

ALLIED CAPITAL CORP

Form 497

March 06, 2008

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The information in this prospectus supplement is not complete and may be changed. A registration statement relating to these securities has been declared effective by the Securities and Exchange Commission. This prospectus supplement is not an offer to sell these securities and is not soliciting offers to buy these securities in any state where such offer or sale is not permitted.

**Filed Pursuant to Rule 497  
Registration Statement No. 333-141848**

**Subject to Completion March 6, 2008**

**PROSPECTUS SUPPLEMENT**

(To Prospectus dated August 23, 2007)

4,000,000 Shares  
**Common Stock**

We are offering 4,000,000 shares of our common stock, par value \$0.0001 per share. We will receive all of the net proceeds from the sale of our common stock.

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The last reported sale price for our common stock on March 5, 2008, was \$22.02 per share.

Please read this prospectus supplement, and the accompanying prospectus, before investing, and keep it for future reference. The prospectus supplement and the accompanying prospectus contain important information about us that a prospective investor should know before investing in our common stock. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006, or by telephone at (202) 721-6100 or on our website at [www.alliedcapital.com](http://www.alliedcapital.com). The information on this website is not incorporated by reference into this prospectus supplement and the accompanying prospectus. The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains such information.

**Before buying any of these shares of our common stock, you should review the information, including the risk of leverage, set forth under Risk Factors on page S-24 of this prospectus supplement.**

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

	<b>Per Share</b>	<b>Total</b>
Public offering price	\$	\$
Underwriting discount	\$	\$
Proceeds, before expenses, to us <sup>(1)</sup>	\$	\$

<sup>(1)</sup> Expenses payable by us are estimated to be approximately \$320,000.

The underwriter proposes to offer the shares of common stock to the public at the public offering price set forth above. If all of the shares are not sold at the initial offering price, the underwriter may change the public offering price and the other selling terms.

The underwriters may also purchase from us up to an additional 600,000 shares of our common stock at the public offering price less the underwriting discount, to cover overallotments, if any, within 30 days of the date of this prospectus supplement.

The underwriters are offering the shares of our common stock as described in Underwriting. Delivery of the shares will be made on or about March , 2008.

Merrill Lynch & Co.

The date of this prospectus supplement is March , 2008

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

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### **ABOUT THIS PROSPECTUS**

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

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

(i)

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

<b>Shareholder Transaction Expenses</b>	
Sales load (as a percentage of offering price) <sup>(1)</sup>	%
Dividend reinvestment plan fees <sup>(2)</sup>	None
<b>Annual Expenses (as a percentage of consolidated net assets attributable to common stock)<sup>(3)</sup></b>	
Operating expenses <sup>(4)</sup>	6.31%
Interest payments on borrowed funds <sup>(5)</sup>	4.77%
Acquired fund fees and expenses <sup>(6)</sup>	%
 Total annual expenses <sup>(7)(8)</sup>	 11.08%

**Example**

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

	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>	<b>10 Years</b>
You would pay the following expenses on a \$1,000 investment, assuming a 5.0% annual return	\$	\$	\$	\$

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

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

- (1) Represents the underwriting discounts or commissions with respect to the shares sold by us in this offering.
- (2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases or sales, if any. See Dividend Reinvestment Plan in the accompanying prospectus.
- (3) Consolidated net assets attributable to common stock equals net assets (i.e., total consolidated assets less total consolidated liabilities), which at December 31, 2007, was \$2.8 billion.
- (4) Operating expenses represent our operating expenses for the year ended December 31, 2007, excluding interest on indebtedness. See Management's Discussion and Analysis of Financial Condition and Results of Operations in this prospectus supplement.

- (5) Interest payments on borrowed funds represents our interest expense for the year ended December 31, 2007. We had outstanding borrowings of \$2.3 billion at December 31, 2007. See Risk Factors in the accompanying prospectus supplement.
- (6) See our Consolidated Statement of Investments as of December 31, 2007, on pages S-104 through S-114 for our investments in funds.
- (7) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that Total annual expenses percentage be calculated as a percentage of net assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 5.9% of consolidated total assets.
- (8) The holders of shares of our common stock (and not the holders of our debt securities or preferred stock, if any) indirectly bear the cost associated with our annual expenses.

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**USE OF PROCEEDS**

We estimate that our net proceeds from the sale of the 4,000,000 shares of common stock we are offering will be approximately \$        million and approximately \$        million, if the underwriters' over-allotment option is exercised in full, and after deducting the underwriting discount and estimated offering expenses payable by us. We may change the size of this offering based on demand and market conditions.

We expect to use the net proceeds from this offering to reduce borrowings under our revolving line of credit, if any, to invest in debt or equity securities in primarily privately negotiated transactions, and for other general corporate purposes. Amounts repaid under our revolving line of credit will remain available for future borrowings. At March 5, 2008, the interest rate on our revolving line of credit was approximately 4.2% and there was approximately \$280.0 million outstanding. This revolving line of credit expires on September 30, 2008.

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We intend to offer the shares through Merrill Lynch, Pierce, Fenner & Smith Incorporated. Subject to the terms and conditions described in an underwriting agreement among us and the underwriter, we have agreed to sell to the underwriter, and the underwriter has agreed to purchase from us, 4,000,000 shares of our common stock.

The underwriter has agreed that it must purchase all of the shares sold under the underwriting agreement if it purchases any of them. However, the underwriter is not required to take or pay for the shares covered by the underwriter's overallotment option described below. We have agreed to indemnify the underwriter against certain liabilities, including liabilities under the Securities Act and to contribute to payments the underwriter may be required to make in respect of those liabilities.

The underwriter is offering the shares, subject to prior sale, when, as and if issued to and accepted by them, subject to approval of legal matters by their counsel, including the validity of the shares, and other conditions contained in the underwriting agreement, such as the receipt by the underwriter of officer's certificates and legal opinions. The underwriter reserves the right to withdraw, cancel or modify offers to the public and to reject orders in whole or in part.

The underwriter proposes to offer the shares of common stock to the public at the public offering price set forth on the cover of this prospectus supplement. If all of the shares are not sold at the initial offering price, the underwriter may change the public offering price and the other selling terms.

**Commissions and Discounts**

The following table shows the per share and total underwriting discounts and commissions we will pay to the underwriter assuming both no exercise and full exercise of the underwriter's overallotment option to purchase up to an additional 600,000 shares.

	<b>Per Share</b>	<b>Without Option</b>	<b>With Option</b>
<b>Underwriting Discount</b>	\$	\$	\$

We estimate that the total expenses of this offering, which will be paid by us, excluding the underwriting discount, will be approximately \$320,000.

**Overallotment Option**

We have granted an option to the underwriter to purchase up to 600,000 additional shares at the public offering price less the underwriting discount. The underwriter may exercise this option for 30 days from the date of this prospectus solely to cover any overallotments. If the underwriter exercises this option, it will be obligated, subject to conditions contained in the purchase agreement, to purchase the additional shares.

**No Sales of Similar Securities**

We and certain of our executive officers have agreed not to offer, sell, contract to sell or otherwise dispose of, or to engage in certain hedging and derivative transactions with respect to, our common stock for a period of 30 days after the date of this prospectus supplement, without first obtaining the written consent of Merrill Lynch, Pierce, Fenner & Smith Incorporated, except in limited circumstances, including our additional issuance of equity securities through privately negotiated transactions that may or may not involve an underwriter, whether or not registered with

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the SEC, aggregating not more than \$150 million. This consent may be given at any time without public notice.

**Price Stabilization and Short Positions**

Until the distribution of the shares is completed, SEC rules may limit the underwriter from bidding for and purchasing our common stock. However, the underwriter may engage in transactions that stabilize the price of the common stock, such as bids or purchases to peg, fix or maintain that price.

If the underwriter creates a short position in the common stock in connection with the offering, i.e., if it sells more shares than are listed on the cover of this prospectus supplement, the underwriter may reduce that short position by purchasing shares in the open market. The underwriter may also elect to reduce any short position by exercising all or part of the overallotment option described above. Purchases of the common stock to stabilize its price or to reduce a short position may cause the price of the common stock to be higher than it might be in the absence of such purchases.

Neither we nor the underwriter makes any representation or prediction as to the magnitude of any effect that the transactions described above may have on the price of the common stock. In addition, neither we nor the underwriter makes any representation that the underwriter will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

**Electronic Delivery**

The underwriter may make prospectuses available in electronic (PDF) format. A prospectus in electronic (PDF) format may be made available on a web site maintained by the underwriter, and the underwriter may distribute such prospectuses electronically. The underwriter intends to allocate a limited number of shares for sale to its online brokerage customers.

**Other Relationships**

In the ordinary course of business, the underwriter or its affiliates have engaged and may in the future engage in various financing, commercial banking and investment banking services with, and provide financial advisory services to, us and our affiliates, for which they have received or may receive customary fees and expenses. Affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated are members of the lending syndicate for our unsecured revolving line of credit and may receive proceeds of this offering by reason of the repayment of amounts outstanding thereunder. Because more than 10% of the net proceeds of the offering may be received by members of the NASD participating in the offering or their affiliates, the offering is being conducted in accordance with NASD Conduct Rule 2710(h).

The principal business address of Merrill Lynch, Pierce, Fenner & Smith Incorporated is 4 World Financial Center, 250 Vesey Street, New York, NY 10080.

**LEGAL MATTERS**

Certain legal matters with respect to the validity of the shares of common stock we are offering will be passed upon for us by Sutherland Asbill & Brennan LLP, Washington, D.C. Certain legal matters related to the offering will be passed upon for the underwriter by Fried, Frank, Harris, Shriver & Jacobson LLP, Washington D.C.

