ALLIED CAPITAL CORP
Form 497
July 17, 2006

The information in this preliminary prospectus supplement is not complete and may be changed. A registration statement relating to these securities has been filed with and declared effective by the Securities and Exchange Commission. This preliminary prospectus supplement and the accompanying prospectus are not an offer to sell and are 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. 333-132515**

**SUBJECT TO COMPLETION**
**PRELIMINARY PROSPECTUS SUPPLEMENT, DATED JULY 17, 2006**

**PROSPECTUS SUPPLEMENT**
**(To Prospectus dated April 27, 2006)**

4,500,000 Shares
**Common Stock**

We are offering 4,500,000 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 July 14, 2006, was $28.88 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. 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 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 10 of the accompanying prospectus.**

**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.**

| | **Per Share** | **Total** |
|---|---|---|
| Public offering price | $ | $ |
| Underwriting discounts and commissions | $ | $ |
| Proceeds, before expenses, to us[1] | $ | $ |

[1] Expenses payable by us are estimated to be approximately $460,000.

The underwriters may also purchase from us up to an additional 675,000 shares of our common stock at the public offering price less the underwriting discounts and commissions, to cover over-allotments, 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 July , 2006.

*Joint Book-Running Managers*

**Merrill Lynch & Co.** **Banc of America Securities LLC** **Citigroup**

*Co-Managers*

**Lehman Brothers** **SunTrust Robinson Humphrey**

The date of this prospectus supplement is July , 2006

**You should rely only on the information contained in this prospectus supplement and the accompanying prospectus. We have not, and the underwriters have 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 underwriters are 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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**Prospectus Supplement**

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 the accompanying prospectus and certain other factors noted throughout this prospectus supplement and the accompanying prospectus constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

## FEES AND EXPENSES

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

| | |
|---|---|
| **Shareholder Transaction Expenses** | |
| Sales load (as a percentage of offering price)(1) | 5.0% |
| Dividend reinvestment plan fees(2) | None |
| **Annual Expenses (as a percentage of consolidated net assets attributable to common stock)(3)** | |
| Operating expenses(4) | 5.5% |
| Interest payments on borrowed funds(5) | 3.9% |
| Total annual expenses(6)(7) | 9.4% |

(1) Represents the underwriting discounts and 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 March 31, 2006, was $2.7 billion.

(4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2006, excluding interest on indebtedness. Estimated operating expenses for the year ending December 31, 2006, exclude any expense related to option cancellation payments (OCP) described below under Recent Developments. This percentage for the year ended December 31, 2005, was 5.7%. See Management and Compensation of Executive Officers and Directors in the accompanying prospectus.

(5) Interest payments on borrowed funds represents our estimated interest expense for the year ending December 31, 2006. We had outstanding borrowings of $1.3 billion at March 31, 2006. This percentage for the year ended December 31, 2005, was 2.9%. See Risk Factors in the accompanying prospectus.

(6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that 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 6.2% of consolidated total assets.

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

**Example**

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

| | 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|---|
| You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return | $ 140 | $ 317 | $ 490 | $ 904 |

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.**

**RECENT DEVELOPMENTS**

At March 31, 2006, we had a $772.5 million unsecured revolving line of credit. Effective May 22, 2006, we expanded the committed amount under the facility by $150.0 million, which brought the total committed amount to $922.5 million. The facility is now fully committed. The revolving line of credit expires on September 30, 2008.

On May 11, 2006, we amended the terms of the facility related to interest rates and certain reporting requirements. The interest rate spread was reduced from 1.30% to 1.05%. At our option, borrowings under the revolving line of credit will now generally bear interest at a rate equal to (i) LIBOR (for the period selected by us) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit continues to require the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans, and monthly payments of interest on other loans. All principal is due upon maturity. At May 11, 2006, there was $99.3 million in outstanding borrowings under the revolving line of credit.

The revolving credit facility continues to provide for a sub-facility for the issuance of letters of credit for up to an amount equal to 16.67% of the committed facility. The letter of credit fee will now be 1.05% per annum on letters of credit issued, which is payable quarterly. At May 11, 2006, there were $39.8 million of standby letters of credit issued under the facility.

In connection with our 2006 Annual Meeting of Stockholders, the stockholders approved the issuance of up to 2,500,000 shares of our common stock in exchange for the cancellation of vested in-the-money stock options granted to certain officers and directors under the Amended Stock Option Plan. Under the initiative, which has been reviewed and approved by our Board of Directors, all optionees who hold vested stock options with exercise prices below the market value of the stock (or in-the-money options), would be offered the opportunity to receive cash and common stock in exchange for their voluntary cancellation of their vested stock options. The sum of the cash and common stock to be received by each optionee would equal the in-the-money value of the stock option cancelled. As part of this initiative, the Board of Directors is also considering the adoption of a target ownership structure that would establish minimum ownership levels for our senior officers and continue to further align the interests of our officers with those of our stockholders. Unlike the accounting treatment typically associated with a stock option exercise, the option cancellation payment (OCP) would be recorded as an expense for financial reporting purposes, and the expense may be significant. Based on the 13 million vested options outstanding and the market price of $30.50 of our stock on March 10, 2006, the expense related to the OCP would be approximately $106 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. For income tax purposes, our tax expense resulting from the OCP would be similar to the tax expense that would result from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market would be limited by Section 162(m) of the Code for persons subject to Section 162(m).

On June 22, 2006, the Securities and Exchange Commission declared our registration statement registering debt securities up to an aggregate principal amount of $1 billion using the shelf registration process effective. We may raise new debt and equity capital from time to time in order to fund our investments and operations.

## USE OF PROCEEDS

We estimate that our net proceeds from the sale of the 4,500,000 shares of common stock we are offering will be approximately $123.0 million and approximately $141.5 million, if the underwriters over-allotment option is exercised in full, assuming a public offering price of $28.88 per share (based on the last reported sale price of our common stock on July 14, 2006) and after deducting the underwriting discounts and commissions 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, 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 July 14, 2006, the interest rate on our revolving line of credit was approximately 6.7% and there was approximately $85.0 million outstanding. This revolving line of credit expires on September 30, 2008.

