 3/13)	36,227	36,058	36,058
	Common Stock (2,097,234 shares)		19,250	17,166
Financial Pacific Company (Financial Services)	Subordinated Debt (17.4%, Due 2/12 8/12)	72,306	72,102	72,102
	Preferred Stock (10,964 shares)		10,276	17,576
	Common Stock (14,735 shares)		14,819	70,473
ForeSite Towers, LLC (Tower Leasing)	Equity Interests			913

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

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

Table of Contents**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)****June 30, 2007**

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
			(unaudited)	
Global Communications, LLC (Business Services)	Senior Loan (10.7%, Due 9/02 11/07) ⁽⁶⁾ Subordinated Debt (17.0%, Due 12/03 9/05) ⁹⁾ Preferred Equity Interest Options	\$ 15,957 11,339	\$ 15,957 11,336 14,067 1,639	\$ 15,957 3,221
Gordian Group, Inc. (Business Services)	Senior Loan (10.0%, Due 6/06 12/08) ⁽⁶⁾ Common Stock (1,000 shares)	11,792	11,794 6,942	
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan (8.8%, Due 2/11-2/12) Subordinated Debt (13.7%, Due 8/12 2/13) Subordinated Debt (16.0%, Due 2/13) ⁽⁶⁾ Common Stock (1,147,453 shares)	49,660 61,532 20,841	49,450 61,293 20,750 56,187	49,450 48,155
Huddle House, Inc. (Retail)	Subordinated Debt (15.0%, Due 12/12) Common Stock (415,328 shares)	58,949	58,686 41,533	58,686 43,070
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			320
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt (15.0%, Due 9/12) Subordinated Debt (19.0%, Due 9/12) ⁽⁶⁾ Preferred Stock (25,000 shares) Common Stock (620,000 shares)	44,257 16,181	44,123 16,130 25,000 6,325	44,569 16,457 209
Jakel, Inc. (Industrial Products)	Subordinated Debt (15.5%, Due 3/08) ⁽⁶⁾ Preferred Stock (6,460 shares) Common Stock (158,061 shares)	15,692	15,692 6,460 9,347	
Legacy Partners Group, Inc. (Financial Services)	Senior Loan (14.0%, Due 5/09) ⁽⁶⁾ Equity Interests	3,843	3,843 4,261	3,843 568

Litterer Beteiligungs-GmbH ⁽⁴⁾ (Business Services)	Subordinated Debt (8.0%, Due 3/07) Equity Interest	706	706 1,809	706 2,906
Mercury Air Centers, Inc. (Business Services)	Subordinated Debt (16.0%, Due 4/09 11/12) Common Stock (57,970 shares)	50,361	50,252 35,053	50,252 269,886
MVL Group, Inc. (Business Services)	Senior Loan (12.0%, Due 6/09 7/09) Subordinated Debt (14.5%, Due 6/09 7/09) Common Stock (648,661 shares)	30,674 39,687	30,623 39,364 643	30,623 39,364 2,013
Old Orchard Brands, LLC (Consumer Products)	Subordinated Debt (18.0%, Due 7/14) Equity Interests	19,300	19,206 18,767	19,206 18,767
Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt (15.5%, Due 8/13) Equity Interests	38,748	38,583 21,128	38,583 27,532
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan (15.0%, Due 12/07) ⁽⁶⁾⁽⁺⁾ Preferred Stock (1,483 shares) Warrants	12,748	12,748	12,748

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- (+) Loan repayments of \$11.4 million were received on July 2, 2007.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

June 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
				(unaudited)
Service Champ, Inc.	Subordinated Debt (15.5%, Due 4/12)	\$ 28,084	\$ 27,982	\$ 27,982
(Business Services)	Common Stock (63,888 shares)		13,662	21,194
Staffing Partners Holding Company, Inc.	Subordinated Debt (13.5%, Due 1/07) ⁽⁶⁾	541	541	549
(Business Services)				
Startec Global Communications Corporation	Senior Loan (10.0%, Due 5/07 5/09)	11,175	11,175	11,175
(Telecommunications)	Common Stock (19,180,000 shares)		37,255	17,109
Sweet Traditions, Inc.	Senior Loan (9.0%, Due 8/11) ⁽⁶⁾	39,392	35,752	35,752
(Retail)	Preferred Stock (961 Shares)		950	950
	Common Stock (10,000 Shares)		50	50
Triview Investments, Inc. ⁽⁸⁾	Senior Loan (9.6%, Due 12/07 6/08)	14,758	14,758	14,758
(Broadcasting & Cable/Business Services/Consumer Products)	Subordinated Debt (14.7%, Due 1/10 5/17)	75,484	75,116	75,116
	Subordinated Debt (8.5%, Due 11/07 7/08) ⁽⁹⁾	5,000	5,000	5,087
	Common Stock (202 shares)		110,744	47,062
	Guaranty (\$800)			
	Standby Letter of Credit (\$200)			
Total companies more than 25% owned			\$ 1,775,496	\$ 1,709,770
Companies 5% to 25% Owned				
Advantage Sales & Marketing, Inc.	Subordinated Debt (12.0%, Due 3/14)	\$ 153,856	\$ 153,231	\$ 153,231
(Business Services)	Equity Interests			11,000
Air Medical Group Holdings LLC	Senior Loan (8.5%, Due 3/11)	1,787	1,729	1,729
(Healthcare Services)	Equity Interests		3,470	9,200

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Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock (622 shares) Common Stock (13,513 shares)		622 14	696 100
Amerex Group, LLC (Consumer Products)	Subordinated Debt (12.0%, Due 1/13) Equity Interests	8,400	8,400 3,509	8,400 21,787
BB&T Capital Partners/Windsor Mezzanine Fund, LLC ⁽⁵⁾ (Private Equity Fund)	Equity Interests		5,873	5,608
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt (14.5%, Due 8/12) Common Stock(5,073 shares)	24,552	24,477 5,813	24,477 3,600
BI Incorporated (Business Services)	Subordinated Debt (13.5%, Due 2/14) Common Stock (40,000 shares)	30,499	30,374 4,000	30,374 6,800

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (8) Triview Investments, Inc. holds investments in Longview Cable & Data, LLC (Broadcasting & Cable) with a cost of \$68.0 million and a value of \$7.4 million, Triax Holdings, LLC (Consumer Products) with a cost of \$98.9 million and a value of \$94.4 million, and Crescent Hotels & Resorts, LLC and affiliates (Business Services) with a cost of \$38.8 million and a value of \$40.3 million.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

June 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	(unaudited)	
			Cost	Value
CitiPostal, Inc. and Affiliates (Business Services)	Senior Loan (11.1%, Due 8/13-11/14) Equity Interests	\$ 20,610	\$ 20,513 4,578	\$ 20,513 6,900
Creative Group, Inc. (Business Services)	Subordinated Debt (12.0%, Due 9/13) ⁽⁶⁾ Warrant	15,000	13,686 1,387	11,198
Drew Foam Companies, Inc. (Business Services)	Preferred Stock (722 shares) Common Stock (7,287 shares)		722 7	428
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan (6.0%, Due 8/09) ⁽⁶⁾ Subordinated Debt (10.0%, Due 8/14) ⁽⁶⁾ Convertible Subordinated Debt (2.0%, Due 8/14) ⁽⁶⁾ Equity Interests	7,164 5,184 2,970	7,164 5,184 984 1,416	7,164 2,129
MHF Logistical Solutions, Inc. (Business Services)	Subordinated Debt (11.5%, Due 6/12) ⁽⁶⁾ Subordinated Debt (18.0%, Due 6/13) ⁽⁶⁾ Common Stock (20,934 shares) ⁽¹²⁾ Warrants ⁽¹²⁾	33,600 11,211	33,448 11,154 20,942	17,277
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt (11.3%, Due 11/11) Equity Interests	19,900	19,792 2,000	19,792 940
PresAir LLC (Industrial Products)	Senior Loan (7.5%, Due 12/10) ⁽⁶⁾ Equity Interests	5,729	5,411 1,341	2,082
Progressive International Corporation (Consumer Products)	Subordinated Debt (16.0%, Due 12/09) Preferred Stock (500 shares) Common Stock (197 shares) Warrants	7,629	7,613 500 13	7,613 1,068 4,300

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Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan (11.1%, Due 6/12)	1,250	1,233	1,233
	Unitranche Debt (11.1%, Due 6/12)	12,000	11,949	11,949
	Equity Interests		1,500	1,720
SGT India Private Limited ⁽⁴⁾ (Business Services)	Common Stock (109,524 shares)		4,093	3,076
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt (12.0%, Due 11/10)	14,500	13,661	13,661
	Equity Interests		2,170	2,592
Universal Environmental Services, LLC (Business Services)	Unitranche Debt (15.5%, Due 2/09) ⁽⁶⁾	10,989	10,963	6,010
	Equity Interests		1,810	
Total companies 5% to 25% owned			\$ 446,746	\$ 418,647
Companies Less Than 5% Owned				
3SI Security Systems, Inc. (Consumer Products)	Subordinated Debt (14.5%, Due 8/13)	\$ 27,376	\$ 27,268	\$ 27,268
AgData, L.P. (Consumer Services)	Senior Loan (10.3%, Due 7/12)	1,726	1,694	1,694
Axiom Healthcare Pharmacy, Inc. (Healthcare Services)	Unitranche Debt (12.0%, Due 12/12)	8,500	8,423	8,423
	Common Stock (26,500 shares)		2,650	1,400
Baird Capital Partners IV Limited Partnership ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,557	1,298

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- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

June 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
			(unaudited)	
BenefitMall, Inc. (Business Services)	Unitranche Debt (13.3%, Due 8/12) Common Stock (45,528,000 shares) ⁽¹²⁾ Warrants ⁽¹²⁾ Standby Letters of Credit (\$9,981)	\$ 110,030	\$ 109,682 45,528	\$ 109,682 56,162
Broadcast Electronics, Inc. (Business Services)	Senior Loan (9.4%, Due 7/12)	4,938	4,908	4,908
Callidus Debt Partners CDO Fund I, Ltd. ⁽⁴⁾⁽¹⁰⁾ (CDO/CLO Fund)	Class C Notes (12.9%, Due 12/13) Class D Notes (17.0%, Due 12/13)	18,800 9,400	18,940 9,470	18,988 9,494
Callidus Debt Partners CLO Fund III, Ltd. ⁽⁴⁾⁽¹⁰⁾ (CDO/CLO Fund)	Preferred Shares (23,600,000 shares, 15.1%) ⁽¹¹⁾		22,158	22,947
Callidus Debt Partners CLO Fund IV, Ltd. ⁽⁴⁾⁽¹⁰⁾ (CDO/CLO Fund)	Income Notes (13.0%) ⁽¹¹⁾		12,492	12,143
Callidus Debt Partners CLO Fund V, Ltd. ⁽⁴⁾⁽¹⁰⁾ (CDO/CLO Fund)	Income Notes (15.8%) ⁽¹¹⁾		14,143	14,143
Callidus MAPS CLO Fund I LLC ⁽¹⁰⁾ (CDO/CLO Fund)	Class E Notes (10.9%, Due 12/17) Income Notes (11.6%) ⁽¹¹⁾	17,000 17,000	17,000 50,515	17,112 44,672
Callidus MAPS CLO Fund II, Ltd. ⁽⁴⁾⁽¹⁰⁾ (CDO/CLO Fund)	Income Notes (14.8%) ⁽¹¹⁾		17,396	17,396
Camden Partners Strategic Fund II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		997	2,219
Carlisle Wide Plank Floors, Inc.	Unitranche Debt (10.5%, Due 6/11)	3,161	3,119	3,119