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**BUSINESS**

**General**

We are a business development company, or BDC, in the private equity business and we are internally managed. Specifically, we provide long-term debt and equity capital to primarily private middle market companies in a variety of industries. We believe the private equity capital markets are important to the growth of small and middle market companies because such companies often have difficulty accessing the public debt and equity capital markets. We believe that we are well positioned to be a source of capital for such companies. We provide our investors the opportunity to participate in the U.S. private equity industry through an investment in our publicly traded stock.

We have participated in the private equity business since we were founded in 1958. Since then through December 31, 2007, we have invested more than \$13 billion in thousands of companies nationwide. We primarily invest in the American entrepreneurial economy, helping to build middle market businesses and support American jobs. We generally invest in established companies with adequate cash flow for debt service and that are well positioned for growth. We are not venture capitalists, and we generally do not provide seed, or early stage, capital. At December 31, 2007, our private finance portfolio included investments in 120 companies that generate aggregate annual revenues of over \$13 billion and employ more than 95,000 people.

Our investment objective is to achieve current income and capital gains. In order to achieve this objective, we primarily invest in debt and equity securities of private companies in a variety of industries. However, from time to time, we may invest in companies that are public but lack access to additional public capital.

We have also participated in commercial real estate finance over our history. Over the past few years, we have not actively participated in commercial real estate finance as we believed that the market for commercial real estate had become too aggressive and that investment opportunities were not priced appropriately. As a result, our commercial real estate finance portfolio totaled \$121.2 million at value, or 2.3% of our total assets, at December 31, 2007, and contained primarily commercial mortgage loans. As the capital markets evolve and should commercial real estate investment opportunities improve, we may become more active investors in commercial real estate finance for our own portfolio or through a future managed fund. See **Managed Funds** below.

In addition to managing our own assets, we manage certain funds that also invest in the debt and equity securities of primarily private middle market companies in a variety of industries. We may invest in the equity of these funds, along with other third parties, from which we may earn a current return and/or a future incentive allocation. We may also manage the assets held by these funds, for which we may earn management or other fees for our services. See **Managed Funds** below.

We are internally managed, led by an experienced management team with our senior officers and managing directors possessing, on average, 22 years of experience. At December 31, 2007, we had 177 employees, who are focused on transaction sourcing, origination and execution, portfolio monitoring, accounting, valuation and other operational and administrative activities. We are headquartered in Washington, DC, with offices in New York, NY, Chicago, IL, and Los Angeles, CA and have centralized investment approval and portfolio management processes.

**Private Equity Investing**

As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, developing, valuing, and ultimately exiting our investments. We generally target companies in less cyclical industries with, among other things, high returns on

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invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and the ability to generate free cash flow. Each investment is subject to an extensive due diligence process. It is not uncommon for a single investment to take from two months to a full year to complete, depending on the complexity of the transaction.

Our investment activity is primarily focused on making long-term investments in the debt and equity of primarily private middle market companies. These investments are generally long-term in nature and privately negotiated, and no readily available market exists for them. This makes our investments highly illiquid and, as a result, we cannot readily trade them. When we make an investment, we enter into a long-term arrangement where our ultimate exit from that investment may be three to ten years in the future.

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

We have focused on investments in the debt and equity of primarily private middle market companies because they can be structured to provide recurring cash flow to us as the investor. In addition to earning interest income, we may earn income from management, consulting, diligence, structuring or other fees. We may also enhance our total return with capital gains realized from investments in equity instruments or from equity features, such as nominal cost warrants. For the years 1998 through 2007, we have realized \$1.4 billion in cumulative net realized gains from our investment portfolio. Net realized gains for this period as a percentage of total assets are shown in the chart below.

One measure of the performance of a private equity investor is the internal rate of return generated by the investor's portfolio. Since our merger on December 31, 1997, through December 31, 2007, our combined aggregate cash flow internal rate of return, or IRR, has been approximately 21% for private finance and real estate-related CMBS/CDO investments exited during this period. The IRR is calculated using the aggregate portfolio cash flow for all investments exited over this period. For investments exited during this period, we invested capital totaling \$4.6 billion. The weighted average holding period of these investments was 38 months. Investments are considered to be exited

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when the original investment objective has been achieved through the receipt of cash and/or non-cash consideration upon the repayment of our debt investment or sale of an equity investment, or through the determination that no further consideration was collectible and, thus, a loss may have been realized. The aggregate cash flow IRR for private finance investments was approximately 21% and for CMBS/CDO investments was approximately 24% for the same period. The weighted average holding period of the private finance and CMBS/CDO investments was 49 months and 22 months, respectively, for the same period. These IRR results represent historical results. Historical results are not necessarily indicative of future results.

We believe our business model is well suited for long-term investing in illiquid assets. Our balance sheet is capitalized with significant equity capital and we use only a modest level of debt capital, which allows us the ability to be patient and to manage through difficult market conditions with less risk of liquidity issues. Under the Investment Company Act of 1940 (the 1940 Act), we are restricted to a debt to equity ratio of approximately one-to-one. Thus, our capital structure, which includes a modest level of long-term leverage, is well suited for long-term illiquid investments.

In general, we compete for investments with a large number of private equity funds and mezzanine funds, other business development companies, hedge funds, investment banks, other equity and non-equity based investment funds, and other sources of financing, including specialty finance companies and traditional financial services companies such as commercial banks. However, we primarily compete with other providers of long-term debt and equity capital to middle market companies, including private equity funds and other business development companies.

**Private Finance Portfolio.** Our private finance portfolio is primarily composed of debt and equity investments. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. These investments are also generally illiquid.

Our capital is generally used to fund:

Buyouts	Recapitalizations
Acquisitions	Note purchases
Growth	Other types of financings

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

Management team with meaningful equity ownership

Dominant or defensible market position

High return on invested capital

Stable operating margins

Ability to generate free cash flow

Well-constructed balance sheet

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We generally target investments in companies in the following industries:

Business Services	Financial Services
Consumer Products	Consumer Services
Industrial Products	Retail

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. Our strategy is to manage risk in these investments through the structure and terms of our debt and equity investments. It is our preference to structure our investments with a focus on current recurring interest and other income, which may include management, consulting or other fees. We generally target debt investments of \$10 million to \$150 million and buyout investments of up to \$300 million of invested capital.

Debt investments may include senior loans, unitranche debt (generally in a first lien position), or subordinated debt (with or without equity features). The junior debt that we invest in that is lower in repayment priority than senior debt is also known as mezzanine debt. We may make equity investments for a minority equity stake in portfolio companies or may receive equity features, such as nominal cost warrants, in conjunction with our debt investments.

Senior loans may carry a fixed rate of interest or a floating rate of interest, usually set as a spread over LIBOR, and may 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 us monthly or quarterly. Unitranche debt generally carries a fixed rate of interest. Unitranche debt generally requires 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 us 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 on subordinated debt is generally paid to us quarterly.

We may underwrite or arrange senior loans related to our portfolio investments or for other companies that are not in our portfolio. When we underwrite or arrange senior loans, we may earn a fee for such activities. Senior loans underwritten or arranged by us may or may not be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, or funds managed by Callidus or by us, including the Allied Capital Senior Debt Fund, L.P. After completion of the loan sales, we may or may not retain a position in these senior loans. We generally earn a fee on the senior loans we underwrite or arrange whether or not we fund the underwritten commitment. In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Principal collections include repayments of senior debt funded by us that was subsequently sold by us or refinanced or repaid by the portfolio companies.

We may also invest in the bonds or preferred shares/income notes of collateralized loan obligations (CLOs) or collateralized debt obligations (CDOs), where the underlying collateral pool

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consists of senior loans. Certain of the CLOs and CDOs in which we invest may be managed by Callidus Capital Management, a subsidiary of Callidus.

In a buyout transaction, we generally invest in senior debt, subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest. If we invest in non-voting equity in a buyout investment, we generally have an option to acquire a controlling stake in the voting securities of the portfolio company at fair market value. We generally structure our buyout investments such that we seek to earn a blended current return on our total capital invested of approximately 10% through a combination of interest income on our loans and debt securities, dividends on our preferred and common equity, and management, consulting, or transaction services fees to compensate us for the managerial assistance that we may provide to the portfolio company. As a result of our significant equity investment in a buyout investment there is potential to realize larger capital gains through buyout investing as compared to debt or mezzanine investing.

The structure of each debt and equity security is specifically negotiated to enable us to protect our investment, with a focus on preservation of capital, and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our senior loans and unitranche debt are generally in a first lien position, however in a liquidation scenario, the collateral, if any, may not be sufficient to support our outstanding investment. Our junior or mezzanine loans are generally unsecured. Our investments may be subject to certain restrictions on resale and generally have no established trading market.

At December 31, 2007, 73.3% of the private finance portfolio at value consisted of loans and debt securities and 26.7% consisted of equity securities. At December 31, 2007, 86% of our private finance loans and debt securities carried a fixed rate of interest and 14% carried a floating rate of interest. The mix of fixed and variable rate loans and debt securities in the portfolio may vary depending on the level of floating rate senior loans or unitranche debt in the portfolio at a given time. The weighted average yield on our private finance loans and debt securities was 12.1% at December 31, 2007.

At December 31, 2007, 27.4% of the private finance investments at value were in companies more than 25% owned, 8.4% were in companies 5% to 25% owned, and 64.2% were in companies less than 5% owned.