## UNDERWRITING

Subject to the terms and conditions set forth in our underwriting agreement, we are offering the shares of our common stock described in this prospectus supplement through the underwriters named below. Merrill Lynch, Pierce, Fenner & Smith Incorporated, Banc of America Securities LLC and Citigroup Global Markets Inc. are acting as representatives. Each of the underwriters has severally agreed to purchase the number of shares of common stock listed next to its name in the following table:

| Underwriters | Number of shares |
|---|---|
| Merrill Lynch, Pierce, Fenner & Smith Incorporated | |
| Banc of America Securities LLC | |
| Citigroup Global Markets Inc. | |
| Lehman Brothers Inc. | |
| SunTrust Capital Markets, Inc. | |
| **Total** | **4,500,000** |

The underwriting agreement provides that the obligations of the underwriters to purchase the shares of common stock offered hereby are subject to certain conditions precedent and that the underwriters will purchase all of the shares of common stock offered by this prospectus supplement, other than those covered by the over-allotment option described below, if any of these shares are purchased.

The underwriters propose to offer the shares of common stock to the public at the public offering price set forth on the cover of this prospectus supplement and to dealers at a price that represents a concession not in excess of $ per share under the public offering price. The underwriters may allow, and these dealers may re-allow, a concession of not more than $ per share to other dealers. If all the shares are not sold at the public offering price, the underwriters may change the offering price and the other selling terms.

The underwriters have the option to purchase up to 675,000 additional shares of common stock from us at the same price they are paying for the 4,500,000 shares offered hereby. The underwriters may purchase additional shares only to cover over-allotments made in connection with this offering and only within 30 days after the date of this prospectus supplement. The underwriters will offer any additional shares that they purchase on the terms described in the preceding section.

The underwriting discounts and commissions per share are equal to the public offering price per share of common stock less the amount paid by the underwriters to us per share of common stock. The underwriting discounts and commissions are 5.0% of the public offering price. We have agreed to pay the underwriters the following discounts and commissions, assuming a public offering price of $28.88 per share (based on the last reported sale price of our common stock on July 14, 2006). These amounts are shown assuming either no exercise or full exercise by the underwriters of the underwriters over-allotment option:

| | | Total Fees | |
|---|---|---|---|
| | **Fee Per Share** | **Without Exercise of Over-Allotment Option** | **With Full Exercise of Over-Allotment Option** |
| **Underwriting discounts and commissions** | $ 1.44 | $ 6,498,000 | $ 7,472,700 |

We estimate that the total expenses of this offering, which will be paid by us, excluding the underwriting discounts and commissions, will be approximately $460,000.

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

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 60 days after the date of this prospectus supplement without first obtaining the written consent of Merrill Lynch, Pierce, Fenner & Smith Incorporated, Banc of America Securities LLC and Citigroup Global Markets Inc., 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 the SEC, aggregating not more than $75 million. This consent may be given at any time without public notice.

The underwriters do not intend to confirm sales to any account over which they exercise discretionary authority.

In connection with this offering, the underwriters may purchase and sell shares of our common stock in the open market. These transactions may include stabilizing transactions, short sales and purchases to cover positions created by short sales and stabilizing transactions.

Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in this offering. Covered short sales are sales made in an amount not greater than the underwriters over-allotment option to purchase additional shares in this offering. The underwriters may close out any covered short position by either exercising their over-allotment option or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option.

Naked short sales are sales in excess of the over-allotment option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned there may be downward pressure on the price of shares in the open market prior to the completion of this offering.

Stabilizing transactions consist of various bids for or purchases of our common stock made by the underwriters in the open market prior to the completion of this offering.

The underwriters may impose a penalty bid. This occurs when a particular underwriter repays to the other underwriters a portion of the underwriting discount received by it because the representatives of the underwriters have repurchased shares sold by or for the account of that underwriter in stabilizing or short covering transactions.

Purchase to cover a short position and stabilizing transactions may have the effect of preventing or slowing a decline in the market price of our common stock. Additionally, these purchases, along with the imposition of a penalty bid, may stabilize, maintain or otherwise affect the market price for our common stock. As a result, the price of our common stock may be higher than the price that might otherwise exist in the open market. These transactions may be effected on the New York Stock Exchange, in the over-the-counter market or otherwise.

In the ordinary course of business certain of the underwriters or their 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, Banc of America Securities LLC, Citigroup Global Markets Inc. and SunTrust Capital Markets, Inc. are members of the lending syndicate for our unsecured revolving line of credit and will 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 National Association of Securities Dealers, Inc. ( NASD ) participating in the offering or their affiliates, the offering is being conducted in accordance with NASD Conduct Rule 2710(h).

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

The principal business address of Merrill Lynch, Pierce, Fenner & Smith Incorporated is 4 World Financial Center, 250 Vesey Street, New York, NY 10080. The principal business address of Banc of America Securities LLC is 9 West 57th Street, New York, NY 10019. The principal business address of Citigroup Global Markets Inc. is 388 Greenwich Street, New York, NY 10013.

## 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 underwriters by Fried, Frank, Harris, Shriver & Jacobson LLP, Washington D.C.

**INTERIM MANAGEMENT S DISCUSSION AND ANALYSIS**
**OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company s Consolidated Financial Statements and the Notes thereto included herein and in the Company s annual report on Form 10-K for the year ended December 31, 2005. In addition, this quarterly report on Form 10-Q 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 below in the Risk Factors section. Other factors that could cause actual results to differ materially include:*

*changes in the economy and general economic conditions;*

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

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

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

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

**OVERVIEW**

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 lending and investment activity has generally been focused on private finance and commercial real estate finance, which included primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS, and collateralized debt obligation bonds and preferred shares, which we refer to as CDOs.

On May 3, 2005, we completed the sale of our portfolio of CMBS and real estate related CDO investments. Upon the completion of this transaction, our lending and investment activity has been focused primarily on private finance investments. 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 growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

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

| | March 31, 2006 | March 31, 2005 | December 31, 2005 |
|---|---|---|---|
| Private finance | 96% | 74% | 96% |
| Commercial real estate finance | 4% | 26% | 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 interest expense on borrowed capital, operating expenses and income taxes including excise tax. Interest income results from the stated interest rate earned on a loan or debt security and the amortization of loan origination fees and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio outstanding during the period 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.