(Consumer Products)	Preferred Stock (400,000 Shares)	400	600
Catterton Partners V, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest	3,760	4,016
Catterton Partners VI, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest	1,573	1,454
Centre Capital Investors IV, LP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest	2,022	2,100

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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (10) The fund is managed by Callidus Capital, a portfolio company of Allied Capital.
- (11) Represents the effective yield earned on these preferred equity investments and income notes. The yield is included in interest income from companies less than 5% owned in the consolidated statement of operations.
- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

June 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
			(unaudited)	
Commercial Credit Group, Inc. (Financial Services)	Subordinated Debt (14.8%, Due 2/11) Preferred Stock (42,478 shares) Warrants	\$ 10,000	\$ 9,964 7,018	\$ 9,964 8,319
Community Education Centers, Inc. (Education Services)	Subordinated Debt (13.5%, Due 12/10 11/13)	34,814	34,732	34,732
Component Hardware Group, Inc. (Industrial Products)	Subordinated Debt (13.5%, Due 1/13)	18,295	18,218	18,218
Cook Inlet Alternative Risk, LLC (Business Services)	Unitranche Debt (10.8%, Due 4/13) Equity Interests	100,000	99,484 640	99,484 2,100
Cortec Group Fund IV, L.P. ⁽⁵⁾ (Private Equity)	Limited Partnership Interest		3,345	2,919
CSAV, Inc. (Business Services)	Subordinated Debt (11.9%, Due 6/13)	37,500	37,500	37,500
DCWV Acquisition Corporation (Consumer Products)	Senior Loan (9.7%, Due 7/12) Unitranche Debt (11.0%, Due 7/12)	2,499 19,363	2,486 19,276	2,486 19,276
Digital VideoStream, LLC (Business Services)	Unitranche Debt (11.0%, Due 2/12) Convertible Subordinated Debt (10.0%, Due 2/16)	17,886 3,919	17,790 3,904	17,790 3,904
Distant Lands Trading Co. (Consumer Products)	Senior Loan (10.2%, Due 11/11) Unitranche Debt (11.0%, Due 11/11) Common Stock (4,000 shares)	5,750 42,375	5,711 42,202 4,000	5,711 42,202 3,969
Driven Brands, Inc. d/b/a Meineke and Econo Lube (Consumer Services)	Senior Loan (8.8%, Due 6/11) Subordinated Debt (12.1%, Due 6/12 6/13) Common Stock (11,675,331 shares) ⁽¹²⁾ Warrants ⁽¹²⁾	37,070 83,000	36,934 82,719 29,455	36,934 82,719 19,516

Dynamic India Fund IV ⁽⁴⁾⁽⁵⁾ (Private Equity Fund)	Equity Interests		6,050	6,050
EarthColor, Inc. (Business Services)	Subordinated Debt (15.0%, Due 11/13)	107,000	106,516	106,516
	Common Stock (53,540 shares) ⁽¹²⁾ Warrants ⁽¹²⁾		53,540	30,185
eCentury Capital Partners, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		6,274	2,123

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- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

June 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	(unaudited)		
		Principal	Cost	Value
Elexis Beta GmbH ⁽⁴⁾ (Industrial Products)	Options		\$ 426	\$ 50
Farley s & Sathers Candy Company, Inc. (Consumer Products)	Subordinated Debt (11.4%, Due 3/11)	\$ 8,000	7,975	7,975
Fidus Mezzanine Capital, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		3,244	3,244
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	290
Garden Ridge Corporation (Retail)	Subordinated Debt (7.0%, Due 5/12) ⁽⁶⁾	22,500	22,500	22,500
Geotrace Technologies, Inc. (Energy Services)	Subordinated Debt (10.0%, Due 6/09) Warrants	7,921	7,713 2,350	7,713 2,500
Grant Broadcasting Systems II (Broadcasting & Cable)	Subordinated Debt (5.0%, Due 6/11)	3,005	3,005	3,005
Grotech Partners, VI, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		8,723	6,745
Havco Wood Products LLC (Industrial Products)	Senior Debt (9.8%, Due 8/11) Unitranche Debt (11.5%, Due 8/11) Equity Interests	1,750 10,350	1,733 9,481 1,055	1,733 9,481 4,000
Haven Eldercare of New England, LLC (Healthcare Services)	Subordinated Debt (12.0%, Due 8/09)	2,227	2,227	2,227
HealthASPex Services Inc. (Business Services)	Senior Loan (4.0%, Due 7/08) ⁽⁶⁾	500	500	441
The Hillman Companies, Inc. ⁽³⁾	Subordinated Debt (10.0%, Due 9/11)	44,580	44,442	44,442

(Consumer Products)

The Homax Group, Inc. (Consumer Products)	Senior Loan (9.2%, Due 10/12)	12,400	12,400	12,400
	Subordinated Debt (12.0%, Due 4/14)	14,000	13,207	13,207
	Preferred Stock (89 shares)		89	78
	Common Stock (28 shares)		6	
	Warrants		1,106	972
Ideal Snacks Corporation (Consumer Products)	Senior Loan (10.0%, Due 6/10)	33	33	33
Integrity Interactive Corporation (Business Services)	Unitranche Debt (10.5%, Due 2/12)	13,759	13,646	13,646
International Fiber Corporation (Industrial Products)	Subordinated Debt (14.0%, Due 6/12)	24,324	24,219	24,219
	Preferred Stock (25,000 shares)		2,500	2,200
Jones Stephens Corporation (Consumer Products)	Senior Loan (8.9%, Due 9/12)	5,579	5,565	5,565

- (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.
- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

June 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	(unaudited)		
		Principal	Cost	Value
K2 Advisors Subsidiary Holdings, LLC (Business Services)	Senior Loan (8.6%, Due 4/13)	\$ 10,000	\$ 10,000	\$ 10,000
Kodiak Fund LP ⁽⁵⁾ (Private Equity Fund)	Equity Interests		9,423	8,243
Line-X, Inc. (Consumer Products)	Senior Loan (12.0%, Due 8/11) Unitranche Debt (12.0% Due 8/11) Standby Letter of Credit (\$1,500)	2,200 48,355	2,183 48,174	2,183 48,174
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares) Common Stock (50,000 shares)		2,049	3,769 200
Mid-Atlantic Venture Fund IV, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		6,975	3,019
Mogas Energy, LLC (Energy Services)	Subordinated Debt (9.5%, Due 8/08)	16,285	15,125	16,285
NetShape Technologies, Inc. (Industrial Products)	Senior Debt (8.6%, Due 2/13)	5,689	5,657	5,657
Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (10.5%, Due 12/11) Convertible Subordinated Debt (9.8%, Due 12/15)	21,086 13,242	21,204 13,306	21,204 14,121
Norwesco, Inc. (Industrial Products)	Subordinated Debt (12.6%, Due 1/12 7/12) Common Stock (559,603 shares) ⁽¹²⁾ Warrants ⁽¹²⁾	82,703	82,421 38,313	82,421 96,386
Novak Biddle Venture Partners III, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,910	2,007
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		239	900

Odyssey Investment Partners Fund III, LP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,542	1,371
Passport Health Communications, Inc. (Healthcare Services)	Subordinated Debt (14.0%, Due 4/12) Preferred Stock (651,381 shares) Common Stock (19,680 shares)	10,299	10,260 2,000 48	10,260 2,325 48
Pendum, Inc. (Business Services)	Subordinated Debt (17.0%, Due 1/11) ⁽⁶⁾ Preferred Stock (82,715 shares) Warrants	34,028	34,028	18,622
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	

- (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.
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- (5) Non-registered investment company.
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- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

June 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	(unaudited)		
		Principal	Cost	Value
Postle Aluminum Company, LLC (Industrial Products)	Unitranche Debt (11.0%, Due 10/12) Equity Interests	\$ 61,750	\$ 61,476 2,500	\$ 61,476 2,700
Pro Mach, Inc. (Industrial Products)	Subordinated Debt (13.0%, Due 6/12) Equity Interests	14,489	14,427 1,500	14,427 1,900
Promo Works, LLC (Business Services)	Unitranche Debt (10.3%, Due 12/11) Guaranty (\$900)	26,215	25,980	25,980
S.B. Restaurant Company (Retail)	Unitranche Debt (9.8%, Due 4/11) Preferred Stock (54,125 shares) Warrants Standby Letters of Credit (\$3,557)	26,501	26,226 135 619	26,226 135 2,100
SBBUT, LLC (Consumer Products)	Equity Interests			
Service Center Metals, LLC (Industrial Products)	Subordinated Debt (15.5%, Due 9/11) Equity Interests	5,000	4,979 313	4,979 331
SPP Mezzanine Funding, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,207	2,604
SPP Mezzanine Funding II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,990	1,690
Stag-Parkway, Inc. (Business Services)	Unitranche Debt (10.8%, Due 7/12)	51,000	50,793	50,793
STS Operating, Inc. (Industrial Products)	Subordinated Debt (11.0%, Due 1/13)	30,386	30,262	30,262
The Step2 Company, LLC (Consumer Products)	Unitranche Debt (10.5%, Due 4/12) Equity Interests	51,923	51,700 2,000	51,700 2,368
Tradesmen International, Inc.		9,136	8,648	8,648

	Subordinated Debt (12.0%, Due 12/09)			
(Business Services)				
TransAmerican Auto Parts, LLC	Subordinated Debt (14.0%, Due 11/12)	13,076	13,027	13,027
(Consumer Products)	Equity Interests		1,198	953
Trover Solutions, Inc.	Senior Loan (11.1%, Due 5/12 11/12)	81,000	80,710	80,710
(Business Services)				
Universal Air Filter Company	Senior Loan (10.3%, Due 11/12)	30,000	29,864	29,864
(Industrial Products)				
Udata Venture Partners II, L.P. ⁽⁵⁾	Limited Partnership Interest		4,627	4,955
(Private Equity Fund)				
Venturehouse-Cibernet Investors, LLC	Equity Interest			54
(Business Services)				
Venturehouse Group, LLC ⁽⁵⁾	Equity Interest			108
(Private Equity Fund)				

- (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.
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- (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.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

June 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
VICORP Restaurants, Inc. (Retail)	Warrants		\$ 33	\$
Walker Investment Fund II, LLLP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,330	375
WMA Equity Corporation and Affiliates d/b/a Wear Me Apparel (Consumer Products)	Subordinated Debt (13.6%, Due 4/13) Subordinated Debt (9.0%, Due 4/14) Common Stock (100 shares)	\$ 125,000 12,750	123,932 12,750 46,046	123,932 12,750 46,046
Webster Capital II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		75	75
Woodstream Corporation (Consumer Products)	Subordinated Debt (13.5%, Due 11/12 5/13) Common Stock (180 shares) Warrants	53,477	53,363 673	53,363 4,897 3,703
York Insurance Services Group, Inc. (Business Services)	Subordinated Debt (14.5%, Due 1/14) Common Stock (15,000 shares)	44,693	44,503 1,500	44,503 2,400
Other companies	Other debt investments ⁽⁶⁾ Other equity investments	223	94 8	89
Total companies less than 5% owned			\$ 2,197,112	\$ 2,219,839
Total private finance (143 portfolio companies)			\$ 4,419,354	\$ 4,348,256

(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.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Commercial Real Estate Finance
(in thousands, except number of loans)

			June 30, 2007	
	Interest Rate Ranges	Number of Loans	(unaudited)	
			Cost	Value
Commercial Mortgage Loans				
	Up to 6.99%	3	\$ 20,416	\$ 19,770
	7.00% 8.99%	9	26,118	26,118
	9.00% 10.99%	3	8,369	8,369
	11.00% 12.99%	1	10,450	10,450
	15.00% and above	2	3,970	3,970
Total commercial mortgage loans ⁽¹³⁾		18	\$ 69,323	\$ 68,677
Real Estate Owned			\$ 15,659	\$ 20,412
Equity Interests⁽²⁾ Companies more than 25% owned			\$ 15,823	\$ 33,715
Guarantees (\$6,871)				
Standby Letter of Credit (\$1,295)				
Total commercial real estate finance			\$ 100,805	\$ 122,804
Total portfolio			\$ 4,520,159	\$ 4,471,060

	Yield	Cost	Value
Liquidity Portfolio⁽¹⁴⁾			
American Beacon Money Market Select FD Fund	5.2%	\$ 86,376	\$ 86,376
Certificate of Deposit (Due September 2007)	5.5%	60,049	60,049
American Beacon Money Market Fund	5.2%	20,157	20,157
SEI Daily Income Tr Prime Obligation Fund	5.2%	34,150	34,150
Total liquidity portfolio		\$ 200,732	\$ 200,732
Other Investments in Money Market Securities⁽¹⁴⁾			
Columbia Treasury Reserves Money Market Fund	5.2%	\$ 103,675	\$ 103,675

(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.