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Our ten largest investments at value at December 31, 2007, were as follows:

		At December 31, 2007			
(\$ in millions)					
Portfolio			Unrealized		Percentage
Company	Company Information	Cost	Appreciation (Depreciation)	Value	of Total Assets
Norwesco, Inc.	Designs, manufactures and markets a broad assortment of polyethylene tanks primarily to the agricultural and septic tank markets.	\$ 121.0	\$ 79.5	\$ 200.5	3.8%
EarthColor, Inc.	Commercial printer focused on providing a one-stop printing solution of electronic pre-press, printing and finishing primarily for promotional products such as direct mail pieces, brochures, product information and free standing inserts.	\$ 200.0	\$ (10.9)	\$ 189.1	3.6%
Advantage Sales & Marketing, Inc.	Sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry.	\$ 154.8	\$ 11.0	\$ 165.8	3.2%
BenefitMall, Inc.	Insurance general agency providing brokers with products, tools, and services that make selling employee benefits to small businesses more efficient.	\$ 127.4	\$ 36.9	\$ 164.3	3.2%
WMA Equity Corporation and Affiliates d/b/a/ Wear Me Apparel	Designer and marketer of licensed and private children's apparel.	\$ 183.1	\$ (32.1)	\$ 151.0	2.9%
Driven Brands, Inc.	Business format franchisor in the car care sector of the automotive aftermarket industry and in the general car care services with approximately 1,100 locations worldwide operating primarily under the Meineke Car Care Centers <sup>®</sup> and Econo Lube N-Tune <sup>®</sup> brands.	\$ 149.2	\$ (13.5)	\$ 135.7	2.6%
Financial Pacific Company	Specialized commercial finance company that leases business-essential equipment to small businesses nationwide.	\$ 97.9	\$ 32.8	\$ 130.7	2.5%

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Huddle House, Inc.	Franchisor of value-priced, full service family dining restaurants primarily in the Southeast.	\$ 101.2	\$	2.6	\$ 103.8	2.0%
The Step2 Company, LLC	Manufacturer of branded plastic children's and home products manufactured through a rotational molding process.	\$ 98.2	\$	0.5	\$ 98.7	1.9%
Woodstream Corporation	Manufactures and markets poison free pest control and pet and wildlife caring control products.	\$ 97.1			\$ 97.1	1.9%

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We monitor the portfolio to maintain diversity within the industries in which we invest. We may or may not concentrate in any industry or group of industries in the future. The industry composition of the private finance portfolio at value at December 31, 2007 and 2006, was as follows:

	2007	2006
<b>Industry</b>		
Business services	37%	39%
Consumer products	25	20
Industrial products	10	9
Financial services	7	9
CLO/CDO <sup>(1)</sup>	6	3
Retail	4	6
Consumer services	4	6
Healthcare services	3	3
Other	4	5
<b>Total</b>	<b>100%</b>	<b>100%</b>

<sup>(1)</sup> These funds primarily invest in senior corporate loans. Certain of these funds are managed by Callidus, a portfolio company of Allied Capital.

**Commercial Real Estate Finance Portfolio.** Since 1998, our commercial real estate investments were generally in the non-investment grade tranches of commercial mortgage-backed securities, also known as CMBS, and in the bonds and preferred shares of collateralized debt obligations, also known as CDOs. On May 3, 2005, we completed the sale of our portfolio of CMBS and CDO investments to affiliates of Caisse de dépôt et placement du Québec (the Caisse). See Management's Discussion and Analysis of Financial Condition and Results of Operations. Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement, under which we have agreed not to primarily invest in non-investment grade 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 our existing portfolio and related activities.

At December 31, 2007, our commercial real estate finance portfolio consisted of commercial mortgage loans, real estate owned and equity interests, which totaled \$121.2 million at value, or 2.3% of our total assets.

**Managed Funds**

We manage funds that invest in the debt and equity of primarily private middle market companies in a variety of industries. As of December 31, 2007, the funds that we manage had total assets of approximately \$400 million. During 2007, we launched the Allied Capital Senior Debt Fund, L.P. and the Unitranche Fund LLC, and in early 2008, we formed the AGILE Fund I, LLC, all discussed below (together, the Managed Funds). Our responsibilities to the Managed Funds may include deal origination, underwriting, and portfolio monitoring and development services consistent with the activities that we perform for our portfolio as outlined below. Each of the Managed Funds may separately invest in the debt or equity of a portfolio company. Our portfolio may include debt or equity investments issued by the same portfolio company as investments held by one or more Managed Funds, and these investments may be senior, pari passu or junior to the debt and equity investments held by us. We may or may not participate in investments made by investment funds managed by us or one of our affiliates. We expect to continue to grow our managed capital base and have identified other private equity-related funds that we intend to develop. By growing our privately managed capital base, we are seeking to diversify our sources of capital, leverage our core investment expertise and increase fees and other income from asset management activities.



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**Allied Capital Senior Debt Fund, L.P.** The Allied Capital Senior Debt Fund, L.P. (ACSDF) is a private fund that generally invests in senior, unitranche and second lien debt. ACSDF has closed on \$125 million in equity capital commitments and had total assets of approximately \$400 million at December 31, 2007. A.C. Corporation (AC Corp), our wholly-owned subsidiary, is the investment manager and Callidus acts as special manager to ACSDF. One of our affiliates is the general partner of ACSDF, and AC Corp serves as collateral manager to a warehouse financing vehicle associated with ACSDF. AC Corp will earn a management fee of up to 2% per annum of the net asset value of ACSDF and will pay Callidus 25% of that management fee to compensate Callidus for its role as special manager.

We are a special limited partner in ACSDF, which is a portfolio investment, and have committed and funded \$31.8 million to ACSDF. At December 31, 2007, our investment in ACSDF totaled \$31.8 million at cost and \$32.8 million at value. As a special limited partner, we expect to earn an incentive allocation of 20% of the annual net income of ACSDF, subject to certain performance benchmarks.

From time to time, we may offer to sell loans to ACSDF or the warehouse financing vehicle. ACSDF or the warehouse financing vehicle may purchase loans from us. They also purchase loans from other third parties.

**Unitranche Fund LLC.** In December 2007, we formed the Unitranche Fund LLC (Unitranche Fund), which we co-manage with an affiliate of General Electric Capital Corporation (GE). The Unitranche Fund is a private fund that generally focuses on making first lien unitranche loans to middle market companies with Earning Before Interest, Taxes, Depreciation, and Amortization (EBITDA) of at least \$15 million. The Unitranche Fund may invest up to \$270 million for a single borrower. For financing needs greater than \$270 million, we and GE may jointly underwrite additional financing for a total unitranche financing of up to \$500 million. Allied Capital, GE and the Unitranche Fund may co-invest in a single borrower, with the Unitranche Fund holding at least a majority of the issuance. We may hold the portion of a unitranche loan underwritten by us. GE has committed \$3.075 billion to the Unitranche Fund consisting of \$3.0 billion of senior notes and \$0.075 billion of subordinated certificates and we have committed \$525.0 million of subordinated certificates. The Unitranche Fund will be capitalized as transactions are completed. At December 31, 2007, our investment in the Unitranche Fund totaled \$0.7 million at cost and at value.

The Unitranche Fund is governed by an investment committee with equal representation from Allied Capital and GE and both Allied Capital and GE and its affiliates provide origination, underwriting and portfolio management services to the Unitranche Fund. We will earn a management and sourcing fee totaling 0.375% per annum of managed assets.

**AGILE Fund I, LLC.** In January 2008, we entered into an investment agreement with the Goldman Sachs Private Equity Group, part of Goldman Sachs Asset Management (Goldman Sachs). As part of the investment agreement, we agreed to sell a pro-rata strip of private equity and debt investments to AGILE Fund I, LLC (AGILE), a private fund in which a fund managed by Goldman Sachs owns substantially all of the interests, for a total transaction value of \$169 million. The majority of the investment sale closed simultaneously with the execution of the investment agreement. The sales of the remaining assets are expected to close by the end of the first quarter of 2008, subject to certain terms and conditions.

The sale to AGILE included 13.7% of our equity investments in 23 of our buyout portfolio companies and 36 of our minority equity portfolio companies for a total purchase price of \$109 million. In addition, we sold approximately \$60 million in debt investments, which represented 7.3% of our unitranche, second lien and subordinated debt investments in the buyout investments included in the equity sale. AGILE generally has the right to co-invest in its proportional share of any future follow-on investment opportunities presented by the companies in its portfolio.

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We are the managing member of AGILE, and will be entitled to an incentive allocation subject to certain performance benchmarks. We own the remaining interests in AGILE not held by Goldman Sachs.

In addition, pursuant to the investment agreement Goldman Sachs has committed to invest at least \$125 million in future investment vehicles managed by us and will have future opportunities to invest in our affiliates, or vehicles managed by them, and to co-invest alongside us in the future, subject to various terms and conditions. As part of this transaction, we have also agreed to sell 11 venture capital and private equity limited partnership investments for approximately \$28 million to a fund managed by Goldman Sachs, which will assume the \$6.5 million of unfunded commitments related to these limited partnership investments. The sales of these limited partnership investments are expected to be completed by May 2008.

### **Business Processes**

**Business Development and New Deal Origination.** Over the years, we believe we have developed and maintained a strong industry reputation and an extensive network of relationships. We have a team of business development professionals dedicated to sourcing investments through our relationships with numerous private equity investors, investment banks, business brokers, merger and acquisition advisors, financial services companies, banks, law firms and accountants through whom we source investment opportunities. Through these relationships, we believe we have been able to strengthen our position as a private equity investor. We are well known in the private equity industry, and we believe that our experience and reputation provide a competitive advantage in originating new investments.

We believe that our debt portfolio relationships and sponsor relationships are a significant source for buyout investments. We generally source our buyout transactions in ways other than going to broad auctions, which include capitalizing on existing relationships with companies and sponsors to participate in proprietary buyout opportunities. We work closely with these companies and sponsors while we are debt investors so that we may be positioned to partner with them on buyout opportunities in a subsequent transaction.

From time to time, we may receive referrals for new prospective investments from our portfolio companies as well as other participants in the capital markets. We may pay referral fees to those who refer transactions to us that we consummate.