Because we are a regulated investment company for tax purposes, we intend to distribute substantially all of our annual taxable income as dividends to our shareholders. 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 three months ended March 31, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

| ($ in millions) | At and for the Three Months Ended March 31, 2006 | At and for the Three Months Ended March 31, 2005 | At and for the Year Ended December 31, 2005 |
|---|---|---|---|
| Portfolio at value | $ 3,691.0 | $ 3,195.0 | $ 3,606.4 |
| Investments funded[1] | $ 797.9 | $ 265.6 | $ 1,675.8 |
| Change in accrued or reinvested interest and dividends [2] | $ (2.1) | $ 10.5 | $ 6.6 |
| Principal collections related to investment repayments or sales | $ 340.4 | $ 158.3 | $ 1,503.4 |
| Yield on interest-bearing investments[3] | 12.3% | 13.6% | 12.8% |

(1) Investments funded for the three months ended March 31, 2006, included a $150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

(2) Includes a change in accrued or reinvested interest of $1.1 million for the three months ended March 31, 2006, related to our investments in money market securities.

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

interest-bearing investments less the annual amortization of loan origination costs, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

**Private Finance**

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

| | At and for the Three Months Ended March 31, | | | | At and for the Year Ended December 31, | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2005 | |
| ($ in millions) | Value | Yield[(2)] | Value | Yield[(2)] | Value | Yield[(2)] |
| Portfolio at value: | | | | | | |
| Loans and debt securities: | | | | | | |
| Senior loans | $ 420.1 | 9.3% | $ 253.5 | 8.6% | $ 239.8 | 9.5% |
| Unitranche debt | 362.7 | 11.1% | 44.2 | 14.8% | 294.2 | 11.4% |
| Subordinated debt | 1,747.2 | 13.6% | 1,258.7 | 14.9% | 1,560.9 | 13.8% |
| Total loans and debt securities | $ 2,530.0 | 12.5% | $ 1,556.4 | 13.8% | $ 2,094.9 | 13.0% |
| Equity securities | 1,031.6 | | 822.1 | | 1,384.4 | |
| Total portfolio | $ 3,561.6 | | $ 2,378.5 | | $ 3,479.3 | |
| Investments funded[(1)] | $ 795.9 | | $ 168.2 | | $ 1,462.3 | |
| Change in accrued or reinvested interest and dividends | $ (4.2) | | $ 7.9 | | $ 24.6 | |
| Principal collections related to investment repayments or sales | $ 336.6 | | $ 151.2 | | $ 703.9 | |

(1) Investments funded for the three months ended March 31, 2006, included a $150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

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

Our investment activity is 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 (a single debt investment that is a blend of senior and subordinated debt), 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.

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. Senior loans at March 31, 2006, included approximately $200 million of senior loans that are currently in the process of being refinanced. Repayments include repayments of senior debt funded by us that was subsequently refinanced or repaid by the portfolio companies.

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. Recently, we believe many junior debt financing opportunities in the market have become less attractive from a risk/return perspective. To address the current market, our strategy is to focus on buyout and recapitalization transactions where we can manage risk through the structure and terms of our debt and equity investments and where we can potentially realize more attractive total returns from both current interest and fee income and future capital gains. We are also focusing our debt investing on smaller middle market companies where we can provide both senior and subordinated debt or unitranche debt, where our current yield may be lower than traditional subordinated debt only. We believe that providing both senior and subordinated debt or unitranche debt provides greater protection in the capital structures of our portfolio companies.

***Investments Funded.*** Investments funded and the weighted average yield on investments funded for the three months ended March 31, 2006 and 2005, and for the year ended December 31, 2005, consisted of the following:

| | For the Three Months Ended March 31, 2006 | | | | | |
|---|---|---|---|---|---|---|
| | **Debt Investments** | | **Buyout Investments** | | **Total** | |
| **($ in millions)** | **Amount** | **Weighted Average Yield(1)** | **Amount** | **Weighted Average Yield(1)** | **Amount** | **Weighted Average Yield(1)** |
| Loans and debt securities: | | | | | | |
| Senior loans | $ 85.0 | 9.1% | $ 117.8 | 8.9% | $ 202.8 | 9.0% |
| Unitranche debt(2) | 75.0 | 10.6% | | | 75.0 | 10.6% |
| Subordinated debt(3) | 279.3 | 12.5% | 145.4 | 13.9% | 424.7 | 13.0% |
| Total loans and debt securities | 439.3 | 11.5% | 263.2 | 11.6% | 702.5 | 11.6% |
| Equity | 24.6 | | 68.8 | | 93.4 | |
| Total | $ 463.9 | | $ 332.0 | | $ 795.9 | |

| | For the Three Months Ended March 31, 2005 | | | | | |
|---|---|---|---|---|---|---|
| | **Debt Investments** | | **Buyout Investments** | | **Total** | |
| **($ in millions)** | **Amount** | **Weighted Average Yield(1)** | **Amount** | **Weighted Average Yield(1)** | **Amount** | **Weighted Average Yield(1)** |
| Loans and debt securities: | | | | | | |
| Senior loans | $ 5.8 | 12.5% | $ 48.1 | 5.4% | $ 53.9 | 6.2% |
| Unitranche debt(2) | | | | | | |
| Subordinated debt | 87.9 | 12.1% | 11.9 | 15.5% | 99.8 | 12.5% |
| Total loans and debt securities | 93.7 | 12.2% | 60.0 | 7.4% | 153.7 | 10.3% |
| Equity | 11.5 | | 3.0 | | 14.5 | |
| Total | $ 105.2 | | $ 63.0 | | $ 168.2 | |

(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.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.

(3) Debt investments for the three months ended March 31, 2006, included a $150 million, 12.0% subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

(4) Buyout senior loans funded included $174.9 million that was repaid during the year.

| | For the Year Ended December 31, 2005 | | | | | |
|---|---|---|---|---|---|---|
| | Debt Investments | | Buyout Investments | | Total | |
| ($ in millions) | Amount | Weighted Average Yield[1] | Amount | Weighted Average Yield[1] | Amount | Weighted Average Yield[1] |
| Loans and debt securities: | | | | | | |
| Senior loans[4] | $ 76.8 | 10.0% | $ 250.2 | 6.4% | $ 327.0 | 7.2% |
| Unitranche debt[2] | 259.5 | 10.5% | | | 259.5 | 10.5% |
| Subordinated debt | 296.9 | 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% |
| Equity | 82.5 | | 165.5 | | 248.0 | |
| 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.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.

(3) Debt investments for the three months ended March 31, 2006, included a $150 million, 12.0% subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

(4) Buyout senior loans funded included $174.9 million that was repaid during the year.