(13) Commercial mortgage loans totaling \$19.1 million at value were on non-accrual status and therefore were considered non-income producing.

(14) Included in investments in money market and other securities on the accompanying Consolidated Balance Sheet.

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

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Information at and for the three and six months ended
June 30, 2007 and 2006 is unaudited)**

Note 1. Organization

Allied Capital Corporation, a Maryland corporation, is a closed-end, non-diversified 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 real estate investment trust subsidiary, Allied Capital REIT, Inc. (Allied REIT), and several subsidiaries that are single member limited liability companies established for specific purposes, including holding real estate properties. ACC also has a subsidiary, A.C. Corporation (AC Corp), that generally provides diligence and structuring services, as well as transaction, management, consulting, and other services, including underwriting and arranging senior loans, to the Company and its portfolio companies.

ACC and its subsidiaries, collectively, are referred to as the Company. The Company consolidates the results of its subsidiaries for financial reporting purposes.

Pursuant to Article 6 of Regulation S-X, the financial results of the Company s portfolio investments are not consolidated in the Company s financial statements. Portfolio investments are held for purposes of deriving investment income and future capital gains.

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company has primarily invested in debt and equity securities of private companies in a variety of industries.

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 2006 balances to conform with the 2007 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2007, the results of operations for the three and six months ended June 30, 2007 and 2006, and changes in net assets and cash flows for the six months ended June 30, 2007 and 2006. The results of operations for the three and six months ended June 30, 2007, are not necessarily indicative of the operating results to be expected for the full year.

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:

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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 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, including investments in money market and other securities, 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 that may be considered related party transactions.

Valuation of Portfolio Investments

The Company, as a BDC, has invested in illiquid securities including debt and equity securities of companies and CDO and CLO bonds and preferred shares/income notes. The Company's investments may be subject to certain 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/or 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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

determination of fair value at a different amount. The value of loan and debt securities may be greater than the Company's cost basis if the amount that would be repaid on the loan or debt security upon the sale or recapitalization of the portfolio company is greater than the Company's cost basis.

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

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

Equity Securities

The Company's equity securities 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, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. The determined equity values are generally discounted when the company has a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

The value of the Company's equity investments in private debt and equity funds are generally valued at the fund's net asset value. The value of the Company's equity securities 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 on preferred equity securities is recorded as dividend income on an accrual basis to the extent that such amounts are expected to be collected and to the extent that the Company has the option to receive the dividend in cash. Dividend income on common equity securities is recorded on the record date for private companies or on the ex-dividend date for publicly traded companies.

Collateralized Debt Obligations (CDO) and Collateralized Loan Obligations (CLO)

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

The Company recognizes interest income on the preferred shares/income notes using the effective interest method, based on the anticipated yield and the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred share/income note from the date the estimated yield was changed. CDO and CLO bonds have stated interest rates.

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 period, net of recoveries. Net change in unrealized appreciation or depreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 2. Summary of Significant Accounting Policies, continued

proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

Fee Income

Fee income includes fees for loan prepayment premiums, guarantees, commitments, and services rendered by the Company to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Loan prepayment premiums are recognized at the time of prepayment. Guaranty and commitment fees are generally recognized as income over the related period of the guaranty or commitment, respectively. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management, consulting and other services fees are generally recognized as income as the services are rendered.

Guarantees

Guarantees meeting the characteristics described in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation) and issued or modified after December 31, 2002, are recognized at fair value at inception. Guarantees made on behalf of portfolio companies are considered in determining the fair value of the Company's investments. See Note 5.

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 using a method that approximates the effective interest method. Costs associated with the issuance of common stock are recorded as a reduction to the proceeds from the sale of common stock. Financing costs generally include underwriting, accounting and legal fees, and printing costs.

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company has a stock-based employee compensation plan. See Note 9. Effective January 1, 2006, the Company adopted the provisions of FASB Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement). The Statement was adopted using the modified prospective method of application, which required the Company to recognize compensation costs on a prospective basis beginning January 1, 2006. Accordingly, the Company did not restate prior year financial statements. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

operations beginning in 2006, using the fair value amounts determined for pro forma disclosure under the Statement. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized over the related service period in the consolidated statement of operations. The stock option expense for the three and six months ended June 30, 2007 and 2006, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
(\$ in millions, except per share amounts)				
Employee Stock Option Expense:				
Previously awarded, unvested options as of January 1, 2006	\$ 3.3	\$ 3.3	\$ 6.5	\$ 6.7
Options granted on or after January 1, 2006	6.2	1.3	6.7	1.5
Total employee stock option expense	\$ 9.5	\$ 4.6	\$ 13.2	\$ 8.2
Per basic share	\$ 0.06	\$ 0.03	\$ 0.09	\$ 0.06
Per diluted share	\$ 0.06	\$ 0.03	\$ 0.09	\$ 0.06

In addition to the employee stock option expense, for the three and six months ended June 30, 2007 and 2006, administrative expense included \$0.2 million of expense related to options granted to directors during each respective period. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

The stock option expense shown in the table above was based on the underlying value of the options granted by the Company. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following weighted average assumptions were used to calculate the fair value of options granted during the three and six months ended June 30, 2007 and 2006:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
Expected term (in years)	5.0	5.0	5.0	5.0
Risk-free interest rate	4.6%	5.0%	4.6%	4.8%
Expected volatility	26.5%	29.6%	26.5%	29.6%
Dividend yield	9.0%	9.0%	9.0%	9.0%
Weighted average fair value per option	\$ 2.98	\$ 3.65	\$ 2.98	\$ 3.54

The expected term of the options granted represents the period of time that such options are expected to be outstanding. To determine the expected term of the options, the Company used historical data to estimate option exercise time frames, including considering employee terminations. The risk free rate was based on the U.S. Treasury bond yield curve at the date of grant. Expected volatilities were determined based on the historical volatility of the Company's common stock over a historical time period consistent

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 2. Summary of Significant Accounting Policies, continued

with the expected term. The dividend yield was determined based on the Company's historical dividend yield over a historical time period consistent with the expected term.

To determine the stock options expense, the calculated fair value of the options granted is applied to the options granted, net of assumed future option forfeitures. The Company estimates that the employee-related stock option expense under the Statement that will be recorded in the Company's statement of operations will be approximately \$20.3 million, \$9.2 million, and \$2.6 million for the years ended December 31, 2007, 2008, and 2009, respectively, which includes approximately \$10.9 million, \$6.3 million, and \$2.6 million, respectively, related to options granted since adoption of the Statement (January 1, 2006). This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant. The aggregate total stock option expense remaining as of June 30, 2007, is expected to be recognized over an estimated weighted-average period of 1.3 years.

Federal and State Income Taxes and Excise Tax

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). ACC and any 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 income taxes exclusive of excise taxes for these entities.

If the Company does not distribute at least 98% of its annual taxable income in the year earned, the Company will generally be required to pay an excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions from such taxable income during the year earned. To the extent that the Company determines that its estimated current year annual taxable income will be in excess of estimated current year dividend distributions from such taxable income, the Company accrues excise taxes on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 2. Summary of Significant Accounting Policies, continued

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, if any.

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 \$4.5 billion at both June 30, 2007, and December 31, 2006. At June 30, 2007, and December 31, 2006, 89% and 92%, respectively, of the Company's total assets represented portfolio investments whose fair values had 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.

Recent Accounting Pronouncements

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

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of this statement to have a significant effect on the Company's consolidated financial position or its results of operations.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115*. This statement permits an entity to choose to measure many financial instruments and certain other items at fair value. This statement applies to all reporting entities, and contains financial statement presentation and disclosure requirements for assets and

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

liabilities reported at fair value as a consequence of the election. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of this statement to have a significant effect on the Company's consolidated financial position or its results of operations.

Note 3. Portfolio**Private Finance**

At June 30, 2007, and December 31, 2006, the private finance portfolio consisted of the following:

	2007			2006		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 451.9	\$ 409.8	8.3%	\$ 450.0	\$ 405.2	8.4%
Unitranche debt ⁽²⁾	686.4	681.4	11.4%	800.0	799.2	11.2%
Subordinated debt	1,996.1	1,892.2	12.5%	2,038.3	1,980.8	12.9%
Total loans and debt securities ⁽³⁾	3,134.4	2,983.4	11.7%	3,288.3	3,185.2	11.9%
Equity securities	1,285.0	1,364.9		1,209.1	1,192.7	
Total	\$ 4,419.4	\$ 4,348.3		\$ 4,497.4	\$ 4,377.9	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At June 30, 2007, and December 31, 2006, the cost and value of subordinated debt included the Class A equity interests in BLX and the guaranteed dividend yield on these equity interests, to the extent it was accrued, was included in interest income. During the fourth quarter of 2006, the Class A equity interests were placed on non-accrual status. The weighted average yield is computed as of the balance sheet date.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms.

(3) The total principal balance outstanding on loans and debt securities was \$3,157.0 million and \$3,322.3 million at June 30, 2007, and December 31, 2006, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$22.6 million and \$34.0 million at June 30, 2007, and December 31, 2006, 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 debt and equity investments are generally issued by private companies and are generally illiquid and may be subject to certain restrictions on resale.

The Company's private finance debt 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 the Company's rights and priority in

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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 June 30, 2007, and December 31, 2006, 90% and 86%, respectively, of the private finance loans and debt securities had a fixed rate of interest and 10% and 14%, respectively, had a floating rate of interest. Senior loans may carry a fixed rate of interest or a floating rate of interest, usually set as a spread over LIBOR, and generally require payments of both principal and interest throughout the life of the loan. Senior loans generally have contractual maturities of three to six years and interest is generally paid to the Company monthly or quarterly. Unitranche debt generally carries a fixed rate of interest and may require payments of both principal and interest throughout the life of the loan. Unitranche debt generally has contractual maturities of five to six years and interest is generally paid to the Company quarterly. Subordinated debt generally carries a fixed rate of interest generally with contractual maturities of five to ten years and generally has interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest is generally paid to the Company quarterly.