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

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

Our investments are tailored to the facts and circumstances of each deal. The specific structure is designed to protect our rights and manage our risk in the transaction. We generally structure the

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debt instrument to require restrictive affirmative and negative covenants, default penalties, or other protective provisions. In addition, each debt investment is individually priced to achieve a return that reflects our rights and priorities in the portfolio company's capital structure, the structure of the debt instrument, and our perceived risk of the investment. Our loans and debt securities have an annual stated interest rate; however, that interest rate is only one factor in pricing the investment. The annual stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity or upon prepayment. In addition to the interest earned on loans and debt securities, our debt investments may include equity features, such as nominal cost warrants or options to buy a minority interest in the portfolio company. In a buyout transaction where our equity investment represents a significant portion of the equity, our equity ownership may or may not represent a controlling interest. If we invest in non-voting equity in a buyout, we generally have an option to acquire a controlling stake in the voting securities of the portfolio company at fair market value.

We have a centralized, credit-based approval process. The key steps in our investment process are:

Initial investment screening;

Initial investment committee approval;

Due diligence, structuring and negotiation;

Internal review of diligence results, including peer review;

Final investment committee approval;

Approval by the Investment Review Committee of the Board of Directors for all debt investments that represent a commitment equal to or greater than \$20 million and every buyout transaction; and

Funding of the investment (due diligence must be completed with final investment committee approval and Board Investment Review Committee approval, as needed, before funds are disbursed).

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

In January 2008, our Board of Directors established an Investment Review Committee and delegated authority to this committee to review and approve certain types of investments, which the Board's Executive Committee previously reviewed, among other duties. The Investment Review Committee is composed of five permanent board members, who have been appointed to serve for the year, and three additional board members, each of whom will serve during at least one quarter during the year on a rotating schedule.

**Portfolio Monitoring and Development.** Middle market companies often lack the management expertise and experience found in larger companies. As a BDC, we are required by the 1940 Act to make available significant managerial assistance to our portfolio companies. Our senior level professionals work with portfolio company management teams to assist them in building their businesses. Managerial assistance includes, but is not limited to, management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters. Our corporate finance assistance includes supporting our portfolio companies' efforts to structure and attract additional capital. We believe our extensive network of industry relationships and our internal resources help make us a collaborative partner in the development of our portfolio companies.

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Our team of investment professionals regularly monitors the status and performance of each investment. This portfolio company monitoring process generally includes review of the portfolio company's financial performance against its business plan, review of current financial statements and compliance with financial covenants, evaluation of significant current developments and assessment of future exit strategies. For debt investments we may have board observation rights that allow us to attend portfolio company board meetings. For buyout investments, we generally hold a majority of the seats on the board of directors where we own a controlling interest in the portfolio company and we have board observation rights where we do not own a controlling interest in the portfolio company.

Our portfolio management committee is responsible for review and oversight of the investment portfolio, including reviewing the performance of selected portfolio companies, overseeing portfolio companies in workout status, reviewing and approving certain modifications or amendments to or certain additional investments in existing investments, reviewing and approving certain portfolio exits, reviewing and approving certain actions by portfolio companies whose voting securities are more than 50% owned by us, reviewing significant investment-related litigation matters where we are a named party, and reviewing and approving proxy votes with respect to our portfolio investments. Our portfolio management committee is chaired by our Chief Executive Officer and includes our Chief Operating Officer, Chief Financial Officer, Chief Valuation Officer (non-voting member), our private finance general counsel, and certain of our Managing Directors. From time to time we will identify investments that require closer monitoring or become workout assets. We develop a workout strategy for workout assets and the portfolio management committee gauges our progress against the strategy.

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

**Portfolio Grading**

We employ a grading system for our entire portfolio. Grade 1 is for those investments from which a capital gain is expected. Grade 2 is for investments performing in accordance with plan. Grade 3 is for investments that require closer monitoring; however, no loss of investment return or principal is expected. Grade 4 is for investments that are in workout and for which some loss of current investment return is expected, but no loss of principal is expected. Grade 5 is for investments that are in workout and for which some loss of principal is expected. At December 31, 2007, Grade 1, 2, and 3 investments totaled \$4,577.8 million, or 95.8% of the total portfolio at value, and Grade 4 and 5 investments totaled \$202.7 million, or 4.2% of the total portfolio at value.

**Portfolio Valuation**

We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the 1940 Act, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly

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from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

Our valuation process begins with each portfolio company or investment being initially valued by the investment professionals, led by the Managing Director or senior officer who is responsible for the portfolio company relationship (the Deal Team).

The CVO and third-party valuation consultants, as applicable (see below), review the preliminary valuation documentation as prepared by the Deal Team.

The CVO, members of the valuation team, and third-party consultants (see below), as applicable, meet with each Managing Director or responsible senior officer to discuss the preliminary valuation determined and documented by the Deal Team for each of their respective investments.

The CEO, COO, CFO and the Managing Directors meet with the CVO to discuss the preliminary valuation results.

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

The Audit Committee of the Board of Directors meets separately from the full Board of Directors with the third-party consultants (see below) to discuss the assistance provided and results. The CVO attends this meeting.

The CVO discusses and reviews the valuations with the Board of Directors.

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

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

In connection with our valuation process to determine the fair value of a private finance investment, we work with third-party consultants to obtain assistance and advice as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter. In addition, we may receive other third-party assessments of a particular private finance portfolio



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company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process.

The valuation analysis prepared by management is submitted to our Board of Directors who is ultimately responsible for the determination of fair value of the portfolio in good faith. Valuation assistance from Duff & Phelps, LLC (Duff & Phelps) for our private finance portfolio consisted of certain limited procedures (the Procedures) we identified and requested them to perform. Based upon the performance of the Procedures on a selection of our final portfolio company valuations, Duff & Phelps concluded that the fair value of those portfolio companies subjected to the Procedures did not appear unreasonable. In addition, we also received third-party valuation assistance from other third-party consultants for certain private finance portfolio companies.

We currently intend to continue to work with third-party consultants to obtain valuation assistance for a portion of the private finance portfolio each quarter. We currently anticipate that we will generally obtain valuation assistance for all companies in the portfolio where we own more than 50% of the outstanding voting equity securities on a quarterly basis and that we will generally obtain assistance for companies where we own equal to or less than 50% of the outstanding voting equity securities at least once during the course of the calendar year. Valuation assistance may or may not be obtained for new companies that enter the portfolio after June 30 of any calendar year during that year or for investments with a cost and value less than \$250,000. For the quarter ended December 31, 2007, we received valuation assistance for 112 portfolio companies, which represented 91.1% of the private finance portfolio at value. See Management's Discussion and Analysis of Financial Condition and Results of Operations below.

### **Disposition of Investments**

We manage our portfolio of investments in an effort to maximize our expected returns. We are generally repaid by our borrowers and exit our debt and equity investments as portfolio companies are sold, recapitalized or complete an initial public offering.

We may retain a position in the senior loans we originate or we may sell all or a portion of these investments. In our debt investments where we have equity features, we are generally in a minority ownership position in a portfolio company, and as a result, generally exit the investment when the majority equity stakeholder decides to sell or recapitalize the company. Where we have a control position in an investment, as we may have in buyout investments, we have more flexibility and can determine whether or not we should exit our investment. Our most common exit strategy for a buyout investment is the sale of a portfolio company to a strategic or financial buyer. If an investment has appreciated in value, we may realize a gain when we exit the investment. If an investment has depreciated in value, we may realize a loss when we exit the investment.

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

### **Dividends**

We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986 (the Code). Assuming that we continue to qualify as a regulated investment company, we generally will not be subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. We pay regular quarterly dividends based upon an estimate of annual taxable income available for distribution to shareholders, which includes our taxable interest, dividend, and fee income, as well as taxable net capital gains. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent

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differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses generally are not included in taxable income until they are realized. In addition, gains realized for financial reporting purposes may differ from gains included in taxable income as a result of our election to recognize gains using installment sale treatment, which generally results in the deferment of gains for tax purposes until notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends, which includes contractual payment-in-kind interest, and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

As a regulated investment company, we distribute substantially all of our annual taxable income to shareholders through the payment of cash dividends. Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared considering our estimate of annual taxable income available for distribution to shareholders and the amount of taxable income carried over from the prior year for distribution in the current year. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid from such taxable income for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Code. The maximum amount of excess taxable income that may be carried over for distribution in the next year under the Code is the total amount of dividends paid in the following year, subject to certain declaration and payment guidelines. Excess taxable income carried over and paid out in the next year is generally subject to a nondeductible 4% excise tax. See Management's Discussion and Analysis of Financial Condition and Results of Operation - Other Matters - Regulated Investment Company Status. We believe that carrying over excess taxable income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend.

We began paying quarterly dividends in 1963, and our portfolio has provided sufficient ordinary taxable income and realized net capital gains to sustain or grow our dividends over time. Since inception through December 31, 2007, our average annual total return to shareholders (assuming all dividends were reinvested) was 16.9%. Over the past one, three, five and ten years (assuming each period ended on December 31, 2007), our total return to shareholders (assuming all dividends were reinvested) has been (27.6%), 2.5%, 8.9% and 8.8%, respectively, with the dividend providing a meaningful portion of this return.

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The percentage of our dividend generated by ordinary taxable income versus capital gain income will vary from year to year. The percentage of ordinary taxable income versus net capital gain income supporting the dividend since 1987 is shown below.

**Corporate Structure and Offices**

We are a Maryland corporation and a closed-end, non-diversified management investment company that has elected to be regulated as a business development company under the 1940 Act. We have a real estate investment trust subsidiary, Allied Capital REIT, Inc., and several subsidiaries that are single-member limited liability companies established for specific purposes, including holding real estate property. We also have a subsidiary, A.C. Corporation, that generally provides diligence and structuring services, as well as transaction, management, consulting, and other services, including underwriting and arranging senior loans, to Allied Capital and our portfolio companies. A.C. Corporation also provides fund management services to certain funds managed by us.

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC 20006-3434 and our telephone number is (202) 721-6100. In addition, we have regional offices in New York, Chicago, and Los Angeles.