In April 2006, we funded private finance investments totaling $254.9 million.

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.

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period 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. We believe that merger and acquisition activity in the middle market is strong, which has resulted in an increase in private finance investment opportunities, as well as increased repayments. We continue to have an active pipeline of new investments under consideration. We believe that merger and acquisition activity for middle market companies will remain strong in 2006.

***Portfolio Yield.*** The yield on private finance loans and debt securities was 12.5% at March 31, 2006, as compared to 13.8% and 13.0% at March 31, 2005, and December 31, 2005, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period 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 and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. The yield on the private finance portfolio has declined partly due to our strategy to pursue more buyout and recapitalization transactions, which may include investing in lower-yielding senior debt, as well as pursue unitranche investments.

***Outstanding Investment Commitments.*** At March 31, 2006, we had outstanding private finance investment commitments totaling $316.3 million, including the following:

$33.3 million in the form of debt to Promo Works, LLC.

$30.0 million in the form of debt to Business Loan Express, LLC.

$29.9 million in the form of equity to eleven private equity and venture capital funds.

$14.0 million in the form of debt to S.B. Restaurant Company.

$14.0 million in the form of debt to Integrity Interactive Corp.

$9.6 million in the form of debt to 3SI Security Systems Inc.

$8.3 million in the form of debt to Hot Stuff Foods, LLC.

$7.8 million in the form of debt to Mercury Air Centers, Inc.

$6.5 million in co-investment commitments to Pine Creek Equity Partners, LLC.

We have various commitments to Callidus Capital Corporation (Callidus), which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments. Our commitment to Callidus consisted of the following at March 31, 2006:

| **($ in millions)** | **Committed Amount** | **Amount Drawn** | **Amount Available to be Drawn** |
|---|---|---|---|
| Subordinated debt to support warehouse facilities & warehousing activities[1] | $ 40.0 | $ | $ 40.0 |
| Revolving line of credit for working capital | 4.0 | 3.8 | 0.2 |
| Revolving line of credit facility to support warehousing activities[2] | 50.0 | 3.7 | 46.3 |
| Total | $ 94.0 | $ 7.5 | $ 86.5 |

[1] Callidus has a secured warehouse credit facility with a third party for up to $400 million. The facility is used primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate our $40 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

[2] This facility supports Callidus purchase of middle market senior loans pending the sale of such loans to its warehouse credit facilities.

In addition, at March 31, 2006, we had a commitment to Callidus to purchase preferred equity in future CLO transactions of $32.4 million.

In addition to these outstanding investment commitments at March 31, 2006, 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 totaling $184.7 million. See Financial Condition, Liquidity and Capital Resources.

Our largest investment at value at March 31, 2006, was in Business Loan Express, LLC and our largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. (Advantage) and Business Loan Express, LLC (BLX).

***Business Loan Express, LLC.*** At March 31, 2006, our investment in BLX totaled $291.3 million at cost and $326.2 million at value, or 7.9% of our total assets, which includes unrealized appreciation of $35.0 million. We acquired BLX in 2000.

Total interest and related portfolio income earned from the Company s investment in BLX for the three months ended March 31, 2006 and 2005, was as follows:

| **($ in millions)** | **2006** | **2005** |
|---|---|---|
| Interest income | $ 3.9 | $ 3.4 |
| Dividend income | | 2.0 |
| Fees and other income | 2.2 | 2.4 |
| Total interest and related portfolio income | $ 6.1 | $ 7.8 |

Interest and dividend income from BLX for the three months ended March 31, 2006 and 2005, included interest and dividend income of $1.8 million and $1.6 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. Accrued interest and dividends receivable and other assets at March 31, 2006, included accrued interest and fees due from BLX totaling $3.4 million, of which $2.2 million was paid in cash in the second quarter of 2006.

Net change in unrealized appreciation or depreciation included a net decrease in unrealized appreciation on our investment in BLX of $22.7 million and $6.3 million for the three months ended March 31, 2006 and 2005, respectively. See Results of Operations for a discussion of the net change in unrealized appreciation or depreciation related to this investment.

BLX is a national, non-bank lender that participates in the SBA s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a nationwide preferred lender, as designated by the SBA, and originates, sells, and services small business loans. In addition, BLX originates conventional small business loans and small investment real estate loans. BLX has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, could negatively affect our financial results.

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

We had a commitment to BLX of $30.0 million in the form of a subordinated revolving credit facility to provide working capital to the company that expired on April 30, 2006. There were no amounts outstanding under this facility at March 31, 2006.

At December 31, 2005, BLX had a three-year $275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, we had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At December 31, 2005, the principal amount of loans outstanding on the revolving credit facility was $228.2 million and letters of credit issued under the facility were $41.7 million. The total obligation guaranteed by us at December 31, 2005, was $135.4 million.

On March 17, 2006, BLX closed on a new three-year $500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to $600.0 million at BLX s option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. We have provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At March 31, 2006, the principal amount outstanding on the revolving credit facility was $240.2 million and letters of credit issued under the facility were $41.7 million. The total obligation guaranteed by us at March 31, 2006, was $141.1 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility, which includes certain defaults under our revolving credit facility. BLX was in compliance with the terms of this facility at March 31, 2006. At March 31, 2006, we had also provided four standby letters of credit totaling $34.1 million in connection with four term securitization transactions completed by BLX.

***Advantage Sales & Marketing, Inc.*** At December 31, 2005, our investment in Advantage totaled $257.7 million at cost and $660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of $402.7 million. We completed the purchase of a majority ownership in Advantage in June 2004.

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our $184 million in subordinated debt outstanding and realized a gain on our equity investment sold of $433.1 million, subject to post-closing adjustments. As consideration for the common stock sold in the transaction, we received a $150 million subordinated note, with the balance of the consideration paid in cash. Approximately $34 million of our cash proceeds from the sale of the common stock have been held in escrow, subject to certain holdback provisions. In addition, there is potential for us to receive additional consideration through an earn-out payment that would be based on Advantage s 2006 audited results. Our realized gain of $433.1 million excludes any earn-out amounts. For tax purposes, the receipt of the $150 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected. In connection with the transaction, we retained an equity investment in the business valued at $15 million as a minority shareholder.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest for the three months ended March 31, 2006 and 2005, was as follows:

| **($ in millions)** | **2006** | **2005** |
|---|---|---|
| Interest income | $ 7.3 | $ 7.7 |
| Loan prepayment premiums | 5.0 | |
| Fees and other income | 1.8 | 1.5 |
| Total interest and related portfolio income | $ 14.1 | $ 9.2 |

In addition, we earned structuring fees of $2.3 million on our new $150 million subordinated debt investment in Advantage upon the closing of the sale transaction.