Equity securities consist primarily of securities issued by private companies and may be subject to certain restrictions on their resale and are generally illiquid. The Company may make equity investments for minority stakes in portfolio companies or may receive equity features, such as nominal cost warrants, in conjunction with its debt investments. The Company may also invest in the equity (preferred and/or voting or non-voting common) of a portfolio company where the Company's equity ownership may represent a significant portion of the equity, but may or may not represent a controlling interest. If the Company invests in non-voting equity in a buyout investment, the Company generally has the option to acquire a controlling stake in the voting securities of the portfolio company at fair market value. The Company may incur costs associated with making buyout investments that will be included in the cost basis of the Company's equity investment. These include costs such as legal, accounting and other professional fees associated with diligence, referral and investment banking fees, and other costs. Equity securities generally do not produce a current return, but are held with the potential for investment appreciation and ultimate gain on sale.

Mercury Air Centers, Inc. At June 30, 2007, the Company's investment in Mercury Air Centers, Inc. (Mercury) totaled \$85.3 million at cost and \$320.1 million at value, which included unrealized appreciation of \$234.8 million. At December 31, 2006, the Company's investment in Mercury totaled \$84.3 million at cost and \$244.2 million at value, which included unrealized appreciation of \$159.9 million.

Mercury owns and operates fixed base operations generally under long-term leases from local airport authorities, which consist of terminal and hangar complexes that service the needs of the general aviation community. Mercury is headquartered in Richmond

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Heights, OH. The Company completed the purchase of a majority ownership in Mercury in April 2004.

Total interest and related portfolio income earned from the Company's investment in Mercury for the three and six months ended June 30, 2007 and 2006, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
(\$ in millions)				
Interest income	\$ 2.1	\$ 2.4	\$ 4.1	\$ 5.3
Fees and other income	0.1	0.1	0.2	0.3
Total interest and related portfolio income	\$ 2.2	\$ 2.5	\$ 4.3	\$ 5.6

Interest income from Mercury for the three and six months ended June 30, 2007, included \$0.5 million and \$1.0 million, respectively, which was paid in kind. Interest income from Mercury for the three and six months ended June 30, 2006, included interest income of \$0.5 million and \$1.0 million, respectively, which was paid in kind. The interest paid in kind was paid to the Company through the issuance of additional debt.

Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on the Company's investment in Mercury of \$18.2 million and \$74.9 million for the three and six months ended June 30, 2007, respectively. Net change in unrealized appreciation or depreciation included a decrease in unrealized appreciation of \$0.4 million and a net increase in unrealized appreciation of \$4.3 million for the three and six months ended June 30, 2006, respectively.

In April 2007, the Company signed a definitive agreement to sell its majority equity interest in Mercury. Based on this definitive agreement, which was amended in June 2007 to increase the sales price, Mercury is expected to sell for an enterprise value of approximately \$451 million, subject to pre-and post-closing adjustments. In connection with the transaction, the Company expects to be repaid approximately \$51 million of subordinated debt outstanding to Mercury at closing. The transaction is expected to close in the third quarter of 2007 upon satisfying certain closing conditions, including regulatory approvals.

Business Loan Express, LLC. BLX originates, sells, and services primarily real estate secured loans, including real estate secured conventional small business loans, Small Business Administration's 7(a) loans and small investment real estate loans. BLX is headquartered in New York, NY.

The Company's investment in BLX totaled \$324.6 million at cost and \$220.8 million at value, which included unrealized depreciation of \$103.8 million, at June 30, 2007, and \$295.3 million at cost and \$210.7 million at value, which included unrealized depreciation of \$84.6 million, at December 31, 2006. In the first six months of 2007, the Company increased its investment in BLX by \$29.2 million by acquiring additional Class A equity interests. In addition, in the first quarter of 2007, the chief executive officer of BLX

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

invested \$3.0 million in the form of Class A equity interests in BLX. The Company agreed to purchase these interests for cash at fair value in the event that BLX amends or otherwise restructures its existing senior credit facility or he is terminated for any reason. The purpose of these additional investments was to fund payments to the SBA in the first quarter of 2007 discussed below and to provide additional equity capital to BLX.

Total interest and related portfolio income earned from the Company's investment in BLX for the three and six months ended June 30, 2007 and 2006, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
(\$ in millions)				
Interest income on subordinated debt and Class A equity interests	\$	\$ 4.0	\$	\$ 7.8
Fees and other income	1.3	2.0	2.8	4.3
Total interest and related portfolio income	\$ 1.3	\$ 6.0	\$ 2.8	\$ 12.1

Interest and dividend income from BLX for the three and six months ended June 30, 2006, included interest income of \$1.9 million and \$3.7 million, respectively, which was paid in kind. The interest paid in kind was paid to the Company through the issuance of additional equity interests. In the fourth quarter of 2006, the Company placed its investment in BLX's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from the Company's investment in BLX for the three or six months ended June 30, 2007, and this resulted in lower interest income from the Company's investment in BLX for the first six months of 2007 as compared to the first six months of 2006.

In consideration for providing a guaranty on BLX's revolving credit facility and standby letters of credit (discussed below), the Company earned fees of \$1.3 million and \$2.8 million for the three and six months ended June 30, 2007, respectively, and \$1.6 million and \$3.1 million for the three and six months ended June 30, 2006, respectively, which were included in fees and other income. Other assets included a receivable from BLX for \$2.8 million related to these fees at June 30, 2007. The remaining fees and other income relate to management fees from BLX. The Company did not charge a management fee to BLX in the first or second quarter of 2007.

Net change in unrealized appreciation or depreciation included a net increase in unrealized depreciation on the Company's investment in BLX of \$19.1 million for both the three and six months ended June 30, 2007. Net change in unrealized appreciation or depreciation for the three and six months ended June 30, 2006, included a net decrease in unrealized appreciation of \$10.9 million and \$33.6 million, respectively, on the Company's investment in BLX.

BLX is a national, non-bank lender that participates in the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company

Table of Contents**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 3. Portfolio, continued**

(SBLC). The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting an ongoing investigation of allegedly fraudulently obtained SBA-guaranteed loans issued by BLX. Specifically, on or about January 9, 2007, BLX became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleges that a former BLX employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. The Company understands that BLX is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. The OIG and the U.S. Department of Justice are also conducting a civil investigation of BLX's lending practices in various jurisdictions. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of BLX's lending practices under the Business and Industry Loan (B&I) program. These investigations are ongoing.

As an SBA lender, BLX is also subject to other SBA and OIG audits, investigations, and reviews. These investigations, audits and reviews, 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 the Company's financial results. The Company has considered BLX's current regulatory issues and ongoing investigations and litigation in performing the valuation of BLX at June 30, 2007. The Company is monitoring the situation.

On March 6, 2007, BLX entered into an agreement with the SBA. According to the agreement, BLX remains a preferred lender in the SBA 7(a) Guaranteed Loan Program and retains the ability to sell loans into the secondary market. As part of this agreement, BLX agreed to the immediate payment of approximately \$10 million to the SBA to cover amounts paid by the SBA with respect to some of the SBA-guaranteed loans that have been the subject of inquiry by the United States Attorney's Office for the Eastern District of Michigan. As part of the SBA's increased oversight, the agreement provides that any loans originated and closed by BLX during the term of the agreement will be reviewed by an independent third party selected by the SBA prior to the sale of such loans into the secondary market. The agreement also requires BLX to repurchase the guaranteed portion of certain loans that default after having been sold into the secondary market, and subjects such loans to a similar third party review prior to any reimbursement of BLX by the SBA. In connection with this agreement, BLX also entered into an escrow agreement with the SBA and an escrow agent in which BLX agreed to deposit \$10 million with the escrow agent for any additional payments BLX may be obligated to pay to the SBA in the future. BLX remains subject to SBA rules and regulations and as a result may be required to make additional payments to the SBA in the ordinary course of business. The agreement states that nothing in the agreement shall affect the rights of BLX to securitize or service its loans. Notwithstanding the foregoing, BLX and the SBA are conducting ongoing discussions with respect to BLX's ability to securitize the unguaranteed portions of SBA loans in accordance with the requirements of the SBA regulations.

BLX has a separate non-recourse warehouse facility to enable it to securitize the unguaranteed portion of its SBA loans. BLX has been receiving temporary extensions of

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

the warehouse facility, and the current extension expires on August 30, 2007. BLX is in negotiations with the warehouse facility providers to renew and amend the facility for an additional one-year term, subject to satisfactory conclusion of discussions with the SBA with respect to BLX's ability to securitize the unguaranteed portions of SBA loans. If the current facility were to expire without renewal, the warehouse facility notes would become due and payable, and substantially all collections on the unguaranteed interests that currently are in the warehouse facility would be applied to repay the outstanding amounts owing to the warehouse providers until the warehouse providers were paid in full, similar to an amortizing term loan. In this event, the warehouse providers would not have recourse to BLX for repayment of the warehouse facility notes. In addition, BLX would not have the right to sell additional unguaranteed interests in SBA loans into this facility. In the event that BLX is unable to reach agreement with the SBA on BLX's ability to securitize the unguaranteed portions of SBA loans or if the warehouse providers do not agree to an extension of the warehouse facility, BLX will be required to seek alternative sources of capital to finance SBA loan originations and could incur higher capital costs.

At June 30, 2007, BLX had a three-year \$500.0 million revolving credit facility provided by third-party lenders that matures in March 2009. The revolving credit facility may be expanded to \$600.0 million through new or additional commitments at BLX's option. This facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. The Company has provided an unconditional guaranty to these 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 this facility. At June 30, 2007, the principal amount outstanding on the revolving credit facility was \$357.7 million and letters of credit issued under the facility were \$52.9 million. The total obligation guaranteed by us at June 30, 2007, was \$205.8 million. At June 30, 2007, the Company had also provided four standby letters of credit totaling \$20.0 million in connection with four term securitization transactions completed by BLX.

The guaranty on the BLX revolving line of credit facility can be called by the lenders in the event of a default, which includes certain defaults under the Company's revolving credit facility. Among other requirements, the BLX facility requires that BLX maintain compliance with certain financial covenants such as interest coverage, maximum debt to net worth, asset coverage, and maintenance of certain asset quality metrics. In addition, BLX would have an event of default if BLX failed to maintain its lending status with the SBA and such failure could reasonably be expected to result in a material adverse effect on BLX, or if BLX failed to maintain certain financing programs for the sale or long-term funding of BLX's loans. In June 2007, BLX received waivers until September 30, 2007, from its lenders with respect to (i) non-compliance with certain facility covenants and (ii) the requirement for BLX to maintain certain financing programs for SBA loans. The waivers regarding financing programs for SBA loans provide that BLX may retain unguaranteed portions of SBA loans on its balance sheet until September 30, 2007. In addition, BLX previously received waivers from its lenders with respect to certain other covenants to permit BLX to comply with its obligations under its agreement with the SBA. BLX's agreement with the SBA has reduced BLX's liquidity due to the working capital required to comply with the agreement. BLX is in negotiations with its lenders to amend

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

the credit facility covenants, but there can be no assurance that such negotiations will be successful. If the credit facility lenders do not agree to amend the covenants or to waive compliance with the covenants at subsequent quarter ends, BLX would be in default under the credit facility.

The current market conditions for small business loans remain very competitive, and as a result, BLX continues to experience high loan prepayments in its securitized loan portfolio. This competitive environment combined with BLX's liquidity constraints has restrained BLX's ability to grow its loan origination volume. Due to the changes in BLX's operations, the status of its current financing facilities and the effect of BLX's current regulatory issues, ongoing investigations and litigation, the Company is in the process of working with BLX with respect to various potential strategic alternatives including, but not limited to, recapitalization, restructuring, joint venture or sale or divestiture of BLX or some or all of its assets. The ultimate resolution of these matters could have a material adverse impact on BLX's financial condition, and, as a result, our financial results could be negatively affected.

On or about January 16, 2007, BLX and Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC), that is pending in the United States District Court for the Northern District of Georgia. The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans made by BLX and BLC. On April 9, 2007, BLX, BLC and the other defendants filed motions to dismiss the complaint in its entirety. The motions are pending.

At December 31, 2006, the Company held all of BLX's Class A and Class B equity interests, and 94.9% of the Class C equity interests. At June 30, 2007, the Company held 97.0% of the Class A equity interests, all of the Class B equity interests and 94.9% of the Class C equity interests. BLX has an equity appreciation rights plan for management that may dilute the value available to the Class C equity interest holders. 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. BLX's taxable income is first allocated to the Class A equity interests to the extent that guaranteed dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and C equity interests.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

will be included in the Company's taxable income, net of the corporate level taxes paid by the Company on the built-in gains. At the date of BLX's reorganization, the Company estimated that its future tax liability resulting from the built-in gains may total up to a maximum of \$40 million. 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 or its interests in BLX are disposed of in the future, it may be necessary to record a liability for these taxes, if any, in the future should the Company intend to sell the assets of or its interests in BLX within the 10-year period. At June 30, 2007, and December 31, 2006, the Company considered the impact on the fair value of its investment in BLX due to BLX's tax attributes as an LLC and has also considered the impact on the fair value of its investment due to estimated built-in gain taxes, if any, in determining the fair value of its investment in BLX.

Advantage Sales and Marketing, Inc. In June 2004, the Company completed the purchase of a majority voting ownership in Advantage, which was subject to dilution by a management option pool. Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company was repaid its \$184 million in subordinated debt outstanding and realized a gain at closing on its equity investment sold of \$433.1 million, subject to post-closing adjustments. Subsequent to closing on this sale, the Company realized additional gains in 2006 resulting from post-closing adjustments totaling \$1.3 million. The Company's realized gain was \$434.4 million for the year ended December 31, 2006, subject to post-closing adjustments and excluding any earn-out amounts. In addition, the Company is entitled to receive additional consideration through an earn-out payment based on Advantage's 2006 audited results. The earn-out payment totaled \$3.1 million, subject to potential post-determination adjustments, and was recorded as a realized gain in the second quarter of 2007.

As consideration for the common stock sold in the transaction, the Company received a \$150 million subordinated note, with the balance of the consideration paid in cash. In addition, a portion of the Company's cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. At June 30, 2007, the amount of the escrow included in other assets in the accompanying consolidated balance sheet was approximately \$24 million.

Total interest and related portfolio income earned from the Company's investment in Advantage while the Company held a majority equity interest for the six months ended June 30, 2006, was \$14.1 million. Net change in unrealized appreciation or depreciation for the six months ended June 30, 2006, included the reversal of \$389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of the Company's majority equity interest in Advantage in the first quarter of 2006.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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

The Company's investment in Advantage, which was composed of subordinated debt and a minority equity interest, totaled \$153.2 million at cost and \$164.2 million at value at June 30, 2007, and \$151.6 million at cost and \$162.6 million at value at December 31, 2006. This investment was included in companies 5% to 25% owned in the consolidated financial statements as the Company continues to hold a seat on Advantage's board of directors.

Collateralized Loan Obligations (CLOs) and Collateralized Debt Obligations (CDOs). At June 30, 2007, and December 31, 2006, the Company owned bonds and preferred shares/income notes in CLOs and a CDO as follows:

	2007			2006		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in millions)						
<i>Bonds⁽²⁾:</i>						
Callidus Debt Partners CDO Fund I, Ltd.	\$ 28.4	\$ 28.5	14.3%	\$ 28.4	\$ 28.4	14.3%
Callidus MAPS CLO Fund I LLC	17.0	17.1	10.9%	17.0	17.2	10.9%
Total bonds	45.4	45.6	13.0%	45.4	45.6	13.0%
<i>Preferred Shares/ Income Notes⁽³⁾:</i>						
Callidus Debt Partners CLO Fund III, Ltd.	22.2	23.0	15.1%	23.3	23.0	12.7%
Callidus Debt Partners CLO Fund IV, Ltd.	12.5	12.1	13.0%	13.0	13.0	13.8%
Callidus Debt Partners CLO Fund V, Ltd.	14.1	14.1	15.8%	13.8	13.8	15.8%
Callidus MAPS CLO Fund I LLC	50.5	44.7	11.6%	51.0	47.4	15.9%
Callidus MAPS CLO Fund II, Ltd.	17.4	17.4	14.8%			
Total preferred shares/ income notes	116.7	111.3	13.5%	101.1	97.2	14.8%
Total	\$ 162.1	\$ 156.9		\$ 146.5	\$ 142.8	

(1) The yield on these securities is included in interest and dividend income in the accompanying statement of operations.

(2) These securities are included in private finance subordinated debt.

(3) These securities are included in private finance equity securities.

The initial yields on the CLO and CDO preferred shares and income notes are based on the estimated future cash flows from the underlying collateral assets expected to be paid to these CLO and CDO classes. As each CLO and CDO preferred share or income note ages, the estimated future cash flows are updated based on the estimated performance of the underlying collateral assets, and the respective yield is adjusted as necessary. As future cash flows are subject to uncertainties and contingencies that are difficult to predict and are subject to future events that may alter

current assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The bonds, preferred shares and income notes of the CLOs and CDO in which the Company has invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes will bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes.

At June 30, 2007, and December 31, 2006, the face value of the CLO and CDO bonds held by the Company were subordinate to approximately 82% to 84% and 82% to 85%, respectively, of the face value of the securities issued in these CLOs and CDO. At both June 30, 2007, and December 31, 2006, the face value of the CLO preferred shares/income notes held by the Company were subordinate to approximately 86% to 92% of the face value of the securities issued in these CLOs.

At June 30, 2007, and December 31, 2006, the underlying collateral assets of these CLO and CDO investments, consisting primarily of senior debt, were issued by 495 issuers and 465 issuers, respectively, and had balances as follows:

(\$ in millions)	2007	2006
Bonds	\$ 268.0	\$ 245.4
Syndicated loans	2,136.4	1,769.9
Cash ⁽¹⁾	33.3	59.5
 Total underlying collateral assets	 \$ 2,437.7	 \$ 2,074.8

⁽¹⁾ Includes undrawn liability amounts.

At June 30, 2007, there were no delinquencies in the underlying collateral assets of the CLO and CDO issuances owned by the Company. At December 31, 2006, there was one defaulted obligor in the underlying collateral assets of Callidus MAPS CLO Fund I LLC. There were no other delinquencies in the underlying collateral assets in the other CLO and CDO issuances owned by the Company. At December 31, 2006, the total face value of defaulted obligations was \$9.6 million, or approximately 0.5% of the total underlying collateral assets.

Allied Capital Senior Debt Fund, L.P. The Company is a special limited partner in the Allied Capital Senior Debt Fund, L.P. (the Fund), a fund that generally invests in senior, unitranche and second lien debt. The Company has committed \$31.8 million to the Fund, which is a portfolio company, of which \$19.1 million has been funded. At June 30, 2007, the Company's investment in the Fund totaled \$19.1 million at cost and \$19.3 million at value. The Fund has closed on \$125 million in equity capital commitments. As a special limited partner, the Company expects to earn an incentive allocation of 20% of the annual net income of the Fund, subject to certain performance benchmarks. The value of the Company's investment in the Fund is based on the net asset

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

value of the Fund, which reflects the capital invested plus its allocation of the net earnings of the Fund, including the incentive allocation.

AC Corp is the investment manager to the Fund. Callidus Capital Corporation, a portfolio investment controlled by the Company, acts as special manager to the Fund. An affiliate of the Company is the general partner of the Fund, and AC Corp serves as collateral manager to a warehouse financing vehicle associated with the Fund. AC Corp will earn a management fee of up to 2% of the net asset value of the Fund and will pay Callidus 25% of that management fee to compensate Callidus for its role as special manager.

In connection with the Fund's formation in June 2007, the Company sold an initial portfolio of approximately \$183 million of seasoned assets with a weighted average yield of 10.3% to a warehouse financing vehicle associated with the Fund. The Company may sell additional loans to the Fund or the warehouse financing vehicle.

Loans and Debt Securities on Non-Accrual Status. At June 30, 2007, and December 31, 2006, private finance loans and debt securities at value not accruing interest were as follows:

	2007	2006
(\$ in millions)		
Loans and debt securities in workout status		
Companies more than 25% owned	\$ 20.4	\$ 51.1
Companies 5% to 25% owned	27.5	4.0
Companies less than 5% owned	22.7	31.6
Loans and debt securities not in workout status		
Companies more than 25% owned	171.0	87.1
Companies 5% to 25% owned	18.3	7.2
Companies less than 5% owned	19.1	38.9
Total	\$ 279.0	\$ 219.9

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Industry and Geographic Compositions. The industry and geographic compositions of the private finance portfolio at value at June 30, 2007, and December 31, 2006, were as follows:

	2007	2006
Industry		
Business services	39%	39%
Consumer products	23	20
Financial services	12	9
Industrial products	10	9
Retail	4	6
CDO/CLO funds ⁽¹⁾	4	3
Consumer services	3	6
Healthcare services	1	3
Energy services	1	2
Other	3	3
Total	100%	100%
Geographic Region⁽²⁾		
Mid-Atlantic	36%	31%
Midwest	30	30
Southeast	17	18
West	15	17
Northeast	2	4
Total	100%	100%

⁽¹⁾ These funds invest in senior debt representing a variety of industries and are managed by Callidus Capital, a portfolio company of Allied Capital.

⁽²⁾ 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 in other geographic regions.

Commercial Real Estate Finance

At June 30, 2007, and December 31, 2006, the commercial real estate finance portfolio consisted of the following:

	2007			2006		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in millions)						
Commercial mortgage loans	\$ 69.3	\$ 68.7	6.6%	\$ 72.6	\$ 71.9	7.5%
Real estate owned	15.7	20.4		15.7	19.6	
Equity interests	15.8	33.7		15.2	26.7	

Total	\$ 100.8	\$ 122.8	\$ 103.5	\$ 118.2
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(1) The weighted average yield on the commercial mortgage loans is computed as the (a) annual stated interest on accruing loans plus the annual amortization of loan origination fees, original issue discount, and market discount on

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

accruing loans 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.

Commercial Mortgage 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 June 30, 2007, and December 31, 2006, approximately 90% and 96%, respectively, of the Company's commercial mortgage loan portfolio was composed of fixed rate loans and approximately 10% and 4%, respectively, was composed of adjustable rate loans. At June 30, 2007, and December 31, 2006, loans with a value of \$19.1 million and \$18.9 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 certain 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 June 30, 2007, and December 31, 2006, were as follows:

	2007	2006
Property Type		
Hospitality	47%	45%
Office	21	20
Retail	17	19
Recreation	13	1
Housing		13
Other	2	2
Total	100%	100%
Geographic Region		
Mid-Atlantic	36%	35%
Southeast	34	36
Midwest	23	21
Northeast	7	8
West		
Total	100%	100%

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt

At June 30, 2007, and December 31, 2006, the Company had the following debt:

	2007			2006		
	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾
(\$ in millions)						
Notes payable and debentures:						
Privately issued unsecured notes payable	\$1,041.8	\$1,041.8	6.1%	\$1,041.4	\$1,041.4	6.1%
Publicly issued unsecured notes payable	880.0	880.0	6.7%	650.0	650.0	6.6%
Total notes payable and debentures	1,921.8	1,921.8	6.4%	1,691.4	1,691.4	6.3%
Revolving line of credit ⁽⁴⁾	922.5		7%	922.5	207.7	6.4% ⁽²⁾
Total debt	\$2,844.3	\$1,921.8	6.6% ⁽³⁾	\$2,613.9	\$1,899.1	6.5% ⁽³⁾

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

(2) There were no amounts drawn on the revolving line of credit at June 30, 2007. The annual interest cost at December 31, 2006, reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$3.8 million and \$3.9 million at June 30, 2007, and December 31, 2006, respectively.

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

(4) At June 30, 2007, \$886.0 million remained unused and available on the revolving line of credit, net of amounts committed for standby letters of credit of \$36.5 million issued under the credit facility.

Notes Payable and Debentures

Privately Issued Unsecured Notes Payable. The Company has privately issued unsecured long-term notes to institutional investors. The notes have five- or seven-year maturities and have fixed rates of interest. The notes require payment of interest only semi-annually, and all principal is due upon maturity. At June 30, 2007, the notes had maturities from May 2008 to May 2013. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreements.

The Company also has privately 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 other unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. Simultaneous with issuing the 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.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

Publicly Issued Unsecured Notes Payable. At June 30, 2007, the Company had outstanding publicly issued unsecured notes as follows:

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

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

On March 28, 2007, the Company completed the issuance of \$200.0 million of 6.875% Notes due 2047 for net proceeds of \$193.0 million. In April 2007, the Company issued additional notes, through an over-allotment option, totaling \$30.0 million for net proceeds of \$29.1 million. Net proceeds are net of underwriting discounts and estimated offering expenses.

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

Scheduled Maturities. Scheduled future maturities of notes payable at June 30, 2007, were as follows:

Year	Amount Maturing
	(\$ in millions)
2007	\$
2008	153.0
2009	269.3
2010	408.0
2011	472.5
Thereafter	619.0
Total	\$ 1,921.8

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued***Revolving Line of Credit***

At June 30, 2007, and December 31, 2006, the Company had an unsecured revolving line of credit with a committed amount of \$922.5 million that expires on September 30, 2008. At the Company's option, borrowings under the revolving line of credit generally bear interest at a rate equal to (i) LIBOR (for the period the Company selects) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America, N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

The annual cost of commitment fees, other facility fees and amortization of debt financing costs was \$3.8 million and \$3.9 million at June 30, 2007, and December 31, 2006, respectively.

The revolving credit facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 16.66% of the committed facility or \$153.7 million. The letter of credit fee is 1.05% per annum on letters of credit issued, which is payable quarterly.

The average debt outstanding on the revolving line of credit was \$93.5 million and \$201.7 million, respectively, for the six months ended June 30, 2007 and 2006. The maximum amount borrowed under this facility and the weighted average stated interest rate for the six months ended June 30, 2007 and 2006, were \$225.5 million and 6.4%, respectively, and \$540.3 million and 6.0%, respectively. At June 30, 2007, the amount available under the revolving line of credit was \$886.0 million, net of amounts committed for standby letters of credit of \$36.5 million issued under the credit facility.

Covenant Compliance

The Company has various financial and operating covenants required by the privately issued unsecured notes payable and the revolving line of credit outstanding at June 30, 2007, and December 31, 2006. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of the Company's assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of June 30, 2007, and December 31, 2006, the Company was in compliance with these covenants.

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

Company Act of 1940, as amended, while these notes are outstanding. As of June 30, 2007, and December 31, 2006, the Company was in compliance with these covenants.

Note 5. Guarantees and 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 June 30, 2007, and December 31, 2006, the Company had issued guarantees of debt, rental obligations, and lease obligations aggregating \$220.9 million and \$202.1 million, respectively, and had extended standby letters of credit aggregating \$36.5 million and \$41.0 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 \$257.4 million and \$243.1 million at June 30, 2007, and December 31, 2006, respectively.

As of June 30, 2007, the guarantees and standby letters of credit expired as follows:

	Total	2007	2008	2009	2010	2011	After 2011
(in millions)							
Guarantees	\$ 220.9	\$ 3.3	\$ 3.0	\$ 208.3	\$	\$ 4.4	\$ 1.9
Standby letters of credit ⁽¹⁾	36.5	3.9	32.6				
Total⁽²⁾	\$ 257.4	\$ 7.2	\$ 35.6	\$ 208.3	\$	\$ 4.4	\$ 1.9

(1) Standby letters of credit are issued under the Company's revolving line of credit that expires in September 2008. 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 September 2008.

(2) The Company's most significant commitments relate to its investment in Business Loan Express, LLC (BLX), which commitments totaled \$228.8 million at June 30, 2007. At June 30, 2007, the Company guaranteed 50% of the outstanding total obligations on BLX's revolving line of credit, which expires in March 2009, for a total guaranteed amount of \$205.8 million and had also provided four standby letters of credit totaling \$20.0 million in connection with four term securitizations completed by BLX. In addition, the Company has agreed to purchase the \$3.0 million of Class A equity interests purchased by the chief executive officer of BLX at fair value in the event that BLX amends or otherwise restructures its existing senior credit facility or he is terminated for any reason. See Note 3.

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 or guaranty certain minimum fees to such parties under certain circumstances.

At June 30, 2007, the Company had outstanding commitments to fund investments totaling \$450.2 million, including \$406.4 million related to private finance investments and \$43.8 related to commercial real estate finance investments.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6. Shareholders' Equity

Sales of common stock for the six months ended June 30, 2007 and 2006, were as follows:

	2007	2006
(in millions)		
Number of common shares	3,325	3,000
Gross proceeds	\$ 97,256	\$ 87,750
Less costs, including underwriting fees	(3,472)	(4,780)
Net proceeds	\$ 93,784	\$ 82,970

The Company issued 0.5 million and 0.4 million shares of common stock upon the exercise of stock options during the six months ended June 30, 2007 and 2006, respectively. In addition, in July 2007, the Company issued 1.7 million unregistered shares of common stock upon the cancellation of stock options pursuant to a tender offer which expired on July 18, 2007. See Note 9.

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 six months ended June 30, 2007 and 2006, the Company issued new shares in order to satisfy dividend reinvestment requests. Dividend reinvestment plan activity for the six months ended June 30, 2007 and 2006, was as follows:

	For the Six Months Ended June 30,	
	2007	2006
(in millions, except per share amounts)		
Shares issued	0.3	0.2
Average price per share	\$ 30.23	\$ 29.63

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Earnings Per Common Share

Earnings per common share for the three and six months ended June 30, 2007 and 2006, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
(in millions, except per share amounts)				
Net increase in net assets resulting from operations	\$ 89.2	\$ 33.7	\$ 222.2	\$ 133.3
Weighted average common shares outstanding basic	152.4	140.0	150.9	139.4
Dilutive options outstanding	3.7	3.2	3.5	3.1
Weighted average common shares outstanding diluted	156.1	143.2	154.4	142.5
Basic earnings per common share	\$ 0.59	\$ 0.24	\$ 1.47	\$ 0.96
Diluted earnings per common share	\$ 0.57	\$ 0.24	\$ 1.44	\$ 0.94

Note 8. Employee Compensation Plans

The Company has deferred compensation plans. Amounts deferred by participants under the deferred compensation plans are funded to a trust, which is managed by a third-party trustee. 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 June 30, 2007, and December 31, 2006, totaled \$21.2 million and \$18.6 million, respectively.

The Company has an Individual Performance Award (IPA), which was established as a long-term incentive compensation program for certain officers. In conjunction with the program, the Board of Directors has approved non-qualified deferred compensation plans (DCP II), which are managed through a trust by a 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 is generally determined annually at the beginning of each year but may be adjusted throughout the year. The IPA 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 both the six months ended June 30, 2007 and 2006, 0.2 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 of the Company's general creditors. Amounts credited to participants under the DCP II are immediately vested and generally non-forfeitable once deposited by the Company into

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8. Employee Compensation Plans, continued

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 in accordance with the plan, 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. 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 in shares of the Company's common stock.

The IPA amounts are 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 held in the deferred compensation trust are not recognized. However, the liability is marked to market with a corresponding charge or credit to employee compensation expense. At June 30, 2007, and December 31, 2006, common stock held in DCP II was \$34.4 million and \$28.3 million, respectively, and the IPA liability was \$38.6 million and \$33.9 million, respectively. At June 30, 2007, and December 31, 2006, the DCP II held 1.2 million shares and 1.0 million shares, respectively, of the Company's common stock.

The IPA expense for the three and six months ended June 30, 2007 and 2006, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
(\$ in millions)				
IPA contributions	\$ 2.4	\$ 2.1	\$ 4.9	\$ 3.8
IPA mark to market expense (benefit)	2.4	(1.5)	(1.6)	(0.6)
Total IPA expense (benefit)	\$ 4.8	\$ 0.6	\$ 3.3	\$ 3.2

The Company also has an individual performance bonus (IPB), which is distributed in cash to award recipients equally throughout the year (beginning in February of each year) as long as the recipient remains employed by the Company. If a recipient terminates

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 8. Employee Compensation Plans, continued

employment during the year, any remaining cash payments under the IPB would be forfeited. For the three months ended June 30, 2007 and 2006, the IPB expense was \$2.6 million and \$2.2 million, respectively. For the six months ended June 30, 2007 and 2006, the IPB expense was \$4.6 million and \$3.6 million, respectively. The IPA and IPB expenses are included in employee expenses.

Note 9. Stock 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 the optionee, which may not exceed ten years from the date the option is granted. The options granted to officers generally vest ratably over up to a three year period. Options granted to non-officer directors vest on the grant date.

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, 2006, there were 32.2 million shares authorized under the Option Plan. On May 15, 2007, the Company's stockholders voted to increase the number of shares of common stock authorized for issuance to 37.2 million shares. At June 30, 2007, and December 31, 2006, the number of shares available to be granted under the Option Plan was 0.7 million and 1.6 million, respectively.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Stock Option Plan, continued

Information with respect to options granted, exercised and forfeited under the Option Plan for the six months ended June 30, 2007, was as follows:

	Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Remaining Term (Years)	Aggregate Intrinsic Value at June 30, 2007 ⁽¹⁾
(in millions, except per share amounts)				
Options outstanding at January 1, 2007	23.2	\$ 24.92		
Granted	6.4	\$ 29.58		
Exercised	(0.5)	\$ 25.02		
Forfeited	(0.5)	\$ 28.94		
Options outstanding at June 30, 2007	28.6	\$ 25.89	5.97	\$ 145.2
Exercisable at June 30, 2007 ⁽²⁾	22.0	\$ 24.95	5.61	\$ 132.5
Exercisable and expected to be exercisable at June 30, 2007 ⁽³⁾	28.1	\$ 25.83	5.94	\$ 144.2

⁽¹⁾ Represents the difference between the market value of the options at June 30, 2007, and the cost for the option holders to exercise the options.

⁽²⁾ Represents vested options.

⁽³⁾ The amount of options expected to be exercisable at June 30, 2007, is calculated based on an estimate of expected forfeitures without consideration of the Company's tender offer completed in July 2007 discussed below.

During the six months ended June 30, 2006, 1.5 million options were granted, 0.4 million options were exercised and 0.3 million options were forfeited.

The fair value of the shares vested during the six months ended June 30, 2007 and 2006, was \$21.4 million and \$16.1 million, respectively. The total intrinsic value of the options exercised during the six months ended June 30, 2007 and 2006, was \$2.4 million and \$2.9 million, respectively.

On July 18, 2007, the Company completed a tender offer related to the Company's offer to all optionees who held vested in-the-money stock options as of June 20, 2007, the opportunity to receive an option cancellation payment equal to the in-the-money value of the stock options cancelled, which would be paid one-half in cash and one-half in unregistered shares of the Company's common stock. The Company accepted for cancellation 10.3 million vested options, which in the aggregate had a weighted average exercise price of \$21.50. This resulted in a total option cancellation payment of approximately \$105.6 million, of which \$52.8 million was paid in cash and \$52.8 million was paid through the issuance of 1.7 million unregistered shares of the Company's common stock, determined using the Weighted Average Market Price of \$31.75. The Weighted Average Market Price represented the volume weighted average price of the Company's common stock over the fifteen trading days preceding the first day of the offer period, or June 20, 2007.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 9. Stock Option Plan, continued

As the consideration paid by the Company for the OCP did not exceed the cancellation date fair value of the options, no expense will be recorded for the transaction in accordance with the guidance in FASB Statement No. 123 (Revised 2004). However, the portion of the OCP paid in cash of \$52.8 million will reduce the Company's paid in capital and will therefore reduce the Company's net asset value in the third quarter of 2007. For income tax purposes, the Company's tax deduction resulting from the OCP will be similar to the tax deduction that would have resulted from an exercise of stock options in the market. Any tax deduction for the Company resulting from the OCP or an exercise of stock options in the market is limited by Section 162(m) of the Code for persons subject to Section 162(m).

Subsequent to the completion of the tender offer and the cancellation of the 10.3 million vested options, there were 11.0 million shares available to be granted under the Option Plan and 18.3 million options outstanding, with a weighted average exercise price of \$28.36 per share and a weighted average contractual remaining term of 7.01 years.

Note 10. Dividends and Distributions and Taxes

The Company's Board of Directors declared and the Company paid a dividend of \$0.63 and \$0.64 per common share for the first and second quarters of 2007, respectively, and \$0.59 and \$0.60 per common share for the first and second quarters of 2006, respectively. These dividends totaled \$193.4 million and \$166.6 million for the six months ended June 30, 2007 and 2006, respectively. The Company declared an extra cash dividend of \$0.05 per share during 2006 and this was paid to shareholders on January 19, 2007. The Company declared an extra cash dividend of \$0.03 per share during 2005, which was paid to shareholders on January 27, 2006.

The Company's Board of Directors also declared a dividend of \$0.65 per common share for each of the third and fourth quarters of 2007.

At December 31, 2006, the Company had estimated excess taxable income of \$397.1 million available for distribution to shareholders in 2007. Estimated excess taxable income for 2006 represents approximately \$120.6 million of ordinary income and approximately \$276.5 million of net long-term capital gains. The excess taxable income for 2006 is an estimate and will not be finally determined until the Company files its 2006 tax return in September 2007.

Dividends paid in 2007 will first be paid out of the excess taxable income carried over from 2006. For the first and second quarters of 2007, the Company paid dividends of \$193.4 million. The remainder of 2006 estimated excess taxable income to be distributed during the second half of 2007 is approximately \$203.7 million. In accordance with regulated investment company distribution rules, the Company must declare current year dividends to be paid from carried over excess taxable income from 2006 before the Company files its 2006 tax return in September 2007, and the Company must pay such dividends by December 31, 2007. To comply with these rules, on July 27, 2007, the Company's Board of Directors declared a \$0.65 per share dividend for both the third and fourth quarters of 2007. The third and fourth quarter dividends will be paid on

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 10. Dividends and Distributions and Taxes, continued

September 26, 2007, and December 26, 2007, respectively. The Company expects that substantially all of the 2007 dividend payments will be made from excess 2006 taxable earnings.

Given that substantially all of 2007's dividend payments will be made from excess taxable income carried over from 2006, the Company currently expects to carry over substantially all of its estimated annual taxable income for 2007 for distribution to shareholders in 2008. The Company will generally be required to pay a nondeductible excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions from such taxable income during the year. The Company accrues an excise tax on the estimated excess taxable income earned for the respective periods. For the three and six months ended June 30, 2007, the Company recorded an excise tax of \$4.0 million and \$7.6 million, respectively. For the three and six months ended June 30, 2006, the Company recorded an excise tax of \$3.2 million and \$11.6 million, respectively.

In addition to excess taxable income carried forward, the Company currently estimates that it has cumulative deferred taxable income related to installment sale gains of approximately \$220.7 million as of December 31, 2006, which is composed of cumulative deferred taxable income of \$39.6 million as of December 31, 2005, and approximately \$181.1 million for the year ended December 31, 2006. These gains have been recognized for financial reporting purposes in the respective years they were realized, but are generally deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. The realized gains deferred through installment treatment for 2006 are estimates and will not be finally determined until the Company files its 2006 tax return in September 2007.

The Company's undistributed book earnings of \$502.2 million as of December 31, 2006, resulted from undistributed ordinary income and long-term capital gains. The difference between undistributed book earnings at the end of the year and taxable income carried over from that year into the next year relates to a variety of timing and permanent differences in the recognition of income and expenses for book and tax purposes.

The Company's consolidated subsidiary, AC Corp, is subject to federal and state income taxes. For the three months ended June 30, 2007 and 2006, income tax expense was \$1.5 million and \$0.3 million, respectively, and for the six months ended June 30, 2007 and 2006, income tax benefit was \$2.7 million and income tax expense was \$0.8 million, respectively.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 11. Supplemental Disclosure of Cash Flow Information

The Company paid interest of \$61.9 million and \$46.0 million, respectively, for the six months ended June 30, 2007 and 2006.

For the six months ended June 30, 2007 and 2006, principal collections related to investment repayments or sales included the collection of discounts previously amortized into interest income and added to the cost basis of a loan or debt security totaling \$0.9 million and \$0.2 million, respectively.

Non-cash operating activities for the six months ended June 30, 2007 and 2006, totaled \$29.0 million and \$262.2 million, respectively. Non-cash operating activities for the six months ended June 30, 2006, included a note received as consideration from the sale of the Company's equity investment in Advantage of \$150.0 million and a note received as consideration from the sale of the Company's equity investment in STS Operating, Inc. of \$30.0 million.

Non-cash financing activities included the issuance of common stock in lieu of cash distributions totaling \$8.3 million and \$7.2 million, for the six months ended June 30, 2007 and 2006, respectively.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12. Financial Highlights

	At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2007 ⁽¹⁾	2006	2006
Per Common Share Data			
Net asset value, beginning of period	\$ 19.12	\$ 19.17	\$ 19.17
Net investment income ⁽²⁾	0.42	0.64	1.30
Net realized gains ⁽²⁾⁽³⁾	0.66	3.74	3.66
Net investment income plus net realized gains ⁽²⁾	1.08	4.38	4.96
Net change in unrealized appreciation or depreciation ⁽²⁾⁽³⁾	0.36	(3.44)	(3.28)
Net increase in net assets resulting from operations ⁽²⁾	1.44	0.94	1.68
Net decrease in net assets from shareholder distributions	(1.27)	(1.19)	(2.47)
Net increase in net assets from capital share transactions ⁽²⁾	0.30	0.25	0.74
Net asset value, end of period	\$ 19.59	\$ 19.17	\$ 19.12
Market value, end of period	\$ 30.96	\$ 28.77	\$ 32.68
Total return ⁽⁴⁾	(1.2)%	1.9%	20.6%
Ratios and Supplemental Data			
(\$ and shares in thousands, except per share amounts)			
Ending net assets	\$ 2,991.1	\$ 2,690.0	\$ 2,841.2
Common shares outstanding at end of period	152.7	140.3	148.6
Diluted weighted average common shares outstanding	154.4	142.5	145.6
Employee, employee stock option and administrative expenses/average net assets ⁽⁵⁾	3.11%	2.66%	5.38%
Total operating expenses/average net assets ⁽⁵⁾	5.31%	4.39%	9.05%
Net investment income/average net assets ⁽⁵⁾	2.20%	3.41%	6.90%
Net increase in net assets resulting from operations/average net assets ⁽⁵⁾	7.57%	4.97%	8.94%
Portfolio turnover rate ⁽⁵⁾	14.68%	21.20%	27.05%
Average debt outstanding	\$ 1,904.4	\$ 1,395.8	\$ 1,491.0
Average debt per share ⁽²⁾	\$ 12.33	\$ 9.80	\$ 10.24

(1) The results for the six months ended June 30, 2007, are not necessarily indicative of the operating results to be expected for the full year.

(2) Based on diluted weighted average number of common shares outstanding for the period.

- (3) Net realized gains and net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.
- (4) Total return assumes the reinvestment of all dividends paid for the periods presented.
- (5) The ratios for the six months ended June 30, 2007 and 2006, do not represent annualized results.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 13. Litigation

On June 23, 2004, the Company was notified by the SEC that the SEC was conducting an informal investigation of the Company. The investigation related to the valuation of securities in the Company's private finance portfolio and other matters. On June 20, 2007, the Company announced that it has entered into a settlement with the SEC that resolves the SEC's informal investigation. As part of the settlement and without admitting or denying the SEC's allegations, the Company agreed to the entry of an administrative order. In the order the SEC alleged that, between June 30, 2001, and March 31, 2003, the Company did not maintain books, records and accounts which, in reasonable detail, supported or accurately and fairly reflected valuations of certain securities in the Company's private finance portfolio and, as a result, did not meet certain recordkeeping and internal controls provisions of the federal securities laws. In the administrative order, the SEC ordered the Company to continue to maintain certain of its current valuation-related controls. Specifically, for a period of two years, the Company has undertaken to: (1) continue to employ a Chief Valuation Officer, or a similarly structured officer-level employee, to oversee its quarterly valuation processes; and (2) continue to employ third-party valuation consultants to assist in its quarterly valuation processes.

On December 22, 2004, the Company received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding the Company and Business Loan Express, LLC in connection with a criminal investigation relating to matters similar to those investigated by the SEC. The Company produced materials in response to the requests from the U.S. Attorney's office and certain current and former employees were interviewed by the U.S. Attorney's Office. The Company has voluntarily cooperated with the investigation.

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

On February 13, 2007, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned Rena Nadoff v. Walton, et al., CA 001060-07, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. The complaint was summarily dismissed in July 2007. The complaint alleged breach of fiduciary duty by the Board of Directors arising from internal control failures and mismanagement of Business Loan Express, LLC, an Allied Capital portfolio company.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Note 13. Litigation, continued

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Thereafter, the court appointed new lead counsel and approved new lead plaintiffs. On July 30, 2007, plaintiffs served an amended complaint. Plaintiffs claim that, between November 7, 2005, and January 22, 2007, Allied Capital either failed to disclose or misrepresented information about its portfolio company, Business Loan Express, LLC. Plaintiffs seek unspecified compensatory and other damages, as well as other relief. The Company believes the lawsuit is without merit, and intends to defend the lawsuit vigorously.

In addition, the Company is party to certain lawsuits in the normal course of business.

While the outcome of any of the open legal proceedings described above cannot at this time be predicted with certainty, the Company does not expect these matters will materially affect its financial condition or results of operations.

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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		December 31, 2006 Value	Gross Additions ⁽³⁾	Gross Reductions ⁽⁴⁾	June 30, 2007 Value
		Credited to Income ⁽⁶⁾	Other ⁽²⁾				
Companies More Than 25% Owned							
Alaris Consulting, LLC (Business Services)	Senior Loan ⁽⁵⁾			\$	\$ 572	\$ (572)	\$
	Equity Interests				1,025	(1,025)	
AllBridge Financial, LLC (Financial Services)	Equity Interests				800		800
Allied Capital Senior Debt Fund, L.P. (Private Debt Fund)	Equity Interests				19,252		19,252
Avborne, Inc. (Business Services)	Preferred Stock			918	54	(45)	927
	Common Stock						
Avborne Heavy Maintenance, Inc. (Business Services)	Preferred Stock						
	Common Stock						
Border Foods, Inc. (Consumer Products)	Preferred Stock						
	Common Stock						
	Class A Equity						

Business Loan Express, LLC (Financial Services)	Interests ⁽⁵⁾		66,622	29,200		95,822
	Class B Equity Interests		79,139		(9,116)	70,023
	Class C Equity Interests		64,976		(10,028)	54,948
Calder Capital Partners, LLC (Financial Services)	Senior Loan ⁽⁵⁾	\$ 49	975	1,026	(49)	1,952
	Equity Interests		2,076	78	(1,616)	538
Callidus Capital Corporation (Financial Services)	Senior Loan	\$ 40		2,100	(1,400)	700
	Subordinated Debt	554	5,762	530		6,292
	Common Stock		22,550	25,791		48,341
Coverall North America, Inc. (Business Services)	Unitranche Debt	2,156	36,333	18	(1,446)	34,905
	Subordinated Debt	456	5,972	4		5,976
	Common Stock		19,619	2,891		22,510
CR Holding, Inc. (Consumer Products)	Subordinated Debt	3,361	39,401	698		40,099
	Common Stock		25,738	12,784		38,522
Direct Capital Corporation (Financial Services)	Subordinated Debt	1,936		36,058		36,058
	Common Stock			19,250	(2,084)	17,166
Financial Pacific Company (Financial Services)	Subordinated Debt	6,300	71,362	740		72,102
	Preferred Stock		15,942	1,634		17,576
	Common Stock		65,186	5,287		70,473
ForeSite Towers, LLC (Tower Leasing)	Equity Interests	1,269	12,290	356	(11,733)	913
Global Communications, LLC	Senior Loan ⁽⁵⁾		15,957			15,957

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(Business Services)	Subordinated Debt ⁽⁵⁾		11,237		(8,016)	3,221
	Preferred Equity					
	Interest					
	Options					
Gordian Group, Inc. (Business Services)	Senior Loan ⁽⁵⁾	(9)		172	(172)	
	Common Stock					
Healthy Pet Corp. (Consumer Services)	Senior Loan	1,309	27,038	6,350	(33,388)	
	Subordinated Debt	2,893	43,579	580	(44,159)	
	Common Stock		28,921	14,897	(43,818)	
HMT, Inc. (Energy Services)	Preferred Stock		2,637		(2,637)	
	Common Stock		8,664	21,509	(30,173)	
	Warrants		3,336	8,281	(11,617)	
Hot Stuff Foods, LLC ⁽⁷⁾ (Consumer Products)	Senior Loan	1,969		49,670	(220)	49,450
	Subordinated Debt	3,647		61,294	(13,139)	48,155
	Subordinated Debt ⁽⁵⁾			8,461	(8,461)	
	Common Stock					
Huddle House, Inc. (Retail)	Senior Loan	426	19,950		(19,950)	
	Subordinated Debt	4,447	58,196	668	(178)	58,686
	Common Stock		41,662	1,545	(137)	43,070
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate		873	1	(554)	320

See related footnotes at the end of this schedule.

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PRIVATE FINANCE		Amount of Interest or Dividends		December 31, 2006		June 30, 2007	
Portfolio Company	(in thousands)						
Insight Pharmaceuticals Corporation	Subordinated Debt	\$ 2,914		\$ 43,884	\$ 685	\$	\$ 44,569
(Consumer Products)	Subordinated Debt ⁽⁵⁾			15,966	2,111	(1,620)	16,457
	Preferred Stock			7,845	209	(7,845)	209
	Common Stock						
Jakel, Inc.	Subordinated Debt ⁽⁵⁾			6,655	500	(7,155)	
(Industrial Products)	Preferred Stock						
	Common Stock						
Legacy Partners Group, Inc.	Senior Loan ⁽⁵⁾			4,843		(1,000)	3,843
(Financial Services)	Equity Interests				613	(45)	568
Litterer Beteiligungs-GmbH	Subordinated Debt	21		692	14		706
(Business Services)	Equity Interest			1,199	1,707		2,906
Mercury Air Centers, Inc.	Subordinated Debt	4,063		49,217	1,035		50,252
(Business Services)	Common Stock			195,019	74,867		269,886
MVL Group, Inc.	Senior Loan	2,120		27,245	3,378		30,623
(Business Services)	Subordinated Debt	2,581		35,478	3,886		39,364
	Common Stock				2,013		2,013
Old Orchard Brands, LLC	Senior Loan	347			23,500	(23,500)	

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(Consumer Products)	Subordinated Debt	601		19,206		19,206
	Common Equity			18,767		18,767
Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt	3,005	37,994	589		38,583
	Equity Interests		25,949	3,567	(1,984)	27,532
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan ⁽⁵⁾		26,192	3,950	(17,394)	12,748
	Subordinated Debt ⁽⁵⁾		962	18,261	(19,223)	
	Preferred Stock Warrants					
Service Champ, Inc. (Business Services)	Subordinated Debt	2,193	27,619	363		27,982
	Common Stock		16,786	4,706	(298)	21,194
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt ⁽⁵⁾		486	63		549
Startec Global Communications Corporation (Telecommunications)	Senior Loan	689	15,965		(4,790)	11,175
	Common Stock		11,232	5,877		17,109
Sweet Traditions, Inc. (Retail)	Senior Loan ⁽⁵⁾	1,088	35,172	580		35,752
	Preferred Stock		400	550		950
	Common Stock		50			50
Triview Investments, Inc. (Broadcasting & Cable/ Business Services/ Consumer Products)	Senior Loan	723	14,747	11		14,758
	Subordinated Debt	3,274	56,008	19,108		75,116
	Subordinated Debt ⁽⁵⁾	1,288	4,342	745		5,087
	Common Stock	37	31,322	16,924	(1,184)	47,062
		\$55,697	\$1,490,180			\$1,709,770

**Total companies more than 25%
owned**

**Companies 5% to 25%
Owned**

Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt Equity Interests	\$ 9,260	\$ 151,648	\$ 1,583	\$	\$ 153,231
			11,000			11,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan Subordinated Debt Equity Interests	125 1,931	1,763 35,128	4,239 55	(4,273) (35,183)	1,729
			5,950	3,250		9,200
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock Common Stock		602	94		696
				100		100
Amerex Group, LLC (Consumer Products)	Subordinated Debt Equity Interests	507	8,400			8,400
			13,823	8,002	(38)	21,787
BB&T Capital Partners/Windsor Mezzanine Fund, LLC (Private Equity Fund)	Equity Interests		5,554	54		5,608
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt Common Stock	1,792	24,163	314		24,477
			3,700		(100)	3,600
BI Incorporated (Business Services)	Subordinated Debt Common Stock	2,076	30,135	239		30,374
			4,100	2,700		6,800
CitiPostal, Inc. and Affiliates (Business Services)	Senior Loan Equity Interests	1,141	20,569	720	(776)	20,513
			4,700	2,253	(53)	6,900

See related footnotes at the end of this schedule.

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PRIVATE FINANCE Portfolio Company (in thousands)	Investment ⁽¹⁾	Amount of Interest or Dividends		December 31, 2006 Value	Gross Additions ⁽³⁾	Gross Reductions ⁽⁴⁾	June 30, 2007 Value
		Credited to Income ⁽⁶⁾	Other ⁽²⁾				
Creative Group, Inc. (Business Services)	Subordinated Debt	\$ 480		\$ 13,656	\$ 30	\$ (2,488)	\$ 11,198
	Warrants			1,387		(1,387)	
Drew Foam Companies, Inc. (Business Services)	Preferred Stock ⁽⁵⁾			722		(294)	428
	Common Stock			7		(7)	
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan ⁽⁵⁾			7,164			7,164
	Subordinated Debt ⁽⁵⁾			1,813	316		2,129
	Convertible Subordinated Debt ⁽⁵⁾						
	Equity Interests				110	(110)	
MHF Logistical Solutions, Inc ⁽⁸⁾ (Business Services)	Subordinated Debt ⁽⁵⁾				27,518	(10,241)	17,277
	Subordinated Debt ⁽⁵⁾						
	Common Stock Warrants						
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt	1,139		19,879	13	(100)	19,792
	Equity Interests			2,000		(1,060)	940
Nexcel Synthetics, LLC	Subordinated Debt	610		10,978	199	(11,177)	
				1,486	269	(1,755)	

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(Consumer Products)	Equity Interests					
PresAir LLC (Industrial Products)	Senior Loan ⁽⁵⁾ Equity Interests	\$ 81	2,206		(124)	2,082
				5	(5)	
Progressive International Corporation	Subordinated Debt	615	7,533	80		7,613
(Consumer Products)	Preferred Stock		1,024	44		1,068
	Common Stock		2,300	2,000		4,300
	Warrants					
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan Unitranche Debt	72	1,232	1		1,233
	Equity Interests	1,103	19,908	41	(8,000)	11,949
			1,616	104		1,720
SGT India Private Limited (Business Services)	Common Stock		3,346	149	(419)	3,076
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt	1,169	17,569	1,092	(5,000)	13,661
	Equity Interests		2,541	51		2,592
Universal Environmental Services, LLC (Business Services)	Unitranche Debt ⁽⁵⁾ Equity Interests	717	10,211		(4,201)	6,010
				15	(15)	
Total companies 5% to 25% owned		\$22,737	\$449,813			\$418,647

This schedule should be read in conjunction with the Company's consolidated financial statements, 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.

(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 June 30, 2007.

- (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, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company into this category from a different category. 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, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company out of this category into a different category. 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 June 30, 2007, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the period may or may not have been on non-accrual status for the full period.
- (6) 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.
- (7) In the first quarter of 2007, the Company exercised its option to acquire a majority of the voting securities of Hot Stuff Foods, LLC (Hot Stuff) at fair market value. Therefore, Hot Stuff was reclassified to companies more than 25% owned in the first quarter of 2007. At December 31, 2006, the Company's investment in Hot Stuff was included in the companies less than 5% owned category.
- (8) In the second quarter of 2007, the Company obtained a seat on the board of directors of MHF Logistical Solutions, Inc. (MHF). Therefore, MHF was reclassified to companies 5% to 25% owned in the second quarter of 2007. At December 31, 2006, the Company's investment in MHF was included in the companies less than 5% owned category.

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4,000,000 Shares
Common Stock

Prospectus Supplement
January 29, 2008

Morgan Stanley