**Available Information**

Our Internet address is [www.alliedcapital.com](http://www.alliedcapital.com). We make available free of charge on our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Information contained on our website is not incorporated by reference into this prospectus supplement or the accompanying prospectus and you should not consider information contained on our website to be part of this prospectus supplement or the accompanying prospectus.

**Employees**

At December 31, 2007, we employed 177 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of our

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employees are located in our Washington, DC office. We believe that our relations with our employees are excellent.

**Properties**

Our principal offices are located at 1919 Pennsylvania Avenue, N.W., Washington, DC 20006-3434. Our lease for approximately 56,000 square feet of office space at that location expires in December 2010. The office is equipped with an integrated network of computers for word processing, financial analysis, accounting and loan servicing. We believe our office space is suitable for our needs for the foreseeable future. We also maintain offices in New York, NY; Chicago, IL; and Los Angeles, CA.

**Certain Government Regulations**

We operate in a highly regulated environment. The following discussion generally summarizes certain government regulations that we are subject to.

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

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

Securities purchased in transactions not involving any public offering, the issuer of which is an eligible portfolio company;

Securities received in exchange for or distributed with respect to securities described in the bullet above or pursuant to the exercise of options, warrants or rights relating to such securities; and

Cash, cash items, government securities or high quality debt securities (within the meaning of the 1940 Act), maturing in one year or less from the time of investment.

An eligible portfolio company is generally a domestic company that is not an investment company and that: does not have a class of securities with respect to which a broker may extend margin credit at the time the acquisition is made;

is controlled by the business development company and has an affiliate of a business development company on its board of directors;

does not have any class of securities listed on a national securities exchange; or

meets such other criteria as may be established by the SEC.

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

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We do not intend to acquire securities issued by any investment company that exceed the limits imposed by the 1940 Act. Under these limits, we generally cannot acquire more than 3% of the voting stock of any investment company (as defined in the 1940 Act), invest more than 5% of the value of our total assets in the securities of one such investment company or invest more than 10% of the value of our total assets in the securities of such investment companies in the aggregate. With regard to that portion of our portfolio invested in securities issued by investment companies, it should be noted that such investments might subject our stockholders to additional expenses.

In October 2006, the SEC re-proposed rules providing for an additional definition of eligible portfolio company. As re-proposed, the rule would expand the definition of eligible portfolio company to include certain public companies that list their securities on a national securities exchange. The SEC sought comment regarding the application of this proposed rule to companies with: (1) a public float of less than \$75 million; (2) a market capitalization of less than \$150 million; or (3) a market capitalization of less than \$250 million. There is no assurance that such proposal will be adopted or what the final proposal will entail.

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

As a business development company, we are entitled to issue senior securities in the form of stock or senior securities representing indebtedness, including debt securities and preferred stock, as long as each class of senior security has an asset coverage of at least 200% immediately after each such issuance. In addition, while any senior securities remain outstanding, we must make provisions to prohibit any distribution to our shareholders unless we meet the applicable asset coverage ratio at the time of the distribution.

We are not generally able to issue and sell our common stock at a price below net asset value per share. We may, however, sell our common stock, at a price below the current net asset value of the common stock, or sell warrants, options or rights to acquire such common stock, at a price below the current net asset value of the common stock if our board of directors determines that such sale is in the best interests of the Company and our stockholders, and our stockholders approve our policy and practice of making such sales. We have included such a proposal in our proxy statement for our 2008 Annual Meeting of Stockholders. In any such case, the price at which our securities are to be issued and sold may not be less than a price which, in the determination of our board of directors, closely approximates the market value of such securities (less any distributing commission or discount).

We are also limited in the amount of stock options that may be issued and outstanding at any point in time. The 1940 Act provides that the amount of a business development company's voting securities that would result from the exercise of all outstanding warrants, options and rights at the time of issuance may not exceed 25% of the business development company's outstanding voting securities, except that if the amount of voting securities that would result from the exercise of all outstanding warrants, options, and rights issued to the business development company's directors, officers, and employees pursuant to any executive compensation plan would exceed 15% of the business development company's outstanding voting securities, then the amount of voting securities that would result from the exercise of all outstanding warrants, options, and rights at the time of issuance shall not exceed 20% of the outstanding voting securities of the business development company.

We have applied for an exemptive order of the SEC to permit us to issue restricted shares of our common stock as part of the compensation packages for certain of our employees and directors. There can be no assurance that the SEC will grant an exemptive order to allow the granting of restricted

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stock. In addition, the issuance of restricted shares of our common stock will require the approval of our stockholders.

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

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

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

We maintain a code of ethics that establishes procedures for personal investment and restricts certain transactions by our personnel. Our code of ethics generally does not permit investment by our employees in securities that have been or are contemplated to be purchased or held by us. Our code of ethics is posted on our website at [www.alliedcapital.com](http://www.alliedcapital.com) and is also filed as an exhibit to our registration statement which is on file with the SEC. You may read and copy the code of ethics at the SEC's Public Reference Room in Washington, D.C. You may obtain information on operations of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the code of ethics is available on the EDGAR database on the SEC Internet site at <http://www.sec.gov>. You may obtain copies of the code of ethics, after paying a duplicating fee, by electronic request at the following email address: [publicinfo@sec.gov](mailto:publicinfo@sec.gov), or by writing to the SEC's Public Reference Section, 100 F Street, NE, Washington, D.C. 20549.

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

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

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

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notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash.

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

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

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

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

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

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

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

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

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

We have adopted certain policies and procedures to comply with the New York Stock Exchange (NYSE) corporate governance rules. In accordance with the NYSE procedures, shortly after our

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2007 Annual Meeting of Stockholders, we submitted the required CEO certification to the NYSE pursuant to Section 303A.12(a) of the listed company manual.

**RISK FACTORS**

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

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

**Investing in private companies involves a high degree of risk.** Our portfolio primarily consists of long-term loans to and investments in middle market private companies. Investments in private businesses involve a high degree of business and financial risk, which can result in substantial losses for us in those investments and accordingly should be considered speculative. There is generally no publicly available information about the companies in which we invest, and we rely significantly on the diligence of our employees and agents to obtain information in connection with our investment decisions. If we are unable to identify all material information about these companies, among other factors, we may fail to receive the expected return on our investment or lose some or all of the money invested in these companies. In addition, these businesses may have shorter operating histories, narrower product lines, smaller market shares and less experienced management than their competition and may be more vulnerable to customer preferences, market conditions, loss of key personnel, or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses. As an investor, we are subject to the risk that a portfolio company may make a business decision that does not serve our interest, which could decrease the value of our investment. Deterioration in a portfolio company's financial condition and prospects may be accompanied by deterioration in the collateral for a loan, if any.

**Substantially all of our portfolio investments, which are generally illiquid, are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments.** At December 31, 2007, portfolio investments recorded at fair value were 92% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. In determining fair value in good faith, we generally obtain financial and other information from portfolio companies, which may represent unaudited, projected or proforma financial information. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a

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quarterly basis and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and/or our equity security has appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material. Our net asset value could be affected if our determination of the fair value of our investments is materially different than the value that we ultimately realize.

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

We are currently analyzing the effect of adoption of Statement No. 157, *Fair Value Measurements*, on our consolidated financial position, including our net asset value and results of operations. We will adopt this statement on a prospective basis beginning in the quarter ending March 31, 2008. Adoption of this statement could have a material effect on our consolidated financial statements, including our net asset value. However, the actual impact on our consolidated financial statements in the period of adoption and subsequent to the period of adoption cannot be determined at this time as it will be influenced by the estimates of fair value for that period and the number and amount of investments we originate, acquire or exit. See Note 2, Summary of Significant Accounting Policies from our Notes to the Consolidated Financial Statements.

**Economic recessions or downturns could impair our portfolio companies and harm our operating results.**

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

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

**Our borrowers may default on their payments, which may have a negative effect on our financial performance.** We make long-term loans and invest in equity securities primarily in private middle market companies, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources, may be highly leveraged and may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. A portfolio company's failure to satisfy financial or operating covenants imposed

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by us or other lenders could lead to defaults and, potentially, termination of its loans or foreclosure on its secured assets, which could trigger cross defaults under other agreements and jeopardize our portfolio company's ability to meet its obligations under the loans or debt securities that we hold. In addition, our portfolio companies may have, or may be permitted to incur, other debt that ranks senior to or equally with our securities. This means that payments on such senior-ranking securities may have to be made before we receive any payments on our subordinated loans or debt securities. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in any related collateral and may have a negative effect on our financial results.

**Our private finance investments may not produce current returns or capital gains.** Our private finance portfolio includes loan and debt securities that require the payment of interest currently and equity securities such as conversion rights, warrants, or options, minority equity co-investments, or more significant equity investments in the case of buyout transactions. Our private finance debt investments are generally structured to generate interest income from the time they are made and our equity investments may also produce a realized gain. We cannot be sure that our portfolio will generate a current return or capital gains.

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

At December 31, 2007, our investment in Ciena Capital LLC (f/k/a Business Loan Express, LLC) (Ciena) totaled \$327.8 million at cost and \$68.6 million at value, after the effect of unrealized depreciation of \$259.2 million. In addition, we have an unconditional guarantee of 100% of the total obligations under Ciena's revolving credit facility that totaled \$399.0 million at January 31, 2008. Ciena focuses on loan products that provide financing to commercial real estate owners and operators. Ciena relies on the asset-backed securitization market to finance its loan origination activity. That financing source is an unreliable one in the current capital markets, and as a result, Ciena has significantly curtailed loan origination activity. Ciena continues to reposition its business; however, there is an inherent risk in repositioning the business and we continue to work with Ciena on restructuring. Ciena is a participant in the SBA's 7(a) Guaranteed Loan Program and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA-guaranteed loans issued by Ciena. The OIG and the U.S. Department of Justice are also conducting a civil investigation of Ciena's lending practices in various jurisdictions. As an SBA lender, Ciena is also subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of Ciena's lending practices under the Business and Industry Loan program. These investigations, audits, and reviews are ongoing. These investigations, audits, and reviews have had and may continue to have a material adverse impact on Ciena and, as a result, could negatively affect our financial results. See

Management's Discussion and Analysis of Financial Condition and Results of Operations—Private Finance, Ciena Capital LLC, and Valuation of Ciena Capital LLC.

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

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consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique. We and, indirectly, our stockholders will bear the cost associated with our leverage activity. Our revolving line of credit and notes payable contain financial and operating covenants that could restrict our business activities, including our ability to declare dividends if we default under certain provisions. Breach of any of those covenants could cause a default under those instruments. Such a default, if not cured or waived, could have a material adverse effect on us.

At December 31, 2007, we had \$2.3 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.5% and a debt to equity ratio of 0.83 to 1.00. We may incur additional debt in the future. If our portfolio of investments fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due. In order for us to cover annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.8% as of December 31, 2007, which returns were achieved.

**We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders.** Under the 1940 Act and the covenants applicable to our public debt, we must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders or investors on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of December 31, 2007, our asset coverage for senior indebtedness was 221%.

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

Assuming that the balance sheet as of December 31, 2007, were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected net income by approximately 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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**We will continue to need additional capital to grow because we must distribute our income.** We will continue to need capital to fund growth in our investments. Historically, we have borrowed from financial institutions or other investors and have issued debt and equity securities to grow our portfolio. A reduction in the availability of new debt or equity capital could limit our ability to grow. We must distribute at least 90% of our investment company taxable ordinary income (as defined in the Code), which excludes realized net long-term capital gains, to our shareholders to maintain our eligibility for the tax benefits available to regulated investment companies. As a result, such earnings will not be available to fund investment originations. In addition, as a business development company, we (i) are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances and (ii) may only issue new equity capital at a price, net of discounts and commissions, above our net asset value unless we have received shareholder approval. We intend to continue to borrow from financial institutions or other investors and issue additional debt and equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which could have a material adverse effect on the value of our debt securities or common stock.

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

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

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

**There are potential conflicts of interest between us and the funds managed by us.** Certain of our officers serve or may serve in an investment management capacity to funds managed by us. As a result, investment professionals may allocate such time and attention as is deemed appropriate and necessary to carry out the operations of the managed funds. In this respect, they may experience diversions of their attention from us and potential conflicts of interest between their work for us and their work for the managed funds in the event that the interests of the managed funds run counter to our interests.

Although managed funds may have a different primary investment objective than we do, the managed funds may, from time to time, invest in the same or similar asset classes that we target. These investments may be made at the direction of the same individuals acting in their capacity on behalf of us and the managed funds. As a result, there may be conflicts in the allocation of investment opportunities between us and the managed funds. In the future, we may not be given the opportunity to participate in investments made by investment funds managed by us or one of our affiliates. See Management's Discussion and Analysis and Results of Operations - Managed Funds below.

We have sold assets to certain managed funds and, as part of our investment strategy, we may offer to sell additional assets to managed funds or we may purchase assets from managed funds. While assets may be sold or purchased at prices that are consistent with those that could be obtained from third parties in the marketplace, there is an inherent conflict of interest in such transactions between us and funds we manage.

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

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

**Failure to invest a sufficient portion of our assets in qualifying assets could preclude us from investing in accordance with our current business strategy.** As a business development company, we may not acquire any assets other than qualifying assets unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets. Therefore, we may be precluded from investing in what we believe are attractive investments if such investments are not qualifying assets for purposes of the 1940 Act. If we do not invest a sufficient portion of our assets in qualifying assets, we could lose our status as a business development company, which would have a

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material adverse effect on our business, financial condition and results of operations. Similarly, these rules could prevent us from making additional investments in existing portfolio companies, which could result in the dilution of our position, or could require us to dispose of investments at inopportune times in order to comply with the 1940 Act. If we were forced to sell nonqualifying investments in the portfolio for compliance purposes, the proceeds from such sale could be significantly less than the current value of such investments.

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

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

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

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

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

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

**The trading market or market value of our publicly issued debt securities may be volatile.** Our publicly issued debt securities may or may not have an established trading market. We cannot assure that a trading market for our publicly issued debt securities will ever develop or be maintained if developed. In addition to our creditworthiness, many factors may materially adversely affect the trading market for, and market value of, our publicly issued debt securities. These factors include, but are not limited to, the following:

the time remaining to the maturity of these debt securities;

the outstanding principal amount of debt securities with terms identical to these debt securities;

the supply of debt securities trading in the secondary market, if any;

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the redemption or repayment features, if any, of these debt securities;

the level, direction and volatility of market interest rates generally; and

market rates of interest higher or lower than rates borne by the debt securities.

There also may be a limited number of buyers for our debt securities. This too may materially adversely affect the market value of the debt securities or the trading market for the debt securities.

**Our credit ratings may not reflect all risks of an investment in the debt securities.** Our credit ratings are an assessment of our ability to pay our obligations. Consequently, real or anticipated changes in our credit ratings will generally affect the market value of the publicly issued debt securities. Our credit ratings, however, may not reflect the potential impact of risks related to market conditions generally or other factors discussed above on the market value of, or trading market for, the publicly issued debt securities.

**Terms relating to redemption may materially adversely affect the return on the debt securities.** If our debt securities are redeemable at our option, we may choose to redeem the debt securities at times when prevailing interest rates are lower than the interest rate paid on the debt securities. In addition, if the debt securities are subject to mandatory redemption, we may be required to redeem the debt securities at times when prevailing interest rates are lower than the interest rate paid on the debt securities. In this circumstance, a holder of the debt securities may not be able to reinvest the redemption proceeds in a comparable security at an effective interest rate as high as the debt securities being redeemed.

**LEGAL PROCEEDINGS**

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

On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC (currently known as Ciena Capital LLC) in connection with a criminal investigation relating to matters similar to those investigated by and settled with the SEC as discussed above. We 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. We have voluntarily cooperated with the investigation.

In late December 2006, we 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

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investigators by us or our 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, we became aware that an agent of Allied Capital 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 we were gathering documents responsive to the subpoena, allegations were made that our management had authorized the acquisition of these records and that management was subsequently advised that these records had been obtained. Our management has stated that these allegations are not true. We have cooperated fully with the inquiry by the U.S. 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. On October 5, 2007, Rena Nadoff sent a letter to our Board of Directors with substantially the same claims and a request that the Board of Directors investigate the claims and take appropriate action. The Board of Directors has established a committee, which is advised by its own counsel, to review the matter.

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 our portfolio company, Business Loan Express, LLC. Plaintiffs seek unspecified compensatory and other damages, as well as other relief. We believe the lawsuit is without merit, and we intend to defend the lawsuit vigorously. On September 13, 2007, we filed a motion to dismiss the lawsuit. The motion is pending.

In addition to the above matters, we are 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, we do not expect these matters will materially affect our financial condition or results of operations; however, there can be no assurance whether any pending legal proceedings will have a material adverse effect on our financial condition or results of operations in any future reporting period.

**Table of Contents****MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

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

*changes in the economy, including economic downturns or recessions;*

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

*future changes in laws or regulations or changes in accounting principles; and*

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

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

**OVERVIEW**

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund buyouts, acquisitions, growth, recapitalizations, note purchases, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at December 31, 2007, 2006, and 2005, was as follows:

	2007	2006	2005
Private finance	97%	97%	96%
Commercial real estate finance	3%	3%	4%

Our earnings depend primarily on the level of interest and dividend income, fee and other income, and net realized and unrealized gains or losses on our investment portfolio after deducting

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interest expense on borrowed capital, operating expenses and income taxes, including excise tax. Interest income primarily results from the stated interest rate earned on a loan or debt security and the amortization of loan origination fees and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio outstanding during the year multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory, and competitive factors that influence new investment activity, interest rates on the types of loans we make, the level of repayments in the portfolio, the amount of loans and debt securities for which interest is not accruing and our ability to secure debt and equity capital for our investment activities. The level of fee income is primarily related to the level of new investment activity and the level of fees earned from portfolio companies and managed funds. The level of investment activity can vary substantially from year to year depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make.

Because we are a regulated investment company for tax purposes, we intend to distribute substantially all of our annual taxable income available for distribution as dividends to our shareholders. See **Other Matters** below.

**PORTFOLIO AND INVESTMENT ACTIVITY**

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the years ended December 31, 2007, 2006, and 2005, were as follows:

	<b>At and for the Years Ended December 31,</b>		
	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>(\$ in millions)</b>			
Portfolio at value	\$ 4,780.5	\$ 4,496.1	\$ 3,606.4
Investments funded <sup>(1)</sup>	\$ 1,846.0	\$ 2,437.8	\$ 1,675.8
Change in accrued or reinvested interest and dividends	\$ 23.9	\$ 8.2	\$ 6.6
Principal collections related to investment repayments or sales <sup>(2)</sup>	\$ 1,211.6	\$ 1,055.3	\$ 1,503.4
Yield on interest-bearing investments <sup>(3)</sup>	12.1%	11.9%	12.8%

(1) Investments funded included investments acquired through the issuance of our common stock as consideration totaling \$7.2 million for the year ended December 31, 2005. See also **Private Finance** below.

(2) Principal collections related to investment repayments or sales for the year ended December 31, 2007, included collections of \$224.2 million related to the sale of loans to the Allied Capital Senior Debt Fund, L.P. See discussion above.