After the completion of the sale transaction, our investment in Advantage at March 31, 2006, which was composed of subordinated debt and a minority equity interest, totaled $151.3 million at cost and $164.3 million at value, which included unrealized appreciation of $13.0 million. Subsequent to the completion of the sale transaction, we estimate that our interest income from our subordinated debt investment in Advantage will be approximately $4.5 million per quarter.

Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

***STS Operating, Inc.*** On May 1, 2006, we announced the completion of the sale of STS Operating, Inc. (STS). We were repaid our $6.8 million in subordinated debt outstanding and we realized a gain on the sale of our common stock in STS of approximately $94 million, subject to post-closing adjustments. The cost basis of our equity was $3.5 million. As part of the consideration for the sale of our equity, we received a $30 million subordinated note. Approximately $10.7 million of our proceeds are subject to certain holdback provisions and post-closing adjustments. For tax purposes, the receipt of the $30 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected.

**Commercial Real Estate Finance**

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

| | At and for the Three Months Ended March 31, | | | | At and for the Year Ended December 31, | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2005 | |
| ($ in millions) | Value | Yield[(1)] | Value | Yield[(1)] | Value | Yield[(1)] |
| Portfolio at value: | | | | | | |
| CMBS bonds | $ | | $ 466.1 | 13.0% | $ | |
| CDO bonds and preferred shares | | | 227.1 | 15.8% | | |
| Commercial mortgage loans | 102.7 | 7.6% | 89.7 | 6.4% | 102.6 | 7.6% |
| Real estate owned | 15.0 | | 18.4 | | 13.9 | |
| Equity interests | 11.7 | | 15.2 | | 10.6 | |
| Total portfolio | $ 129.4 | | $ 816.5 | | $ 127.1 | |
| Investments funded | $ 2.0 | | $ 97.4 | | $ 213.5 | |
| Change in accrued or reinvested interest | $ 1.0 | | $ 2.6 | | $ (18.0) | |
| Principal collections related to investment repayments or sales[(2)] | $ 3.8 | | $ 7.1 | | $ 799.5 | |

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

(2) Principal collections related to investment repayments or sales for the year ended December 31, 2005, included $718.1 million related to the sale of our CMBS and CDO portfolio in May 2005.

Our commercial real estate investments funded for the three months ended March 31, 2006 and 2005, and for the year ended December 31, 2005, was as follows:

| ($ in millions) | Face Amount | Discount | Amount Funded |
|---|---|---|---|
| ***For the Three Months Ended March 31, 2006*** | | | |
| Commercial mortgage loans | $ 0.6 | $ | $ 0.6 |
| Equity interests | 1.4 | | 1.4 |
| Total | $ 2.0 | $ | $ 2.0 |
| ***For the Three Months Ended March 31, 2005*** | | | |
| CMBS bonds (3 new issuances)[1] | $ 160.6 | $ (67.4) | $ 93.2 |
| Commercial mortgage loans | 4.1 | (0.7) | 3.4 |
| Equity interests | 0.8 | | 0.8 |
| Total | $ 165.5 | $ (68.1) | $ 97.4 |
| ***For the Year Ended December 31, 2005*** | | | |
| CMBS bonds (4 new issuances)[1] | $ 211.5 | $ (90.5) | $ 121.0 |
| Commercial mortgage loans | 88.5 | (0.8) | 87.7 |
| Equity interests | 4.8 | | 4.8 |
| Total | $ 304.8 | $ (91.3) | $ 213.5 |

(1) The CMBS bonds invested in during 2005 were sold on May 3, 2005.

At March 31, 2006, we had outstanding funding commitments related to commercial mortgage loans and equity interests of $13.6 million and commitments in the form of standby letters of credit and guarantees related to equity interests of $7.0 million.

***Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares.*** On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of $976.0 million and a net realized gain of $227.7 million, after transaction and other costs of $7.8 million, in the second quarter of 2005. Transaction costs included investment banking fees, legal and other professional fees, and other transaction costs. The CMBS and CDO assets sold had a cost basis at closing of $739.8 million, including accrued interest of $21.7 million. Upon the closing of the sale, we settled all the hedge positions relating to these assets, which resulted in a net realized loss of $0.7 million, which was included in the net realized gain on the sale.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWCapital Investments LLC, an affiliate of the Caisse (CWCapital), pursuant to which we agreed to sell certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. Under this agreement, we have agreed not to invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008, subject to certain limitations and excluding our existing portfolio and related activities.

The real estate securities purchase agreement, under which we sold the CMBS and CDO portfolio, and the platform asset purchase agreement contain customary representations and warranties, and require us to indemnify the affiliates of the Caisse that are parties to the agreements for certain liabilities arising under the agreements, subject to certain limitations and conditions.

**Hedging Activities**

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were $17.5 million and $17.7 million at March 31, 2006, and December 31, 2005, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were $17.5 million and $17.7 million at March 31, 2006, and December 31, 2005, respectively. The amount of the hedge will vary from period to period depending upon the amount of commercial mortgage loans that we own and have hedged as of the balance sheet date.

**Portfolio Asset Quality**

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

At March 31, 2006, and December 31, 2005, our portfolio was graded as follows:

| | 2006 | | 2005 | |
|---|---|---|---|---|
| **Grade** | **Portfolio at Value** | **Percentage of Total Portfolio** | **Portfolio at Value** | **Percentage of Total Portfolio** |
| **($ in millions)** | | | | |
| 1 | $ 1,287.9 | 34.9% | $ 1,643.0 | 45.6% |
| 2 | 2,183.2 | 59.2 | 1,730.8 | 48.0 |
| 3 | 89.1 | 2.4 | 149.1 | 4.1 |
| 4 | 64.5 | 1.7 | 26.5 | 0.7 |
| 5 | 66.3 | 1.8 | 57.0 | 1.6 |
| | $ 3,691.0 | 100.0% | $ 3,606.4 | 100.0% |

Grade 1 portfolio assets decreased from $1.6 billion at December 31, 2005, to $1.3 billion at March 31, 2006, primarily as a result of the sale of Advantage Sales & Marketing, Inc. (Advantage) on March 29, 2006. Advantage had a value of $660.4 million, including $402.7 million of unrealized appreciation, at December 31, 2005. Our investment in Advantage after the sale transaction was

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$164.3 million at value, including $13.0 million of unrealized appreciation, at March 31, 2006, and was included in Grade 1 assets. See Portfolio and Investment Activity above for further discussion. Grade 2 portfolio assets increased from $1.7 billion at December 31, 2005, to $2.2 billion at March 31, 2006, primarily as a result of the level of new investments made during the first quarter of 2006, as new investments generally enter the portfolio as Grade 2 assets.

