

ALLIED CAPITAL CORP
Form 10-Q
July 31, 2003

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

QUARTERLY REPORT PURSUANT TO

**SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934**

**For The Quarterly Period
Ended June 30, 2003**

**Commission File Number:
0-22832**

ALLIED CAPITAL CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Maryland
*(State or Jurisdiction of
Incorporation or Organization)*

52-1081052
*(IRS Employer
Identification No.)*

1919 Pennsylvania Avenue, N.W.

Washington, DC 20006
(Address of Principal Executive Offices)

Registrant's telephone number, including area code: (202) 331-1112

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods as the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
YES NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act) YES NO

On July 30, 2003, there were 116,495,473 shares outstanding of the Registrant's common stock, \$0.0001 par value.

ALLIED CAPITAL CORPORATION

FORM 10-Q INDEX

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	June 30, 2003	December 31, 2002
	(unaudited)	
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2003-\$694,891; 2002-\$628,535)	\$ 803,794	\$ 710,587
Companies 5% to 25% owned (cost: 2003-\$202,942; 2002-\$219,124)	222,143	255,677
Companies less than 5% owned (cost: 2003-\$946,750; 2002-\$863,243)	813,307	776,951
Total private finance	1,839,244	1,743,215
Commercial real estate finance (cost: 2003-\$702,887; 2002-\$718,312)	706,896	744,952
Total portfolio at value	2,546,140	2,488,167
Other assets	118,698	100,221
Deposits of proceeds from sales of borrowed Treasury securities	157,262	194,745
Cash and cash equivalents	7,484	11,186
Total assets	\$2,829,584	\$2,794,319
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures	\$ 954,200	\$ 794,200
Revolving line of credit	25,500	204,250
Obligations to replenish borrowed Treasury securities	156,986	197,027
Accounts payable and other liabilities	34,755	45,771
Total liabilities	1,171,441	1,241,248
Commitments and contingencies		
Preferred stock	7,000	7,000
Shareholders equity:		
Common stock, \$0.0001 par value, 200,000,000 shares authorized; 116,034,030 and 108,698,409 shares issued and outstanding at June 30, 2003, and December 31, 2002, respectively	12	11
Additional paid-in capital	1,698,307	1,547,183
Notes receivable from sale of common stock	(22,985)	(24,704)
Net unrealized appreciation (depreciation) on portfolio	(24,923)	39,411
Undistributed (distributions in excess of) earnings	732	(15,830)

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Total shareholders' equity	<u>1,651,143</u>	<u>1,546,071</u>
Total liabilities and shareholders' equity	<u>\$2,829,584</u>	<u>\$2,794,319</u>
Net asset value per common share	<u>\$ 14.23</u>	<u>\$ 14.22</u>

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2003	2002	2003	2002
(in thousands, except per share amounts)				
	(unaudited)		(unaudited)	
Interest and Related Portfolio Income:				
Interest and dividends				
Companies more than 25% owned	\$ 12,728	\$ 9,374	\$ 27,931	\$ 18,847
Companies 5% to 25% owned	6,480	7,581	12,973	15,021
Companies less than 5% owned	47,929	45,737	91,754	93,797
	<u>67,137</u>	<u>62,692</u>	<u>132,658</u>	<u>127,665</u>
Premiums from loan dispositions				
Companies more than 25% owned			108	
Companies 5% to 25% owned	140		625	
Companies less than 5% owned	1,497	46	2,025	1,659
	<u>1,637</u>	<u>46</u>	<u>2,758</u>	<u>1,659</u>
Fees and other income				
Companies more than 25% owned	4,304	6,954	10,013	13,929
Companies 5% to 25% owned	177	415	230	415
Companies less than 5% owned	3,959	3,086	4,685	11,916
	<u>8,440</u>	<u>10,455</u>	<u>14,928</u>	<u>26,260</u>
Total interest and related portfolio income	<u>77,214</u>	<u>73,193</u>	<u>150,344</u>	<u>155,584</u>
Expenses:				
Interest	19,358	17,515	37,280	34,984
Employee	9,258	8,274	17,379	16,309
Administrative	5,081	4,843	9,498	7,861
	<u>33,697</u>	<u>30,632</u>	<u>64,157</u>	<u>59,154</u>
Net investment income before income taxes	43,517	42,561	86,187	96,430
Income tax benefit	(1,081)		(1,081)	
Net investment income	<u>44,598</u>	<u>42,561</u>	<u>87,268</u>	<u>96,430</u>
Net Realized and Unrealized Gains (Losses):				
Net realized gains (losses)				
Companies more than 25% owned	1,314	(630)	1,314	(630)
Companies 5% to 25% owned			16,688	718
Companies less than 5% owned	7,226	(125)	38,877	8,762
	<u>8,540</u>	<u>(755)</u>	<u>56,879</u>	<u>8,850</u>
Net change in unrealized appreciation or depreciation	6,802	31,648	(64,334)	24,135

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Total net gains (losses)	<u>15,342</u>	<u>30,893</u>	<u>(7,455)</u>	<u>32,985</u>
Net increase in net assets resulting from operations	\$ 59,940	\$ 73,454	\$ 79,813	\$ 129,415
Basic earnings per common share	\$ 0.53	\$ 0.72	\$ 0.71	\$ 1.28
Diluted earnings per common share	\$ 0.52	\$ 0.71	\$ 0.71	\$ 1.26
Weighted average common shares outstanding basic	<u>113,539</u>	<u>101,660</u>	<u>111,510</u>	<u>100,822</u>
Weighted average common shares outstanding diluted	<u>114,552</u>	<u>103,440</u>	<u>112,291</u>	<u>102,900</u>

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

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

(in thousands, except per share amounts)	For the Six Months Ended June 30,	
	2003	2002
	(unaudited)	
Operations:		
Net investment income	\$ 87,268	\$ 96,430
Net realized gains	56,879	8,850
Net change in unrealized appreciation or depreciation	(64,334)	24,135
	79,813	129,415
Shareholder distributions:		
Common stock dividends	(127,474)	(109,482)
Preferred stock dividends	(110)	(110)
	(127,584)	(109,592)
Capital share transactions:		
Sale of common stock	145,126	49,920
Issuance of common stock upon the exercise of stock options	2,657	11,626
Issuance of common stock in lieu of cash distributions	3,327	3,123
Net decrease (increase) in notes receivable from sale of common stock	1,719	(2,162)
Other	14	
	152,843	62,507
Net increase in net assets resulting from capital share transactions		
	105,072	82,330
Net assets at beginning of period	1,546,071	1,352,123
	\$ 1,651,143	\$ 1,434,453
Net assets at end of period		
Net asset value per common share	\$ 14.23	\$ 14.02
	116,034	102,296
Common shares outstanding at end of period		

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Six Months Ended June 30,	
	2003	2002
	(unaudited)	
(in thousands)		
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$ 79,813	\$ 129,415
Adjustments		
Portfolio investments	(526,399)	(195,455)
Repayments of investment principal	150,277	67,017
Proceeds from investment sales	276,708	126,280
Change in accrued or reinvested interest and dividends	(20,405)	(19,463)
Amortization of loan discounts and fees	(7,233)	(6,478)
Changes in other assets and liabilities	(23,172)	(21,788)
Depreciation and amortization	826	657
Gain on cashless exercise of warrants	(3,876)	
Realized losses	4,347	6,579
Net change in unrealized appreciation or depreciation	64,334	(24,135)
Net cash provided by (used in) operating activities	(4,780)	62,629
Cash flows from financing activities:		
Sale of common stock	145,126	49,920
Sale of common stock upon the exercise of stock options	2,657	9,245
Collections of notes receivable from sale of common stock	1,719	220
Common dividends and distributions paid	(127,329)	(106,359)
Preferred stock dividends paid	(110)	(110)
Borrowings under notes payable and debentures	300,000	
Repayments on notes payable and debentures	(140,000)	(6,856)
Net repayments on revolving line of credit	(178,750)	(5,000)
Other financing activities	(2,235)	(259)
Net cash provided by (used in) financing activities	1,078	(59,199)
Net increase (decrease) in cash and cash equivalents	(3,702)	3,430
Cash and cash equivalents at beginning of period	11,186	889
Cash and cash equivalents at end of period	\$ 7,484	\$ 4,319

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽²⁾	June 30, 2003	
		Cost	(unaudited) Value
Companies More Than 25% Owned			
Acme Paging, L.P. (Telecommunications)	Loan Equity Interests Common Stock (940 shares)	\$ 4,265 13,274 27	\$ 4,265 6,525
Alaris Consulting, LLC (Business Services)	Loan Equity Interests Guaranty (\$1,100)	18,635 5,165	17,300
American Healthcare Services, Inc. (Healthcare)	Loan Debt Securities Common Stock (7,956,704 shares) Guaranty (\$1,590)	24,851 17,311 1,000	24,851 11,388
Avborne, Inc. (Business Services)	Loan Preferred Stock (12,500 shares) Common Stock (27,500 shares) Standby Letter of Credit (\$7,006)	2,770 14,138	2,770 2,300
Business Loan Express, LLC (Financial Services)	Loans Debt Securities Class A Equity Interests Class B Equity Interests Class C Equity Interests Guaranty (\$53,591 See Note 3) Standby Letters of Credit (\$25,550 See Note 3)	20,000 39,267 45,044 52,111 108,241	20,000 39,267 45,044 95,986 156,461
The Color Factory, Inc. (Consumer Products)	Loan Preferred Stock (1,000 shares) Common Stock (980,000 shares)	13,389 1,002 6,535	9,854
Foresite Towers, LLC (Tower Leasing)	Equity Interests	15,522	14,170
Gordian Group, Inc. (Business Services)	Loan Common Stock (1,000 shares)	8,935 2,385	8,935 3,500
HealthASPex, Inc. (Business Services)	Preferred Stock (1,000,000 shares) Preferred Stock (1,451,380 shares) Common Stock (1,451,380 shares)	700 4,900 4	700 2,601
The Hillman Companies, Inc. ⁽¹⁾ (Consumer Products)	Debt Securities Common Stock (6,890,937 shares)	42,953 50,645	42,953 138,863

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HMT, Inc.	Debt Securities	9,129	9,129
(Business Services)	Preferred Stock (554,052 shares)	2,303	2,303
	Common Stock (300,000 shares)	3,000	3,000
	Warrants	1,155	1,155

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

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽²⁾	(unaudited)	
		Cost	Value
Housecall Medical Resources, Inc. (Healthcare)	Loan Preferred Stock (3,890,344 shares) Common Stock (864,000 shares)	\$ 15,062 3,889 86	\$ 15,062 3,889 3,687
Jakel, Inc. (Industrial Products)	Loan Debt Securities Preferred Stock (6,460 shares) Common Stock (158,061 shares) Standby Letter of Credit (\$4,500)	500 7,500 6,460 9,347	500 7,500 3,467
Litterer Beteiligungs-GmbH ⁽³⁾ (Business Services)	Debt Securities Equity Interest	1,404 295	1,032
MVL Group, Inc. (Business Services)	Loan Debt Securities Common Stock (648,661 shares)	18,765 16,525 810	18,570 15,132
Powell Plant Farms, Inc. (Consumer Products)	Loan Debt Securities Preferred Stock (1,483 shares) Warrants	18,697 19,224	18,697 9,709
Redox Brands, Inc. (Consumer Products)	Loan Debt Securities Preferred Stock (2,404,086 shares) Warrants Guaranty (\$125)	3,031 10,039 6,965 584	3,031 10,039 6,965 584
Staffing Partners Holding Company, Inc. (Business Services)	Debt Securities Preferred Stock (414,600 shares) Common Stock (50,200 shares) Warrants	6,304 4,968 50 10	6,304 4,074
STS Operating, Inc. (Industrial Products)	Preferred Stock (5,769,424 shares) Common Stock (3,000,000 shares)	6,525 3,177	6,525 3,177
Sure-Tel, Inc. (Consumer Services)	Preferred Stock (1,000,000 shares) Common Stock (37,000 shares)	1,000 5,018	1,000 1,530
Total companies more than 25% owned		\$ 694,891	\$ 803,794
Companies 5% to 25% Owned			
Allied Office Products, Inc. (Business Services)	Common Stock (31,333 shares)	\$ 7,695	\$ 50
Aspen Pet Products, Inc. (Consumer Products)	Loans Preferred Stock (2,112 shares)	17,145 2,024	17,145 1,348

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Common Stock (1,400 shares)	140
Warrants	

Autania AG ^(1,3) (Industrial Products)	Common Stock (250,000 shares)	2,169	2,900
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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽²⁾	(unaudited)	
		Cost	Value
Blue Rhino Corporation ⁽¹⁾ (Consumer Products)	Debt Securities Common Stock (1,070,179 shares)	\$ 5,094 5,076	\$ 5,094 12,842
Border Foods, Inc. (Consumer Products)	Debt Securities Preferred Stock (50,919 shares) Common Stock (1,810 shares) Warrants	9,421 2,000 45 665	9,421 2,000 45 665
CBA-Mezzanine Capital Finance, LLC (Financial Services)	Loan	8,337	8,337
CorrFlex Graphics, LLC (Business Services)	Debt Securities Warrants Options	12,318	12,318 19,332 1,669
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,875 shares)	1,250	1,250
EDM Consulting, LLC (Business Services)	Debt Securities Equity Interests	1,802 250	236
International Fiber Corporation (Industrial Products)	Debt Securities Common Stock (1,029,069 shares) Warrants	22,715 5,483 550	22,715 6,816 684
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities Common Stock (123,929 shares)	3,384 142	3,384
Logic Bay Corporation (Business Services)	Common Stock (1,437,420 shares)	5,000	
Magna Card, Inc. (Consumer Products)	Debt Securities Preferred Stock (1,875 shares) Common Stock (4,687 shares)	154 94	154 28
Master Plan, Inc. (Business Services)	Loan Common Stock (156 shares)	959 42	959
MortgageRamp, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	2,084
Nobel Learning Communities, Inc. ⁽¹⁾ (Education)	Debt Securities Preferred Stock (1,063,830 shares) Warrants	9,809 2,000 575	9,809 2,000 191
Packaging Advantage Corporation (Business Services)	Debt Securities Common Stock (232,168 shares) Warrants	14,290 2,386 963	14,290 2,386 963

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Professional Paint, Inc.	Debt Securities	23,507	23,507
(Consumer Products)	Preferred Stock (15,000 shares)	20,803	20,803
	Common Stock (110,000 shares)	69	5,995

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽²⁾	June 30, 2003	
		Cost	(unaudited) Value
Progressive International Corporation (Consumer Products)	Debt Securities Preferred Stock (500 shares) Common Stock (197 shares) Warrants	\$ 3,973 500 13	\$ 3,973 500 150
Sidarus Holdings, Inc. (Business Services)	Debt Securities Preferred Stock (98,000 shares) Common Stock (492,941 shares) Warrants	4,976 980 20	4,976 980 20
Total Foam, Inc. (Industrial Products)	Debt Securities Common Stock (164 shares)	254 10	124
Total companies 5% to 25% owned		\$202,942	\$222,143
Companies Less Than 5% Owned			
ACE Products, Inc. (Industrial Products)	Loan	\$ 17,164	\$ 50
Advantage Sales and Marketing, Inc. (Business Services)	Debt Securities Warrants	10,625 382	10,625 1,556
Alderwoods Group, Inc. ⁽¹⁾ (Consumer Services)	Common Stock (357,568 shares)	5,006	1,913
American Barbecue & Grill, Inc. (Retail)	Warrants	125	
ASW Holding Corporation (Industrial Products)	Warrants	25	
Aviation Technologies, Inc. (Industrial Products)	Loan	19,901	19,901
Bakery Chef, Inc. (Consumer Products)	Loans	18,838	18,838
Benchmark Medical, Inc. (Healthcare)	Debt Securities Warrants	13,414 18	13,414 18
Camden Partners Strategic Fund II, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	3,247	3,095
Candlewood Hotel Company ⁽¹⁾ (Hospitality)	Preferred Stock (3,250 shares)	3,250	635

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Clif Bar, Inc. (Consumer Products)	Loan	24,906	24,906
Colibri Holding Corporation (Consumer Products)	Debt Securities	3,495	3,495
	Preferred Stock (237 shares)	300	300
	Common Stock (3,362 shares)	1,250	1,088
	Warrants	290	252

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽²⁾	(unaudited)	
		Cost	Value
Component Hardware Group, Inc. (Industrial Products)	Debt Securities Preferred Stock (18,000 shares) Common Stock (2,000 shares)	\$11,544 2,312 200	\$11,544 2,312 700
Cooper Natural Resources, Inc. (Industrial Products)	Loan Debt Securities Preferred Stock (6,316 shares) Warrants	299 1,955 1,427 832	299 1,955 1,427 832
Coverall North America, Inc. (Business Services)	Loan Debt Securities	12,410 6,426	12,410 6,426
CTT Holdings (Consumer Products)	Loan	1,250	1,250
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan Debt Securities	10,918 1,500	
eCentury Capital Partners, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	3,125	735
Elexis Beta GmbH ⁽³⁾ (Industrial Products)	Options	426	289
Eparfin S.A. ⁽³⁾ (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities Warrants	8,852 1,157	
Executive Greetings, Inc. (Business Services)	Debt Securities Warrants	18,830 360	50
Fairchild Industrial Products Company (Industrial Products)	Debt Securities Warrants	5,954 280	5,426
Frozen Specialties, Inc. (Consumer Products)	Debt Securities Warrants	10,050 435	10,050 435
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities Options Standby Letter of Credit (\$37)	49,704	12,712
Garden Ridge Corporation (Retail)	Debt Securities Preferred Stock (1,130 shares) Common Stock (847,800 shares)	27,271 1,130 613	25,000

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Gibson Guitar Corporation (Consumer Products)	Debt Securities Warrants	18,354 525	18,354 2,325
Ginsey Industries, Inc. (Consumer Products)	Loans Convertible Debentures Warrants	5,000 500	5,000 500 2,250

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽²⁾	(unaudited)	
		Cost	Value
Global Communications, LLC (Business Services)	Loan	\$ 2,348	\$ 2,348
	Debt Securities	16,711	16,711
	Preferred Equity Interest	14,067	14,193
	Options	1,639	3,551
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	3,000
Grotech Partners, VI, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	3,520	2,591
The Hartz Mountain Corporation (Consumer Products)	Debt Securities	27,845	27,845
	Common Stock (200,000 shares)	2,000	1,821
	Warrants	2,613	2,379
Haven Eldercare of New England, LLC (Healthcare)	Loan	35,903	35,903
Headwaters Incorporated ⁽¹⁾ (Industrial Products)	Loan	9,958	9,958
Healthmarket, Inc. (Health Insurance)	Debt Securities	9,583	9,583
	Warrants	440	440
Hotelevision, Inc. (Broadcasting & Cable)	Common Stock (315,100 shares)	315	
Icon International, Inc. (Business Services)	Common Stock (25,707 shares)	1,219	1,740
Impact Innovations Group, LLC (Business Services)	Debt Securities	6,797	3,541
	Warrants	1,674	
Insight Pharmaceuticals Corporation (Consumer Products)	Loan	9,952	9,952
Intellirisk Management Corporation (Business Services)	Loan	23,757	23,757
Interline Brands, Inc. (Business Services)	Preferred Stock (199,313 shares)	1,849	1,849
	Common Stock (15,615 shares)	139	
	Warrants	1,181	
JRI Industries, Inc. (Industrial Products)	Debt Securities	1,548	1,548
	Warrants	74	39
Julius Koch USA, Inc. (Industrial Products)	Warrants	259	4,750

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Kirker Enterprises, Inc. (Industrial Products)	Equity Interest Warrants	4 348	4 3,501
Kyrus Corporation (Business Services)	Debt Securities Warrants	6,431 348	6,431 450

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽²⁾	(unaudited)	
		Cost	Value
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	\$ 359	\$ 359
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares) Warrants	500	938
MedAssets, Inc. (Business Services)	Debt Securities Preferred Stock (229,806 shares) Warrants	16,412 2,049 136	16,412 2,049 136
Mid-Atlantic Venture Fund IV, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	4,725	2,674
Midview Associates, L.P. (Housing)	Warrants		
Mogas Energy, LLC (Natural Gas Pipelines)	Debt Securities Warrants	18,226 1,774	18,226 1,774
Norstan Apparel Shops, Inc. (Retail)	Debt Securities Common Stock (29,622 shares) Warrants	11,850 4,750 655	11,850 4,750 655
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	235	235
Novak Biddle Venture Partners III, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	870	694
Nursefinders, Inc. (Business Services)	Debt Securities Warrants	11,262 900	11,262 900
Oahu Waste Services, Inc. (Business Services)	Debt Securities Stock Appreciation Rights	8,178 239	8,178 239
Onyx Television GmbH ⁽³⁾ (Broadcasting & Cable)	Preferred Units	201	
Opinion Research Corporation ⁽¹⁾ (Business Services)	Debt Securities Warrants	14,401 996	14,401 996
Oriental Trading Company, Inc. (Consumer Products)	Preferred Equity Interest Common Equity Interest	1,751	1,751 3,500
Pico Products, Inc. (Industrial Products)	Loan	1,406	1,406
Polaris Pool Systems, Inc.	Debt Securities	10,880	10,880

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(Consumer Products)	Warrants	1,145	1,145
Prosperco Finanz Holding AG ⁽³⁾ (Financial Services)	Convertible Debentures	7,738	5,000
	Common Stock (1,528 shares)	1,059	
	Warrants		

- (1) Public company.
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The accompanying notes are an integral part of these consolidated financial statements.

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽²⁾	(unaudited)	
		Cost	Value
Resun Leasing, Inc. (Business Services)	Loan	\$30,000	\$30,000
Scitor Corporation (Business Services)	Loan	22,511	22,511
Simula, Inc. ⁽¹⁾ (Industrial Products)	Loan	21,853	21,853
SmartMail, LLC (Business Services)	Loan Debt Securities Equity Interests Warrants	3,731 4,400 1,070 3	3,731 4,400 1,070 3
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities Preferred Stock (300 shares) Common Stock (2,000 shares)	9,599 300 200	9,599 300 200
Southwest PCS, LLC (Telecommunications)	Loan	500	500
Spa Lending Corporation (Recreation)	Preferred Stock (28,672 shares)	424	306
Startec Global Communications Corporation ⁽¹⁾ (Telecommunications)	Loan Debt Securities	25,715 20,670	25,715
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans Debt Securities	4,566 2,445	1,424
Sydran Food Services II, L.P. (Retail)	Debt Securities Equity Interests Warrants	12,973 3,747 162	6,646
Tubbs Snowshoe Company, LLC (Consumer Products)	Debt Securities Equity Interests Warrants	4,036 500 54	4,036 500 20
United Pet Group, Inc. (Consumer Products)	Debt Securities Warrants	9,125 85	9,125 350
United Site Services, Inc. (Business Services)	Loan	14,925	14,925
Udata Venture Partners II, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	1,705	2,036

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U.S. Security Holdings, Inc. (Business Services)	Debt Securities Warrants	24,164 826	24,164 1,200
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest	34	34

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽²⁾	(unaudited)	
		Cost	Value
Venturehouse Group, LLC ⁽⁴⁾ (Private Equity Fund)	Equity Interest	\$ 1,000	\$ 236
Vertex Aerospace, LLC (Business Services)	Debt Securities Equity Interest	5,290	5,290 400
VICORP Restaurants, Inc. (Retail)	Debt Securities Warrants	23,849 33	23,849 33
Walker Investment Fund II, LLLP ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	1,246	518
Warn Industries, Inc. (Consumer Products)	Debt Securities Warrants	4,439 1,429	4,439 5,352
Weston Solutions, Inc. (Business Services)	Loan	12,189	12,189
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities Warrants	16,691 735	16,691 855
Wilton Industries, Inc. (Consumer Products)	Loan	9,600	9,600
Woodstream Corporation (Consumer Products)	Debt Securities Common Stock (180 shares) Warrants	16,329 1,800 587	16,329 1,800 587
Total companies less than 5% owned		\$ 946,750	\$ 813,307
Total private finance (128 portfolio companies)		\$ 1,844,583	\$ 1,839,244

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(in Thousands)	Stated Interest	Face	June 30, 2003	
			Cost	(unaudited) Value
Commercial Real Estate Finance				
Commercial Mortgage-Backed Securities				
Mortgage Capital Funding, Series 1998-MC3	5.5%	\$ 47,103	\$ 25,867	\$ 25,543
Morgan Stanley Capital I, Series 1999-RM1	6.4%	29,629	9,685	9,999
COMM 1999-1	5.7%	57,163	26,336	27,489
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	28,595	14,150	12,985
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	44,635	13,913	14,446
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	18,346	5,146	5,911
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	11,603	1,771	1,743
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	20,545	5,481	6,148
FUNB CMT, Series 1999-C4	6.5%	22,887	7,868	7,709
Heller Financial, HFCMC Series 2000 PH-1	6.6%	25,767	8,803	9,110
SBMS VII, Inc., Series 2000-NL1	7.2%	9,214	4,572	4,551
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	24,328	9,459	9,834
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	17,922	5,127	3,975
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	17,484	3,971	4,562
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	21,805	8,497	8,536
JP Morgan-CIBC-Deutsche 2001	5.8%	25,370	6,855	6,815
Lehman Brothers-UBS Warburg 2001-C2	6.4%	22,756	6,598	6,649
SBMS VII, Inc., Series 2001-C1	6.1%	23,049	5,648	4,988
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	21,228	6,355	5,985
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	21,456	5,209	5,343
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	24,493	5,855	5,575
SBMS VII, Inc., Series 2001-C2	6.2%	21,619	5,887	5,711
FUNB CMT, Series 2002-C1	6.0%	28,303	11,624	12,099
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	50,631	24,998	30,182
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	40,573	20,125	22,889
GE Capital Commercial Mortgage Corp., Series 2002-3	5.1%	50,047	22,604	24,218
Morgan Stanley Dean Witter Capital I Trust 2002-IQ3	6.0%	27,858	13,163	14,097
LB-UBS Commercial Mortgage Trust 2003-C1	4.6%	50,896	22,122	23,349
GS Mortgage Securities Corporation II Series 2003-C1	4.7%	39,543	19,148	19,570
J.P. Morgan Chase Commercial Mortgage Securities Corp., Series 2003-ML1	4.9%	15,946	12,315	12,738
Credit Suisse First Boston Mortgage Securities Corp., Series 2003-CK2	4.9%	69,680	37,674	39,150
GE Commercial Mortgage Corporation 2003-C1	5.1%	20,389	16,006	16,873
COMM 2003-LNB1	4.4%	36,803	14,668	14,865
Total commercial mortgage-backed securities		\$987,666	\$407,500	\$423,637

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(in Thousands)	June 30, 2003			
	Cost	Value		
Collateralized Debt Obligations				
Crest 2001-1, Ltd. ⁽³⁾	\$ 23,126	\$ 23,126		
Crest 2002-1, Ltd. ⁽³⁾	23,811	23,811		
Crest 2002-IG, Ltd. ⁽³⁾	4,731	4,731		
Crest Clarendon Street 2002-1, Ltd. ⁽³⁾	1,023	1,023		
Crest 2003-1, Ltd. ⁽³⁾	114,139	114,684		
Total collateralized debt obligations	\$ 166,830	\$ 167,375		
	Interest Rate Ranges	Number of Loans	Cost	Value
Commercial Mortgage Loans				
	Up to 6.99%	11	\$ 10,655	\$ 11,485
	7.00% 8.99%	17	37,178	34,541
	9.00% 10.99%	9	43,972	43,901
	11.00% 12.99%	13	18,211	11,301
	13.00% 14.99%	4	4,824	3,275
	15.00% and above	1	876	876
Total commercial mortgage loans		55	\$ 115,716	\$ 105,379
Real Estate Owned			12,841	10,505
Total commercial real estate finance			702,887	706,896
Total portfolio			\$ 2,547,470	\$ 2,546,140

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Information at and for the six months ended June 30, 2003 and 2002 is unaudited)

Note 1. Organization

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

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

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

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

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

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

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (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, 2003, and the results of operations for the three and six months ended June 30, 2003 and 2002, and changes in net assets and cash flows for the six months ended June 30, 2003 and 2002. The results of operations for the three and six months ended June 30, 2003, are not necessarily indicative of the operating results to be expected for the full year.

The private finance portfolio, the interest and related portfolio income and net realized gains (losses) earned 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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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 are included in the companies less than 5% owned category on the consolidated statement of operations.

Valuation Of Portfolio Investments

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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. Interest on loans and debt securities is not accrued if the Company has doubt about interest collection. Loans in workout status classified as Grade 4 or 5 assets 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 if such companies are in need of additional working capital. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

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

Equity Securities

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

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

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

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

CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

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

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

Fee Income

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

Deferred Financing Costs

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.

Cash and Cash Equivalents

Cash and cash equivalents include cash in banks and all highly liquid investments with original maturities of three months or less.

Guarantees

The Company accounts for guarantees under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation). In accordance with the Interpretation, guarantees meeting the characteristics described in the Interpretation, and issued or modified after December 31, 2002, are recognized at fair value. However, certain guarantees are excluded from the initial recognition provisions of the Interpretation. See Note 5 for disclosures related to the Company's guarantees.

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

At June 30, 2003 and 2002, the Company had a stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net increase in net assets resulting from operations, as all

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net increase in net assets resulting from operations and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	For the Six Months Ended June 30,	
	2003	2002
(in thousands, except per share amounts)		
Net increase in net assets resulting from operations as reported	\$79,813	\$129,415
Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(8,078)	(3,632)
Pro forma net increase in net assets resulting from operations	71,735	125,783
Less preferred stock dividends	(110)	(110)
Pro forma income available to common shareholders	\$71,625	\$125,673
Basic earnings per common share:		
As reported	\$ 0.71	\$ 1.28
Pro forma	\$ 0.64	\$ 1.25
Diluted earnings per common share:		
As reported	\$ 0.71	\$ 1.26
Pro forma	\$ 0.64	\$ 1.22

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, with the following weighted average assumptions for options granted during the six months ended June 30, 2003 and 2002:

	For the Six Months Ended June 30,	
	2003	2002
Risk-free interest rate	2.6%	4.5%
Expected life	5.0	5.0
Expected volatility	38.8%	39.7%
Dividend yield	8.9%	8.5%
Weighted average fair value per option	\$3.31	\$