(3) The weighted average yield on interest-bearing investments 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, plus the effective interest yield on the preferred shares/income notes of CLOs divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

**Table of Contents****Private Finance**

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the years ended December 31, 2007, 2006, and 2005, were as follows:

	<b>At and for the Years Ended December 31,</b>					
	<b>2007</b>		<b>2006</b>		<b>2005</b>	
	<b>Value</b>	<b>Yield<sup>(1)</sup></b>	<b>Value</b>	<b>Yield<sup>(1)</sup></b>	<b>Value</b>	<b>Yield<sup>(1)</sup></b>
<b>(\$ in millions)</b>						
<b>Portfolio at value:</b>						
Loans and debt securities:						
Senior loans	\$ 344.3	7.7%	\$ 405.2	8.4%	\$ 239.8	9.5%
Unitranche debt	653.9	11.5%	799.2	11.2%	294.2	11.4%
Subordinated debt	2,416.4	12.8%	1,980.8	12.9%	1,560.9	13.8%
Total loans and debt securities	3,414.6	12.1%	3,185.2	11.9%	2,094.9	13.0%
Equity securities:						
Preferred shares/income notes of CLOs <sup>(2)</sup>	203.0	14.6%	97.2	15.5%	72.3	13.7%
Other equity securities	1,041.7		1,095.5		1,312.1	
Total equity securities	1,244.7		1,192.7		1,384.4	
Total portfolio	\$ 4,659.3		\$ 4,377.9		\$ 3,479.3	
Investments funded <sup>(3)</sup>	\$ 1,828.0		\$ 2,423.4		\$ 1,462.3	
Change in accrued or reinvested interest and dividends	\$ 24.6		\$ 7.2		\$ 24.6	
Principal collections related to investment repayments or sales <sup>(4)</sup>	\$ 1,188.2		\$ 1,015.4		\$ 703.9	

(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. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value. The weighted average yields are computed as of the balance sheet date.

(2) Investments in the preferred shares/income notes of CLOs earn a current return that is included in interest income in the consolidated statement of operations.

(3) Investments funded for the year ended December 31, 2006, included debt investments in certain portfolio companies received in conjunction with the sale of such companies. See Private Finance - Investments Funded

below.

- (4) Includes collections from the sale or repayment of senior loans totaling \$393.4 million, \$322.7 million, and \$301.8 million for the years ended December 31, 2007, 2006, and 2005, respectively.

Our investment activity is primarily focused on making long-term investments in the debt and equity of primarily private middle market companies. Debt investments may include senior loans, unitranche debt (generally in a first lien position), or subordinated debt (with or without equity features). The junior debt that we invest in that is lower in repayment priority than senior debt is also known as mezzanine debt. Equity investments may include a minority equity stake in connection with a debt investment or a substantial equity stake in connection with a buyout transaction. In a buyout transaction, we generally invest in senior and/or subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest.

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. In addition, we may invest in funds that are managed or co-managed by us that are complementary to our business of investing in middle market companies, such as the Allied Capital

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Senior Debt Fund L.P. and the Unitranche Fund LLC (discussed below). Investments in funds may provide current interest and related portfolio income, including management fees.

During the first six months of 2007, we found it difficult to find investments with reasonable prices and structures. As a result, new investment activity was lower than in prior quarters totaling \$659.1 million for the first six months of 2007. During the second half of the year, our investment pace increased as pricing and structures improved and we invested \$1.2 billion in the last half of 2007.

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from year to year depending on the number and size of investments that we make or that we exit and many other factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make.

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**Investments Funded.** Investments funded and the weighted average yield on loans and debt securities funded for the years ended December 31, 2007, 2006, and 2005, consisted of the following:

**2007 Investments Funded**

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						
Senior loans	\$ 249.0	9.2%	\$ 63.1	8.8%	\$ 312.1	9.1%
Unitranche debt <sup>(2)</sup>	109.1	10.8%	74.9	13.0%	184.0	11.7%
Subordinated debt	719.4 <sup>(4)</sup>	12.8%	197.6	12.1%	917.0	12.6%
Total loans and debt securities	1,077.5	11.7%	335.6	11.7%	1,413.1	11.7%
Preferred shares/income notes of CLOs <sup>(5)</sup>	116.2	16.4%			116.2	16.4%
Equity	152.7 <sup>(6)</sup>		146.0		298.7	
Total	\$ 1,346.4		\$ 481.6		\$ 1,828.0	

**2006 Investments Funded**

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						
Senior loans	\$ 245.4	9.4%	\$ 239.8	8.9%	\$ 485.2	9.2%
Unitranche debt <sup>(2)</sup>	471.7	10.7%	146.5	12.9%	618.2	11.3%
Subordinated debt <sup>(3)</sup>	510.7	13.0%	423.8	14.4%	934.5	13.6%
Total loans and debt securities	1,227.8	11.4%	810.1	12.5%	2,037.9	11.9%
Preferred shares/income notes of CLOs <sup>(5)</sup>	26.1	14.8%			26.1	14.8%
Equity	65.3		294.1		359.4	
Total	\$ 1,319.2		\$ 1,104.2		\$ 2,423.4	

## 2005 Investments Funded

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 76.8	10.0%	\$ 250.2	6.4%	\$ 327.0	7.2%
Unitranche debt <sup>(2)</sup>	259.5	10.5%			259.5	10.5%
Subordinated debt	296.9 <sup>(4)</sup>	12.3%	330.9	12.5%	627.8	12.4%
Total loans and debt securities	633.2	11.3%	581.1	9.9%	1,214.3	10.6%
Preferred shares/income notes of CLOs <sup>(5)</sup>	47.9	14.2%			47.9	14.2%
Equity	34.6		165.5		200.1	
Total	\$ 715.7		\$ 746.6		\$ 1,462.3	

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs funded. The weighted average yield is calculated using yields as of the date an investment is funded.
- (2) Unitranche debt is generally in a first lien position. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt.
- (3) Debt investments funded for the year ended December 31, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a \$30 million subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS.
- (4) Subordinated debt investments for the years ended December 31, 2007 and 2005, included \$45.3 million and \$45.5 million, respectively, in investments in the bonds of collateralized loan obligations (CLOs) and one collateralized debt obligations (CDO). Certain of these CLOs and the CDO are managed by Callidus Capital Corporation (Callidus), a portfolio company controlled by us. These CLOs and the CDO primarily invest in senior corporate loans.
- (5) CLO equity investments included preferred shares/income notes of CLOs that primarily invest in senior corporate loans. Certain of these CLOs are managed by Callidus.
- (6) Equity investments for the year ended December 31, 2007, included \$31.8 million invested in the Allied Capital Senior Debt Fund, L.P. and \$0.7 million invested in the Unitranche Fund LLC. See [Managed Funds](#) below.



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

We may underwrite or arrange senior loans related to our portfolio investments or for other companies that are not in our portfolio. When we underwrite or arrange senior loans, we may earn a fee for such activities. Senior loans underwritten or arranged by us may be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, or funds managed by Callidus or by us, including the Allied Capital Senior Debt Fund, L.P. (discussed below). After completion of loan sales, we may retain a position in these senior loans. We generally earn a fee on the senior loans we underwrite or arrange whether or not we fund the underwritten commitment. In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Principal collections include repayments of senior debt funded by us that was subsequently sold by us or refinanced or repaid by the portfolio companies.

**Yield.** The weighted average yield on the private finance loans and debt securities was 12.1% at December 31, 2007, as compared to 11.9% and 13.0% at December 31, 2006 and 2005, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from year to year depending on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not accruing (see Portfolio Asset Quality Loans and Debt Securities on Non-Accrual Status below) and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the year. Yields on loans and debt securities have generally been lower because of the supply of capital available to middle market companies.

The yield on the private finance portfolio has declined over the past two years partly due to our strategy to pursue investments where our position in the portfolio company capital structure is more senior, such as senior debt and unitranche investments that typically have lower yields than subordinated debt investments. In addition, during the fourth quarter of 2006, the guaranteed dividend yield on our investment in Ciena Capital LLC's 25% Class A equity interests was placed on non-accrual status. The Class A equity interests are included in our loans and debt securities. See Ciena Capital LLC below.

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**Outstanding Investment Commitments.** At December 31, 2007, we had outstanding private finance investment commitments as follows:

	<b>Companies More Than 25% Owned<sup>(1)</sup></b>	<b>Companies 5% to 25% Owned</b>	<b>Companies Less Than 5% Owned</b>	<b>Total</b>
<b>(\$ in millions)</b>				
Senior loans	\$ 12.0	\$ 13.0	\$ 105.1	\$ 130.1 <sup>(2)</sup>
Unitranche debt	3.5		28.1	31.6
Subordinated debt	18.0	0.1		18.1
Total loans and debt securities	33.5	13.1	133.2	179.8
Unitranche Fund <sup>(3)</sup>	524.3			524.3
Equity securities	96.6	10.2	71.5	178.3 <sup>(4)</sup>
<b>Total</b>	<b>\$ 654.4</b>	<b>\$ 23.3</b>	<b>\$ 204.7</b>	<b>\$ 882.4</b>

- <sup>(1)</sup> Includes various commitments to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized loan obligations (CLOs), collateralized debt obligations (CDOs), and other related investments, as follows:

	<b>Committed Amount</b>	<b>Amount Drawn</b>	<b>Amount Available to be Drawn</b>
<b>(\$ in millions)</b>			
Revolving line of credit for working capital	\$ 4.0	\$	\$ 4.0
Subordinated debt to support warehouse facilities & warehousing activities <sup>(*)</sup>		18.0	18.0
<b>Total</b>	<b>\$ 22.0</b>	<b>\$</b>	<b>\$ 22.0</b>

- <sup>(\*)</sup> Callidus has a synthetic credit facility with a third party for up to approximately \$55 million. We have agreed to designate our subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support this facility.
- <sup>(2)</sup> Includes \$126.6 million in the form of revolving senior debt facilities to 32 companies.
- <sup>(3)</sup> Represents our commitment to the Unitranche Fund LLC (see discussion below), which we estimate will be funded over a two to three year period as investments are made by the Unitranche Fund.
- <sup>(4)</sup> Includes \$81.7 million to 22 private equity and venture capital funds, including \$4.4 million in co-investment commitments to one private equity fund.

In addition to these outstanding investment commitments at December 31, 2007, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees. See Financial Condition, Liquidity and Capital Resources below.

***Investments in Collateralized Loan Obligations and Collateralized Debt Obligations (CLO/CDO Assets).*** At December 31, 2007, we had investments in ten CLO issuances and one CDO bond, which represented 5.6% of our total assets, and five CLO issuances and one CDO bond, which

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represented 2.9% of our total assets, at December 31, 2006. At December 31, 2007 and 2006, our CLO/CDO Assets were as follows:

(\$ in millions)	2007			2006		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
CLO/CDO bonds	\$ 90.7	\$ 89.9	13.3%	\$ 45.4	\$ 45.6	12.8%
Preferred shares/income notes of CLOs	218.3	203.0	14.6%	101.1	97.2	15.5%
<b>Total</b>	<b>\$ 309.0</b>	<b>\$ 292.9</b>		<b>\$ 146.5</b>	<b>\$ 142.8</b>	

<sup>(1)</sup> The weighted average yield is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective interest yield on the preferred shares/income notes, divided by (b) CLO and CDO assets at value. The market yield used in the valuation of the CLO and CDO assets may be different than the interest yields shown above.

The CLO and CDO issuances in which we have invested are primarily invested in senior corporate loans. See also Note 3, Portfolio from our Notes to the Consolidated Financial Statements.

The initial yields on the cost basis of the CLO preferred shares and income notes are based on the estimated future cash flows expected to be paid to these CLO classes from the underlying collateral assets. As each CLO 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 on the cost basis 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.

The CLO/CDO Assets in which we have 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 December 31, 2007 and 2006, the face value of the CLO/CDO Assets held by us was subordinate to as much as 94% and 92%, respectively, of the face value of the securities outstanding in these CLOs and CDO.

At December 31, 2007 and 2006, the underlying collateral assets of these CLO and CDO issuances, consisting primarily of senior corporate loans, were issued by 671 issuers and 465 issuers, respectively, and had balances as follows:

(\$ in millions)	2007	2006
Bonds	\$ 288.5	\$ 245.4
Syndicated loans	4,122.7	1,769.9
Cash <sup>(1)</sup>	104.4	59.5
<b>Total underlying collateral assets<sup>(2)</sup></b>	<b>\$ 4,515.6</b>	<b>\$ 2,074.8</b>

- (1) Includes undrawn liability amounts.
- (2) At December 31, 2007 and 2006, the total face value of defaulted obligations was \$18.4 million and \$9.6 million, respectively, or approximately 0.4% and 0.5%, respectively, of the total underlying collateral assets.

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During the second half of 2007, the debt capital markets were volatile and market yields for CLO securities increased. We believe the market yields for our investments in CLO preferred shares/income notes have increased, and as a result, the fair value of certain of our investments in these assets has decreased. At December 31, 2007, the market yields used to value our preferred shares/income notes were 20% to 21%, with the exception of the income notes in one CLO with a cost and value of \$18.7 million where we used a market yield of 15.9% and one CLO with a cost and value of \$22.1 million where we used a market yield of 18.0% due to the characteristics of these issuances. Net change in unrealized appreciation or depreciation for the year ended December 31, 2007, included a net decrease of \$12.4 million related to our investments in CLO/CDO Assets. We received valuation assistance from Duff & Phelps for our investments in the CLO/CDO Assets in each quarter of 2007. See Results of Operations Valuation Methodology Private Finance below for further discussion of the third-party valuation assistance we received.

**Ciena Capital LLC.** Ciena Capital LLC (f/k/a Business Loan Express, LLC) (Ciena) focuses on loan products that provide financing to commercial real estate owners and operators. Ciena is also a participant in the SBA's 7(a) Guaranteed Loan Program and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). Ciena is headquartered in New York, NY and maintains offices in other U.S. locations. We invested in Ciena in 2000.

At December 31, 2007, our investment in Ciena totaled \$327.8 million at cost and \$68.6 million at value, after the effect of unrealized depreciation of \$259.2 million. See Results of Operations, Valuation of Ciena Capital LLC for a discussion of the determination of the value of Ciena at December 31, 2007. In 2007, we increased our investment in Ciena by \$32.4 million. We acquired \$29.2 million in additional Class A equity interests to fund payments to the SBA discussed below and to provide additional capital to Ciena. In addition, we purchased \$3.2 million in Class A equity interests from Ciena's former Chief Executive Officer. At December 31, 2006, our investment in Ciena totaled \$295.3 million at cost and \$210.7 million at value, after the effect of unrealized depreciation of \$84.6 million.

Net change in unrealized appreciation or depreciation included a net decrease on our investment in Ciena of \$174.5 million and \$142.3 million for the years ended December 31, 2007 and 2006, respectively, and a net increase of \$2.9 million for the year ended December 31, 2005. See Results of Operations, Valuation of Ciena Capital LLC below.

Total interest and related portfolio income earned from our investment in Ciena for the years ended December 31, 2007, 2006, and 2005, was as follows:

	2007	2006	2005
<b>(\$ in millions)</b>			
Interest income on subordinated debt and Class A equity interests <sup>(1)</sup>	\$	\$ 11.9	\$ 14.3
Dividend income on Class B equity interests <sup>(1)</sup>			14.0
Fees and other income	5.4	7.8	9.2
 Total interest and related portfolio income	 \$ 5.4	 \$ 19.7	 \$ 37.5

<sup>(1)</sup> Interest and dividend income from Ciena for the years ended December 31, 2006 and 2005, included interest and dividend income of \$5.7 million and \$8.9 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to us through the issuance of additional debt or equity interests.

In the fourth quarter of 2006, we placed our investment in Ciena's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from our investment in Ciena for the year ended December 31, 2007, and interest income for 2006 was lower as compared to 2005. In consideration for providing a guaranty on Ciena's revolving credit facility and standby letters of credit (discussed below), we earned fees of \$5.4 million, \$6.1 million, and \$6.3 million for the years ended December 31, 2007, 2006, and 2005, respectively, which were included in fees and other income. Ciena has not yet paid the \$5.4 million in such fees earned by us in 2007. At December 31, 2007,



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such fees were included as a receivable in other assets. We considered this outstanding receivable in our valuation of Ciena at December 31, 2007. The remaining fees and other income in 2006 and 2005 relate to management fees from Ciena. We did not charge Ciena management fees in 2007 or in the fourth quarter of 2006.

We guarantee Ciena's revolving credit facility that matures in March 2009. On January 30, 2008, Ciena completed an amendment of the terms of its revolving credit facility. The amendment reduced the commitments from the lenders under the facility from \$500 million to \$450 million at the effective date of the amendment, with further periodic reductions in total commitments to \$325 million by December 31, 2008. In addition, certain financial and other covenants were amended. In connection with this amendment, we increased our unconditional guarantee from 60% to 100% of the total obligations under this facility (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) and agreed to replace \$42.5 million in letters of credit issued under the Ciena credit facility with new letters of credit under our revolving line of credit. The guaranty of the Ciena revolving credit facility can be called by the lenders in the event of a default, which includes the occurrence of any event of default under our revolving credit facility, subject to grace periods in certain cases. The amendment also prohibits cash payments from Ciena to us for interest, guarantee fees, management fees, and dividends. On January 30, 2008, the principal amount outstanding on Ciena's revolving credit facility was \$351.9 million and letters of credit issued under the facility were \$89.1 million, of which we replaced \$42.5 million on January 31, 2008. Following the amendment of the revolving credit facility and the replacement of certain letters of credit by us, at January 31, 2008, amounts guaranteed by us under Ciena's line of credit were \$399.0 million, including \$46.6 million of letters of credit issued under the facility. At December 31, 2007, the total obligation guaranteed by us was \$258.7 million, and we had provided four standby letters of credit totaling \$18.0 million in connection with four term securitization transactions completed by Ciena.

Ciena relies on the asset-backed securitization market to finance its loan origination activity. That financing source is an unreliable one in the current capital markets, and as a result, Ciena has significantly curtailed loan origination activity, including loan originations under the SBA's 7(a) Guaranteed Loan Program. Ciena continues to reposition its business. However, there is an inherent risk in this repositioning and we continue to work with Ciena on restructuring. Ciena maintains two non-recourse securitization warehouse facilities, and there is no assurance that Ciena will be able to refinance these facilities in the term securitization market. We have issued performance guaranties whereby we have agreed to indemnify the warehouse providers for any damages, losses, liabilities and related costs and expenses that they may incur as a result of Ciena's failure to perform any of its obligations as loan originator, loan seller or loan servicer under the warehouse securitizations.

The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA guaranteed loans issued by Ciena. Specifically, on or about January 9, 2007, Ciena 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 alleged that a former Ciena employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. We understand that Ciena is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. On October 1, 2007, the former Ciena employee pled guilty to one count of conspiracy to fraudulently originate SBA-guaranteed loans and one count of making a false statement before a grand jury. The OIG and the U.S. Department of Justice are also conducting a civil investigation of Ciena's lending practices in various jurisdictions. As an SBA lender, Ciena is also subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an

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investigation of Ciena's lending practices under the Business and Industry Loan (B&I) program. These investigations, audits and reviews are ongoing.

On March 6, 2007, Ciena entered into an agreement with the SBA. According to the agreement, Ciena 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, Ciena 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 the charges by the U.S. Attorney's Office for the Eastern District of Michigan against Mr. Harrington. As part of the SBA's increased oversight, the agreement provides that any loans originated and closed by Ciena 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 Ciena 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 Ciena by the SBA. In connection with this agreement, Ciena also entered into an escrow agreement with the SBA and an escrow agent in which Ciena agreed to deposit \$10 million with the escrow agent for any additional payments Ciena may be obligated to pay to the SBA in the future. Ciena 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.

On or about January 16, 2007, Ciena and its subsidiary Business Loan Center LLC (BLC) became aware of a l