Total Grade 3, 4 and 5 portfolio assets were $219.9 million and $232.6 million, respectively, or were 5.9% and 6.4%, respectively, of the total portfolio at value at March 31, 2006, and December 31, 2005.

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

***Loans and Debt Securities on Non-Accrual Status.*** At March 31, 2006, and December 31, 2005, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

| **($ in millions)** | **2006** | **2005** |
|---|---|---|
| Loans and debt securities in workout status (classified as Grade 4 or 5)[(1)] | | |
| Private finance | | |
| Companies more than 25% owned | $ 29.0 | $ 15.6 |
| Companies 5% to 25% owned | 5.6 | |
| Companies less than 5% owned | 51.8 | 11.4 |
| Commercial real estate finance | 12.6 | 12.9 |
| Loans and debt securities not in workout status | | |
| Private finance | | |
| Companies more than 25% owned | 40.6 | 58.0 |
| Companies 5% to 25% owned | 5.1 | 0.5 |
| Companies less than 5% owned | 4.4 | 49.5 |
| Commercial real estate finance | 8.6 | 7.9 |
| Total | $ 157.7 | $ 155.8 |
| Percentage of total portfolio | 4.3% | 4.3% |

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

***Loans and Debt Securities Over 90 Days Delinquent.*** Loans and debt securities greater than 90 days delinquent at value at March 31, 2006, and December 31, 2005, were as follows:

| **($ in millions)** | **2006** | **2005** |
|---|---|---|
| Private finance | $ 82.6 | $ 74.6 |
| Commercial mortgage loans | 6.0 | 6.1 |
| Total | $ 88.6 | $ 80.7 |

| | | |
|---|---|---|
| Percentage of total portfolio | 2.4% | 2.2% |

In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. In addition, interest may not accrue on loans to portfolio companies that are more than 50% owned by us depending on such company s capital requirements. To the extent interest payments are received on a loan that is not accruing interest, we may use such payments to reduce our cost basis in the investment in lieu of recognizing interest income.

As a result of these and other factors, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled $88.6 million and $60.7 million at March 31, 2006, and December 31, 2005, respectively.

**RESULTS OF OPERATIONS**

**Comparison of Three Months Ended March 31, 2006 and 2005**

The following table summarizes the Company s operating results for the three months ended March 31, 2006 and 2005.

| ($ in thousands, except per share amounts) | For the Three Months Ended March 31, 2006 | 2005 | Change | Percentage Change |
|---|---|---|---|---|
| | (unaudited) | | | |
| **Interest and Related Portfolio Income** | | | | |
| Interest and dividends | $ 88,881 | $ 84,945 | 3,936 | 5% |
| Loan prepayment premiums | 5,286 | 1,677 | 3,609 | 215% |
| Fees and other income | 16,844 | 8,297 | 8,547 | 103% |
| Total interest and related portfolio income | 111,011 | 94,919 | 16,092 | 17% |
| **Expenses** | | | | |
| Interest | 24,300 | 20,225 | 4,075 | 20% |
| Employee | 21,428 | 15,456 | 5,972 | 39% |
| Stock options | 3,606 | | 3,606 | 100% |
| Administrative | 11,519 | 20,754 | (9,235) | (44)% |
| Total operating expenses | 60,853 | 56,435 | 4,418 | 8% |
| Net investment income before income taxes | 50,158 | 38,484 | 11,674 | 30% |
| Income tax expense (benefit), including excise tax | 8,858 | (268) | 9,126 | ** |
| Net investment income | 41,300 | 38,752 | 2,548 | 7% |
| **Net Realized and Unrealized Gains (Losses)** | | | | |
| Net realized gains | 432,835 | 10,285 | 422,550 | * |
| Net change in unrealized appreciation or depreciation | (374,548) | 70,584 | (445,132) | * |
| Total net gains | 58,287 | 80,869 | (22,582) | * |
| Net income | $ 99,587 | $ 119,621 | (20,034) | (17)% |
| Diluted earnings per common share | $ 0.70 | $ 0.88 | (0.18) | (20)% |
| Weighted average common shares outstanding diluted | 141,738 | 135,579 | 6,159 | 5% |

* Net realized gains (losses) and net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.

** Percentage change is not meaningful.

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

*Interest and Dividends.* Interest and dividend income for the three months ended March 31, 2006 and 2005, was composed of the following:

| ($ in millions) | 2006 | 2005 |
|---|---|---|
| Interest | | |
| Private finance loans and debt securities | $ 82.6 | $ 56.8 |
| CMBS and CDO portfolio | | 22.1 |
| Commercial mortgage loans | 2.8 | 1.5 |
| Cash and cash equivalents and other | 2.9 | 0.4 |
| Total interest | 88.3 | 80.8 |
| Dividends | 0.6 | 4.1 |
| Total interest and dividends | $ 88.9 | $ 84.9 |

Our interest income from our private finance loans and debt securities has increased period over period as a result of the growth in this portfolio since March 31, 2005, as shown below. In addition, during the first quarter of 2006, we resumed accruing interest for certain private finance portfolio companies. Such additional interest income totaled $3.8 million for the three months ended March 31, 2006.

There was no interest income from the CMBS and CDO portfolio in the first quarter of 2006 as we sold this portfolio on May 3, 2005. The CMBS and CDO portfolio sold had a cost basis of $718.1 million and a weighted average yield on the cost basis of the portfolio of approximately 13.8%. We generally reinvested the principal proceeds from the CMBS and CDO portfolio into our private finance portfolio.

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at March 31, 2006 and 2005, were as follows:

| | 2006 | | 2005 | |
|---|---|---|---|---|
| ($ in millions) | Value | Weighted Average Yield[(1)] | Value | Weighted Average Yield[(1)] |
| Private finance loans and debt securities | $ 2,530.0 | 12.5% | $ 1,556.4 | 13.8% |
| CMBS and CDO portfolio | | | 693.2 | 13.9% |
| Commercial mortgage loans | 102.7 | 7.6% | 89.7 | 6.4% |
| Total | $ 2,632.7 | 12.3% | $ 2,339.3 | 13.6% |

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and

debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

The private finance portfolio yield at March 31, 2006, of 12.5% as compared to the private finance portfolio yield of 13.8% at March 31, 2005, reflects the mix of debt investments in the private finance portfolio. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption Private Finance.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests. Dividend income for the three months ended March 31, 2006 and 2005, included $0 and $2.0 million, respectively, of dividends from BLX on the Class B equity interests held by us, which were paid in cash.

*Loan Prepayment Premiums.* Loan prepayment premiums were $5.3 million and $1.7 million for the three months ended March 31, 2006 and 2005, respectively. Loan prepayment premiums for the three months ended March 31, 2006, included $5.0 million related to the repayment of our subordinated debt in connection with the sale of our majority equity interest in Advantage. See Portfolio and Investment Activity above for further discussion. While the scheduled maturities of private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

*Fees and Other Income.* Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management and consulting services to portfolio companies, guarantees, and other services. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes, 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.

Fees and other income for the three months ended March 31, 2006 and 2005, included fees relating to the following:

| ($ in millions) | 2006 | 2005 |
|---|---|---|
| Structuring and diligence | $ 11.0 | $ 1.3 |
| Transaction and other services provided to portfolio companies | 0.1 | 1.2 |
| Management, consulting and other services provided to portfolio companies and guaranty fees | 5.7 | 4.8 |
| Other income | | 1.0 |
| Total fees and other income | $ 16.8 | $ 8.3 |

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level of investment activity and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Structuring and diligence fees for the three months ended March 31, 2006, included structuring fees from Advantage Sales and Marketing, CR Brands, Hot Stuff Foods, and 3SI Security Systems totaling $8.1 million. Structuring and diligence fees may vary substantially from period to period based on the level of new investment originations and the market rates for these types of fees. Private finance investments funded were $795.9 million for the three months ended March 31, 2006, as compared to $168.2 million for the three months ended March 31, 2005.

Management fees for the three months ended March 31, 2006, included $1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See Portfolio and Investment Activity above for further discussion.

Fees and other income related to the CMBS and CDO portfolio for the three months ended March 31, 2005, were $1.7 million. As noted above, we sold our CMBS and CDO portfolio on May 3, 2005.

*BLX and Advantage.* BLX was our largest investment at value at March 31, 2006, and represented 7.9% of our total assets. Advantage and BLX were our largest investments at March 31, 2005, and together represented 19.5% of our total assets.

Total interest and related portfolio income from these investments for the three months ended March 31, 2005 and 2006, was as follows:

| **($ in millions)** | **2006** | **2005** |
|---|---|---|
| Advantage[1] | $ 14.1 | $ 9.2 |
| BLX | $ 6.1 | $ 7.8 |

(1) Includes income from the period we held a majority equity interest only. See Portfolio and Investment Activity above for further discussion.

***Operating Expenses.*** Operating expenses include interest, employee, and administrative expenses.

*Interest Expense.* The fluctuations in interest expense during the three months ended March 31, 2006 and 2005, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and closing costs, at and for the three months ended March 31, 2006 and 2005, were as follows:

| | **At and for the Three Months Ended March 31,** | |
|---|---|---|
| **($ in millions)** | **2006** | **2005** |
| Total outstanding debt | $ 1,274.2 | $ 1,296.4 |
| Average outstanding debt | $ 1,491.5 | $ 1,125.0 |
| Weighted average cost[1] | 6.5% | 6.4% |

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

In addition, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of $0.2 million and $0.5 million for the three months ended March 31, 2006 and 2005, respectively.

*Employee Expense.* Employee expenses for the three months ended March 31, 2006 and 2005, were as follows:

| ($ in millions) | 2006 | 2005 |
|---|---|---|
| Salaries and employee benefits[1] | $ 17.3 | $ 12.0 |
| Individual performance award (IPA) | 1.7 | 1.9 |
| IPA mark to market expense (benefit) | 1.0 | 0.1 |
| Individual performance bonus (IPB) | 1.4 | 1.5 |
| Total employee expense | $ 21.4 | $ 15.5 |
| Number of employees at end of period | 155 | 158 |

(1) Salaries and employee benefits included accrued bonuses of $7.9 million and $3.7 million for the three months ended March 31, 2006 and 2005, respectively.

The change in salaries and employee benefits reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Salaries and employee benefits expense has generally increased due to changes in the composition of our employee resources and compensation increases.

The Individual Performance Award (IPA) is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.

As a result of changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting talent in the private equity industry, the Compensation Committee and the Board of Directors determined that for 2005 and 2006 a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB is distributed in cash to award recipients in equal bi-weekly installments (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2006. We currently estimate the IPA and IPB to be approximately $8.1 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

In connection with our 2006 Annual Meeting of Stockholders, the stockholders are being requested to vote to approve the issuance of up to 2,500,000 shares of our common stock in exchange for the cancellation of vested in-the-money stock options granted to certain officers and directors under the Amended Stock Option Plan. Under the initiative, which has been reviewed and approved by our Board of Directors, all optionees who hold vested stock options with exercise prices below the market value of the stock (or in-the-money options), would be offered the opportunity to receive cash and common stock in exchange for their voluntary cancellation of their vested stock options. The sum of the cash and common stock to be received by each optionee would equal the in-the-money value of the stock option cancelled. As part of this initiative, the Board of Directors is also considering the adoption of a target ownership structure that would establish minimum ownership levels for our senior officers and continue to further align the interests of our officers with those of our stockholders. Unlike the accounting treatment typically associated with a stock option exercise, the

option cancellation payment (OCP) would be recorded as an expense for financial reporting purposes, and the expense may be significant. Based on the 13 million vested options outstanding and the market price of $30.50 of our stock on March 10, 2006, the expense related to the OCP would be approximately $106 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. For income tax purposes, our tax expense resulting from the OCP would be similar to the tax expense that would result from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market would be limited by Section 162(m) of the Code for persons subject to Section 162(m).

*Employee Stock Options Expense.* In December 2004, the FASB issued Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement ), which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement was effective January 1, 2006, and it applies to our stock option plan. Our stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the service period. With respect to options granted prior to January 1, 2006, we have used the modified prospective method for adoption of the Statement. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the service period in the statement of operations beginning in 2006. With respect to options granted on or after January 1, 2006, compensation cost is recognized in the statement of operations over the service period. The effect of this adoption for the three months ended March 31, 2006, was employee-related stock option expense of $3.6 million, which included $3.4 million related to previously awarded options that were unvested as of January 1, 2006, and $0.2 million related to options granted during the three months ended March 31, 2006.

We estimate that the stock option expense that will be recorded in our statement of operations under the Statement, will be approximately $14.3 million, $9.3 million, and $2.8 million for the years ended December 31, 2006, 2007, and 2008, respectively, which includes stock option expense related to options granted in the first quarter of 2006 of approximately $0.8 million, $0.5 million, and $0.2 million, respectively. This estimate may change if the Company s assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant.

*Administrative Expense.* Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, stock record expenses, directors fees, and various other expenses. Administrative expenses for the three months ended March 31, 2006 and 2005, were as follows:

| **($ in millions)** | **2006** | **2005** |
|---|---|---|
| Administrative expenses, excluding investigation related costs | $ 8.6 | $ 8.5 |
| Investigation related costs | 2.9 | 12.3 |
| Total administrative expenses | $ 11.5 | $ 20.8 |

Investigation related costs include costs associated with requests for information in connection with two government investigations. These expenses remain difficult to predict. See Note 14 to the Consolidated Financial Statements.

***Income Tax Expense (Benefit), Including Excise Tax.*** Income tax expense (benefit) for the three months ended March 31, 2006 and 2005, were as follows:

| ($ in millions) | 2006 | 2005 |
|---|---|---|
| Income tax expense (benefit) | $ 0.5 | $ (0.3) |
| Excise tax expense | 8.4 | |
| Income tax expense (benefit), including excise tax | $ 8.9 | $ (0.3) |

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period. In addition, our estimated annual taxable income for 2006 currently exceeds our estimated dividend distributions to shareholders from such taxable income in 2006, and such estimated excess taxable income will be distributed in 2007. Therefore, we will be required to pay a 4% excise tax on the excess of 98% of our taxable income over the amount of actual distributions from such taxable income. Accordingly, we have accrued an estimated excise tax of $8.4 million for the three months ended March 31, 2006, based upon our estimated excess taxable income earned for that period. See Financial Condition, Liquidity and Capital Resources.

***Realized Gains and Losses.*** Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the three months ended March 31, 2006 and 2005, were as follows:

| | For the Three Months Ended March 31, | |
|---|---|---|
| ($ in millions) | 2006 | 2005 |
| Realized gains | $ 436.5 | $ 14.7 |
| Realized losses | (3.7) | (4.4) |
| Net realized gains | $ 432.8 | $ 10.3 |

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three months ended March 31, 2006 and 2005, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

| | For the Three Months Ended March 31, | |
|---|---|---|
| ($ in millions) | 2006 | 2005 |
| Reversal of previously recorded unrealized appreciation associated with realized gains | $ (393.6) | $ (9.9) |

| | | |
|---|---|---|
| Reversal of previously recorded unrealized depreciation associated with realized losses | 2.7 | 4.8 |
| Total reversal | $ (390.9) | $ (5.1) |

Realized gains for the three months ended March 31, 2006 and 2005, were as follows:
**($ in millions)**

**2006**

| **Portfolio Company** | **Amount** |
|---|---|
| **Private Finance:** | |
| Advantage Sales & Marketing, Inc. | $ 433.1 |
| Nobel Learning Communities, Inc. | 1.5 |
| The Debt Exchange Inc. | 1.1 |
| Other | 0.2 |
| Total private finance | 435.9 |
| **Commercial Real Estate:** | |
| Other | 0.6 |
| Total commercial real estate | 0.6 |
| Total gross realized gains | $ 436.5 |

**2005**

| **Portfolio Company** | **Amount** |
|---|---|
| **Private Finance:** | |
| Polaris Pool Systems, Inc. | $ 7.4 |
| U.S. Security Holdings, Inc. | 3.3 |
| Oriental Trading Company, Inc. | 1.0 |
| Woodstream Corporation | 0.9 |
| DCS Business Services, Inc. | 0.7 |
| Other | 0.9 |
| Total private finance | 14.2 |
| **Commercial Real Estate:** | |
| Other | 0.5 |
| Total commercial real estate | 0.5 |
| Total gross realized gains | $ 14.7 |

Realized losses for the three months ended March 31, 2006 and 2005, were as follows:
**($ in millions)**

**2006**

| Portfolio Company | Amount |
|---|---|
| **Private Finance:** | |
| Aspen Pet Products, Inc. | $ 1.5 |
| Nobel Learning Communities, Inc. | 1.4 |
| Other | 0.5 |
| Total private finance | 3.4 |
| **Commercial Real Estate:** | |
| Other | 0.3 |
| Total commercial real estate | 0.3 |
| Total gross realized losses | $ 3.7 |

**2005**

| Portfolio Company | Amount |
|---|---|
| **Private Finance:** | |
| Alderwoods Group, Inc. | $ 0.8 |
| Other | 0.3 |
| Total private finance | 1.1 |
| **Commercial Real Estate:** | |
| Other | 3.3 |
| Total commercial real estate | 3.3 |
| Total gross realized losses | $ 4.4 |

***Change in Unrealized Appreciation or Depreciation.*** We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At March 31, 2006, portfolio investments recorded at fair value were approximately 90% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

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

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

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

As a participant in the private equity business, we invest primarily in private middle market companies for which there is generally no publicly available information. Because of the private nature of these businesses, there is a need to maintain the confidentiality of the financial and other information that we have for the private companies in our portfolio. We believe that maintaining this confidence is important, as disclosure of such information could disadvantage our portfolio companies and could put us at a disadvantage in attracting new investments. Therefore, we do not intend to disclose financial or other information about our portfolio companies, unless required, because we believe doing so may put them at an economic or competitive disadvantage, regardless of our level of ownership or control.

We will continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter. In addition, we may receive third-party assessments of a particular private finance portfolio company s value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these third-party valuation resources, when applicable, is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

For the three months ended March 31, 2006 and 2005, we received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey) for our private finance portfolio as follows: