TC02-160

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TC02-160

DOCKET NO.

In the Matter of IN THE MATTER OF THE APPLICATION OF ALL-STAR ACQUISITION CORPORATION FOR A CERTIFICATE OF AUTHORITY TO PROVIDE INTEREXCHANGE TELECOMMUNICATIONS SERVICES IN SOUTH DAKOTA

Public Utilities Commission of the State of South Dakota

DATE		MEMORANDA
9/19	02	Filed and Docketed;
9/26	02	Weekly Filing;
10/25	02	Request for Waiver of ARSD 20:10:24:02(8);
12/2	02	Order Granting COA;
12/2	02	Docket Closed.

TC02-160

EARLY, LENNON, CROCKER & BARTOSIEWICZ, P.L.C.

ATTORNEYS AT LAW
900 COMERICA BUILDING
KALAMAZOO, MICHIGAN 49007-4752
TELEPHONE (269) 381-8844
FAX (269) 226-4378

RECEIVED
SEP 19 2002
SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

September 18, 2002

Debra Elofson, Executive Director
South Dakota Public Utilities Commission
State Capitol Building
500 East Capital Avenue
Pierre, SD 57501

RE: All-Star Acquisition Corporation

Dear Ms. Elofson:

Enclosed herewith for filing with the Commission, please find an original and ten (10) copies of the above captioned corporation's APPLICATION FOR A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY TO TRANSACT THE BUSINESS OF A RESELLER OF INTEREXCHANGE TELECOMMUNICATIONS SERVICES AND FOR APPROVAL OF ITS INITIAL TARIFF, along with a check in the amount of $250.00 to cover the filing fees related to same.

Also enclosed is an exact duplicate of this letter. Please stamp the duplicate andreturn same in the enclosed, postage-paid envelope.

Should you have any questions, please contact me.

Very truly yours,

EARLY, LENNON, CROCKER & BARTOSIEWICZ, P.L.C.

Patrick D. Crocker

PDC/bmr

enc

TC02-160

RECEIVED

SEP 19 2002

SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

BEFORE THE
PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA

IN THE MATTER OF:

THE APPLICATION OF)
All-Star Acquisition Corporation)
FOR A CERTIFICATE OF PUBLIC CONVENIENCE)
AND NECESSITY TO TRANSACT THE BUSINESS)
OF A RESELLER OF INTEREXCHANGE) SDPUC Docket No.
TELECOMMUNICATIONS SERVICES)
AND FOR APPROVAL OF ITS INITIAL TARIFF)

APPLICATION FOR AUTHORIZATION

All-Star Acquisition Corporation (hereinafter "Applicant") respectfully requests that the Public Utilities Commission of the State of South Dakota (hereinafter referred to as "Commission") grant Applicant authority pursuant to SDCL 49-31-3 and in accordance with ARSD 20:10:24:02 to provide intrastate telecommunications services to the public within South Dakota through the resale of similar services offered by other interexchange carriers ("IXCs") in the State. Applicant further requests that the Commission approve its initial proposed tariff. Applicant, for purposes of verification, and in evidence of its fitness to operate and the public need for its services, offers the following information in support of this Application:

Identification of the Applicant

1. Applicant's name, address, and telephone number:

All-Star Acquisition Corporation
1151 Seven Locks Road
Potomac, MD 20854
(301) 610-4300

2. Applicant is organized under the laws of the State of Delaware. A copy of the Company's Certificate of Incorporation is attached hereto as **Exhibit A**. Applicant has the authority to transact business within the State of South Dakota as a foreign corporation. A copy of the qualifying document is set forth in **Exhibit B** hereto.

3. Correspondence regarding this Application should be directed to:

Patrick D. Crocker
EARLY, LENNON, CROCKER & BARTOSIEWICZ, P.L.C.
900 Comerica Building
Kalamazoo, MI 49007-4752
Telephone: (269) 381-8844
Facsimile: (269) 381-8822
pcrocker@earlylennon.com

4. Applicant's registered agent is:

Ronald D. Olinger
117 East Capitol
Pierre, SD 57501

Description of Authority Requested

5. Applicant seeks authority to operate as a reseller of intrastate telecommunications services to the public on a statewide basis. Applicant seeks authority to offer a full range of "1+" interexchange telecommunications services on a resale basis. Specifically, Applicant seeks authority to provide MTS, in-WATS, out-WATS, and Calling Card services.

6. Applicant does not intend to provide operator services, 900 or 700 services.

7. Applicant owns no transmission facilities. Applicant will offer service to its subscribers using facilities of the communications networks of Startec Global Licensing Company, other facilities-based IXCs and the local exchange telephone companies ("LECs").

8. Applicant has no plans at this time to construct any telecommunications transmission facilities of its own and seeks no construction authority by means of this Application. Applicant will operate exclusively as a reseller.

9. Applicant will abide by all rules governing telecommunications resellers, which the Commission has promulgated or may promulgate in the future, unless application of such rules in specifically waived by the Commission.

Proposed Services

10. Applicant intends to offer MTS, in-WATS, out-WATS, and Calling Card services to subscribers within South Dakota. Applicant combines high quality transmission services with very competitive rates, flexible end user billing, professional customer service and excellent reporting to create a unique blend, which meets the individualized needs of such customers.

11. Applicant's services are designed to be especially attractive to residential and business users.

12. Applicant's intends to engage in "switchless" resale. Applicant will arrange for the traffic of underlying subscribers to be routed directly over the networks of Applicant's network providers.

13. Applicant is committed to the use of ethical sales practices. All distributors of its products must commit in writing to market Applicant's services in a professional manner, and to fairly and accurately portray Applicant's services and the charges for them.

Description and Fitness of Applicant

14. Applicant's officers have extensive managerial, financial and technical experience with which to execute the business plan described herein. In support of Applicant's managerial and technical ability to provide the services for which authority is sought herein, Applicant submits a description of the background and experience of its management team as **Exhibit C.** In support of Applicant's financial ability to provide the proposed services, Applicant attaches financials as **Exhibit D.**

Public Interest Considerations

15. Applicant's entry into the South Dakota marketplace is in the public interest because Applicant intends to make a uniquely attractive blend of service quality, network management and reporting, and low rates available.

16. In addition to the direct benefits delivered to the public by its services, Applicant's entry into the South Dakota marketplace will benefit the public indirectly by increasing the competitive pressure felt by existing IXCs, spurring them to lower costs and improve services in response.

Requested Regulatory Treatment

17. Applicant is a non-dominant reseller of interexchange telecommunications services. Applicant requests to be regulated by the Commission in the same relaxed fashion extended to other, similarly situated resellers.

Initial Proposed Tariff

18. Applicant proposes to offer service pursuant to the rules, regulations, rates and other terms and conditions included in Applicant's initial proposed tariff, which is attached hereto as **Exhibit E.** Billing, payment, credit, deposit and collection terms are set forth in Applicant's proposed tariff.

Compliance with ARSD 20:10:24:02

19. In accordance with ARSD 20:10:24:02, Applicant provides the following information:

(1) The name, address and telephone number of Applicant:

ALL-STAR ACQUISITION CORPORATION
1151 Seven Locks Road
Potomac, MD 20854
(301) 610-4300

(2) Applicant shall provide services under the name:

ALL-STAR ACQUISITION CORPORATION

(3) (a) Applicant was incorporated in the State of Delaware on October 30, 2001. A copy of Applicant's Certificate of Incorporation is attached as Exhibit A. A copy of its certificate of authority to transact business within the State of South Dakota as a foreign corporation is attached as Exhibit B.

(b) Applicant has no principal office in South Dakota. Applicant's registered agent is Ronald D. Olinger, 117 East Capitol, Pierre, SD 57501.

(c) Applicant owns or controls no subsidiaries. The names and addresses of Applicant's shareholders along with percentage owned and current Officers and Board of Directors:

Shareholder:	Allied Capital Corporation 1919 Pennsylvania Avenue, NW Washington, DC 20006	100%
Officers:	Christine Greene 1151 Seven Locks Road Potomac, MD 20854	President/Treasurer
	James Morgan 1151 Seven Locks Road Potomac, MD 20854	Secretary

(4) Applicant is a corporation organized under the laws of Delaware.

(5) See paragraph 5 of the Application.

(6) See paragraph 6 of the Application.

(7) Applicant shall offer services on all equal-access areas within the State of South Dakota. Accordingly, Applicant does not attach a map describing service boundaries.

(8) See Exhibits D and E attached hereto.

(9) (a) All complaints and regulatory matters should be directed to Applicant's attorney as set forth in paragraph 3 of this Application.

(b) Billing to customers will be scheduled monthly. Payment is due by the invoice date printed on the bill. The Company may impose a late charge of 1.5% per month on any delinquent amounts. Applicant will use Billing Concepts, Inc., d/b/a USBI as its billing agents.

(c) Customer service representatives will handle all initial customer disputes. A representative may escalate the resolution of a dispute internally, or refer the customer to the Commission. Customers may reach a representative by calling 1-800-313-2677.

(10) Applicant is a newly formed company that is seeking authority to provide the resale of telecommunications services throughout the United States. Applicant is currently authorized to provide intrastate services in the following jurisdictions: Colorado, District of Columbia, Iowa, Michigan, Montana, New Jersey, Pennsylvania, Texas, Utah, and Virginia. Additionally, Applicant has never been denied registration or certification in any jurisdiction and is in good standing with the regulatory agency in each jurisdiction.

(11) Applicant plans to market their services via advertising, direct marketing, website, and independent distributors. Applicant has no promotional materials at this time.

(12) See paragraph 20 of the Application.

(13) Applicant's federal tax identification number is 01-0741301.

(14) Applicant has not received complaints with any state or federal regulatory commission regarding the unauthorized switching of a customer's telecommunications provider or for the act of charging customers for services that have not been ordered.

(15) Applicant requests a waiver of the cash flow statement required in 20:10:24:02(8).

(16) Applicant agrees with the restrictions relating to prepaid services and deposits.

Applicant's Cost for Underlying Transport Services

20. Applicant proposes to resell services within South Dakota in excess of Applicant's cost of purchasing services from Applicant's underlying carrier Startec Global Licensing Company. Applicant purchases intrastate services from Startec Global Licensing Company and resells to the public as follows:

	Buy	Sell
Switched Inbound	.03	.10
Switched Outbound	.03	.10

Conclusion

21. A decision by the Commission to grant Applicant a Certficate of Public Convenience and Necessity is plainly in the public interest. Applicant will introduce important new products and services at very competitive rates as well as enhance the competitiveness of the overall long distance market in South Dakota.

WHEREFORE, ALL-STAR ACQUISITION CORPORATION respectfully requests that this Commission grant it authority to transact the business of a reseller of interexchange telecommunications services within the State of South Dakota, that the Commission regulate it in a streamlined fashion, and that the Commission approve Applicant's initial proposed tariff effective on the date of the Order granting authority.

Respectfully submitted,

ALL-STAR ACQUISITION CORPORATION

Dated: September 18, 2002 By: ______________________________

Patrick D. Crocker
Early, Lennon, Crocker & Bartosiewicz, P.L.C.
900 Comerica Building
Kalamazoo, MI 49007-4752
Its: Attorneys

VERIFICATION

Patrick D. Crocker, Attorney for ALL-STAR ACQUISITION CORPORATION, first being duly sworn on oath, deposes and says that he has read the foregoing Application and verifies that the statements made therein are true and correct to the best of his knowledge, information, and belief.

ALL-STAR ACQUISITION CORPORATION

By: ______________________________
Patrick D. Crocker
Early, Lennon, Crocker & Bartosiewicz, P.L.C.
Its: Attorneys

The foregoing instrument was acknowledged before me this 18th day of September 2002, by Patrick D. Crocker.

Cheryl L. Adams
____
Notary Public: Cheryl L. Adams
Commission Expires: 06/24/05
County of Kalamazoo, Michigan

<u>EXHIBIT A</u>

Certificate of Incorporation

Delaware

The First State

I, HARRIET SMITH WINDSOR, SECRETARY OF STATE OF THE STATE OF DELAWARE, DO HEREBY CERTIFY THE ATTACHED IS A TRUE AND CORRECT COPY OF THE CERTIFICATE OF INCORPORATION OF "ALL-STAR ACQUISITION CORPORATION", FILED IN THIS OFFICE ON THE THIRTIETH DAY OF OCTOBER, A.D. 2001, AT 9 O'CLOCK A.M.

Harriet Smith Windsor

Harriet Smith Windsor, Secretary of State

3451678 8100

020535409

AUTHENTICATION: 1951960

DATE: 08-23-02

Delaware

The First State

I, HARRIET SMITH WINDSOR, SECRETARY OF STATE OF THE STATE OF DELAWARE, DO HEREBY CERTIFY "ALL-STAR ACQUISITION CORPORATION" IS DULY INCORPORATED UNDER THE LAWS OF THE STATE OF DELAWARE AND IS IN GOOD STANDING AND HAS A LEGAL CORPORATE EXISTENCE SO FAR AS THE RECORDS OF THIS OFFICE SHOW, AS OF THE TWENTY-THIRD DAY OF AUGUST, A.D. 2002.

AND I DO HEREBY FURTHER CERTIFY THAT THE SAID "ALL-STAR ACQUISITION CORPORATION" WAS INCORPORATED ON THE THIRTIETH DAY OF OCTOBER, A.D. 2001.

AND I DO HEREBY FURTHER CERTIFY THAT THE FRANCHISE TAXES HAVE BEEN PAID TO DATE.

Harriet Smith Windsor

Harriet Smith Windsor, Secretary of State

3451678 8300

020535414

AUTHENTICATION: 1957820

DATE: 08-23-02

STATE OF DELAWARE
SECRETARY OF STATE
DIVISION OF CORPORATIONS
FILED 09:00 AM 10/30/2001
010544698 - 3451678

CERTIFICATE OF INCORPORATION
of
All-Star Acquisition Corporation

THE UNDERSIGNED, Jeffrey L. Poersch, for the purpose of organizing a corporation for conducting the business and promoting the purposes hereinafter stated, under the provisions and subject to the requirements of the laws of the State of Delaware (particularly Chapter 1, Title 8 of the Delaware Code and the acts amendatory thereof and supplemental thereto and known, identified and referred to as the "DGCL"), hereby certifies that:

FIRST. Name. The name of the Corporation (which is hereinafter called the "***Corporation***") is:

All-Star Acquisition Corporation

SECOND. Registered Office and Agent. The address of the registered office of the Corporation in the State of Delaware is Corporation Trust Center, 1209 Orange Street, County of New Castle, Wilmington, Delaware 19801. The name of its registered agent at such address is The Corporation Trust Company.

THIRD. Purpose. (a) The purposes for which and any of which the Corporation is formed and the business and objects to be carried on and promoted by it are:

(1) To engage in any lawful acts or activities for which corporations may be organized under the DGCL.

(2) To do and perform all acts necessary or desirable to carry out any of the foregoing purposes

(3) To engage in any other lawful act or activity for which corporations may be organized under DGCL, whether or not related to the business described elsewhere in this Article or to any other business at the time or theretofore engaged in by the Corporation.

(b) The foregoing enumerated purposes and objects shall be in no way limited or restricted by reference to, or inference from, the terms of any other clause of this or any other Article of this Certificate of Incorporation, and each shall be regarded as independent; and they are intended to be and shall be construed as powers as well as purposes and objects of the Corporation and shall be in addition to and not in limitation of the general powers of corporations under the DGCL.

FOURTH. Authorized Capital (a) The total number of shares of capital stock of all classes that the Corporation shall have authority to issue is one thousand (1,000) shares, all of which shares shall initially be classified as common stock, *$0 par value per share* (the "***Common Stock***"). The Board of Directors of the Corporation (the "***Board of Directors***") may, by resolution or resolutions, classify and reclassify any unissued shares of capital stock by setting or changing in any one or more respects the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications or terms or conditions of redemption of such shares of stock.

(b) The following is a description of the preferences, conversion and other rights, voting powers, restrictions, limitations as to dividends, qualifications and terms and conditions of redemption of the Common Stock of the Corporation.

(1) Each share of Common Stock shall have one vote, and, except as otherwise provided in respect of any class of stock hereafter classified or reclassified, the exclusive voting power for all purposes shall be vested in the holders of the Common Stock.

(2) Subject to the provisions of law and any preferences of any class of stock hereafter classified or reclassified, dividends, including dividends payable in shares of another class of the Corporation's stock, may be paid on the Common Stock of the Corporation at such time and in such amounts as the Board of Directors may deem advisable.

(3) In the event of any liquidation, dissolution or winding up of the Corporation, whether voluntary or involuntary, the holders of the Common Stock shall be entitled, after payment or provision for payment of the debts and other liabilities of the Corporation and the amount to which the holders of any class of stock hereafter classified or reclassified having a preference on distributions in the liquidation, dissolution or winding up of the Corporation shall be entitled, together with the holders of any other class of stock hereafter classified or reclassified not having a preference on distributions in the liquidation, dissolution or winding up of the Corporation, to share ratably in the remaining net assets of the Corporation

(c) Authority is hereby expressly granted to the Board of Directors, subject to the provisions of this Article FOURTH and to the limitations prescribed by the DGCL: (1) to classify and reclassify any of the shares of capital stock of the Corporation, including, without limitation, the classification or reclassification of any unissued shares of such stock into a class or classes of preferred stock, preference stock, special stock or other stock, (2) to authorize the issuance of one or more of such classes of stock and, with respect to each such class, (3) to fix by resolution or resolutions providing for the issue of such class, the voting powers, full or limited, if any, of the shares of such class, the designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof.

FIFTH. Term. The Corporation is to have perpetual existence.

SIXTH. Management of the Affairs of the Corporation. (a) The business and affairs of the Corporation shall be managed by its Board of Directors, which may exercise all the powers of the Corporation and do all such lawful acts and things that are not conferred upon or reserved to the stockholders by law, by this Certificate or by the By-laws of the Corporation (the "***By-laws***").

(b) The following provisions are hereby adopted for the purpose of defining, limiting, and regulating the powers of the Corporation and of its directors and stockholders:

(1) The Board of Directors shall have the power to make, alter, amend, change or repeal the By laws by the affirmative vote of a majority of the members of the Board of Directors then in office. In addition, the By-laws may be made, altered, amended, changed or repealed by the stockholders of the Corporation upon the affirmative vote of the holders of at least 51% of the outstanding capital stock entitled to vote thereon.

(2) The number of directors of the Corporation shall initially be one, which number may be increased or decreased pursuant to the By-laws of the Corporation, but shall never be less than the minimum number permitted by the DGCL now or hereafter in force. The name and address of the person who shall serve as the initial director of the Corporation is:

Ram Mukunda
1151 Seven Locks Road
Potomac, MD 20854

(3) The Board of Directors is hereby empowered to authorize the issuance from time to time of shares of its stock of any class, whether now or hereafter authorized, or securities convertible into shares of its stock of any class or classes, whether now or hereafter authorized, for such consideration as may be deemed advisable by the Board of Directors and without any action by the stockholders.

(4) No holder of any stock or any other securities of the Corporation, whether now or hereafter authorized, shall have any preemptive right to subscribe for or purchase any stock or any other securities of the Corporation other than such, if any, as the Board of Directors, in its sole discretion, may determine and at such price or prices and upon such other terms as the Board of Directors, in its sole discretion, may fix; and any stock or other securities which the Board of Directors may determine to offer for subscription may, as the Board of Directors in its sole discretion shall determine, be offered to the holders of any class, series or type of stock or other securities at the time outstanding to the exclusion of the holders of any or all other classes, series or types of stock or other securities at the time outstanding.

(5) The Board of Directors of the Corporation shall, consistent with applicable law, have power in its sole discretion to determine from time to time in accordance with sound accounting practice or other reasonable valuation methods what constitutes annual or other net profits, earnings, surplus, or net assets in excess of capital; to fix and vary from time to time the amount to be reserved as working capital, or determine that retained earnings or surplus shall remain in the hands of the Corporation; to set apart out of any funds of the Corporation

such reserve or reserves in such amount or amounts and for such proper purpose or purposes as it shall determine and to abolish any such reserve or any part thereof; to distribute and pay distributions or dividends in stock, cash or other securities or property, out of surplus or any other funds or amounts legally available therefor, at such times and to the stockholders of record on such dates as it may, from time to time, determine; and to determine whether and to what extent and at what times and places and under what conditions and regulations the books, accounts and documents of the Corporation, or any of them, shall be open to the inspection of stockholders, except as otherwise provided by statute or by the By-laws, and, except as so provided, no stockholder shall have any right to inspect any book, account or document of the Corporation unless authorized to do so by resolution of the Board of Directors.

(6) Notwithstanding any provision of law requiring the authorization of any action by a greater proportion than a majority of the total number of shares of all classes of capital stock or of the total number of shares of any class of capital stock, such action shall be valid and effective if authorized by the affirmative vote of the holders of a majority of the total number of shares of all classes outstanding and entitled to vote thereon, except as otherwise provided in this Certificate.

(c) The enumeration and definition of particular powers of the Board of Directors included in the foregoing shall in no way be limited or restricted by reference to or inference from the terms of any other clause of this or any other Article of this Certificate, or construed as or deemed by inference or otherwise in any manner to exclude or limit any powers conferred upon the Board of Directors under the DGCL now or hereafter in force. The Corporation may in its By-laws confer powers upon the Board of Directors in addition to the foregoing and in addition to the powers and authorities expressly conferred upon the Board of Directors by applicable law.

SEVENTH. Limitation on Liability. No director of the Corporation shall be personally liable to the Corporation or to any stockholder of the Corporation for monetary damages for breach of fiduciary duty as a director, provided that this provision shall not limit the liability of a director (i) for any breach of the director's duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or which involved intentional misconduct or a knowing violation of law, (iii) under Section 174 of the DGCL, or (iv) for any transaction from which the director derived an improper personal benefit.

If the DGCL or any other statute of the State of Delaware hereafter is amended to authorize the further elimination or limitation of the liability of directors of the Corporation, then the liability of a director of the Corporation shall be limited to the fullest extent permitted by the statutes of the State of Delaware, as so amended, and such elimination or limitation of liability shall be in addition to, and not in lieu of, the limitation on the liability of a director provided by the foregoing provisions of this Article SEVENTH

Any repeal of or amendment to this Article SEVENTH shall be prospective only and shall not adversely affect any limitation on the liability of a director of the Corporation existing at the time of such repeal or amendment

EIGHTH. Meetings of Stockholders. Meetings of stockholders may be held within or without the State of Delaware, as the By-laws may provide.

NINTH. Corporate Records. The books of the Corporation may be kept (subject to any provision contained in applicable statutes) outside the State of Delaware at such place or places as may be designated from time to time by the Board of Directors or the President or in the By-laws.

TENTH. Right to Amend. The Corporation reserves the right to amend, alter, change or repeal any provision contained in this Certificate and in any certificate amendatory hereof, including amendments changing the terms or contract rights, as expressly set forth in this Certificate, of any of the Corporation's outstanding stock by classification, reclassification or otherwise, in the manner now or hereafter prescribed by statute, and all rights conferred upon stockholders or others hereunder or thereunder are granted subject to this reservation.

ELEVENTH. Indemnification. (a) The Corporation shall, to the fullest extent permitted by Section 145 of the DGCL, indemnify each person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative, by reason of the fact that he is or was, or has agreed to become, a director or officer of the Corporation, or is or was serving, or has agreed to serve, at the request of the Corporation, as a director, officer or trustee of, or in a similar capacity with, another corporation, partnership, joint venture, trust or other enterprise (including any employee benefit plan), or by reason of any action alleged to have been taken or omitted in such capacity, against all expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by him or on his behalf in connection with such action, suit or proceeding and any appeal therefrom.

(b) Indemnification may include payment by the Corporation of expenses in defending an action or proceeding in advance of the final disposition of such action or proceeding upon receipt of an undertaking by the person indemnified to repay such payment if it is ultimately determined that such person is not entitled to indemnification under this Article ELEVENTH, which undertaking may be accepted without reference to the financial ability of such person to make such repayment.

(c) The Corporation shall not indemnify any such person seeking indemnification in connection with a proceeding (or part thereof) initiated by such person unless the initiation thereof was approved by the Board of Directors of the Corporation as provided in the By-laws.

(d) The indemnification rights provided in this Article ELEVENTH (i) shall not be deemed exclusive of any other rights to which those indemnified may be entitled under any law, agreement or vote of stockholders or disinterested directors or otherwise, and (ii) shall inure to the benefit of the heirs, executors and administrators of such persons. The Corporation may, to the extent authorized from time to time by its Board of Directors, grant indemnification rights to other employees or agents of the Corporation or other persons serving the Corporation and such rights may be equivalent to, or greater or less than, those set forth in this Article ELEVENTH.

(e) No amendment of this Certificate or repeal of any of its provisions shall limit or eliminate the right to indemnification provided hereunder with respect to acts or omissions occurring prior to such amendment or repeal.

TWELFTH. Incorporator. The name and mailing address of the sole incorporator is Jeffrey L. Poersch, Esq., c/o Startec Global Operating Company, 1151 Seven Locks Road, Potomac, Maryland 20854.

THIRTEENTH. The Corporation expressly elects not to be governed by Section 203 of the DGCL.

This Certificate shall be effective upon its filing with the Secretary of State of the State of Delaware.

IN WITNESS WHEREOF, the undersigned, for the purpose of forming a corporation pursuant to the DGCL, does make, file and record this Certificate of Incorporation and does hereby certify that the facts herein stated are true, and accordingly hereto sets his hand this 30th day of October, 2001.

Jeffrey L. Poersch, Incorporator

BaltZ:439108 3/8/22/00
29804-1

EXHIBIT B

Certificate of Authority to Transact Business as a Foreign Corporation

State of South Dakota

OFFICE OF THE SECRETARY OF STATE

Certificate of Authority

ORGANIZATIONAL ID #: FB026582

I, JOYCE HAZELTINE, Secretary of State of the State of South Dakota, hereby certify that the Application for a Certificate of Authority of **ALL-STAR ACQUISITION CORPORATION (DE)** to transact business in this state duly signed and verified pursuant to the provisions of the South Dakota Corporation Acts, have been received in this office and are found to conform to law.

ACCORDINGLY and by virtue of the authority vested in me by law, I hereby issue this Certificate of Authority and attach hereto a duplicate of the application to transact business in this state.

IN TESTIMONY WHEREOF, I have hereunto set my hand and affixed the Great Seal of the State of South Dakota, at Pierre, the Capital, this September 4, 2002.

Joyce Hazeltine
Secretary of State

Secretary of State
State Capitol
500 E. Capitol Ave.
Pierre SD 57501
Phone 605-773-4845
Fax 605-773-4550

FILE NO. ____________

RECEIPT NO. ____________

RECEIVED
SEP 04 '02
S.D. SEC. of STATE

Application for Certificate of Authority

Pursuant to the provisions of SDCL 47-8-7, the undersigned corporation hereby applies for a Certificate of Authority to transact business in the State of South Dakota and for that purpose submits the following statement:

(1) The name of the corporation is ALL-STAR ACQUISITION CORPORATION
(exact corporate name)

(2) If the name of the corporation does not contain the word "corporation", "company", "incorporated" or "limited" or does not contain an abbreviation of one of such words, then the name of the corporation with the word or abbreviation which it elects to add thereto for use in this state is

(3) State where incorporated Delaware Federal Taxpayer ID# 01-0741301

(4) The date of its incorporation is October 30, 2001 and the period of its duration, which may be perpetual, is perpetual.

(5) The address of its principal office in the state or country under the laws of which it is incorporated is
1209 Orange Street, Wilmington, DE Zip Code 19801
mailing address if different from above is: 1151 Seven Locks Road, Potomac, MD Zip Code 20854

(6) The street address, or a statement that there is no street address, of its proposed registered office in the State of South Dakota is
117 East Capitol, Pierre, SD Zip Code 57501
and the name of its proposed registered agent in the State of South Dakota at that address is Ronald D. Olinger.

(7) The purposes which it proposes to pursue in the transaction of business in the State of South Dakota are: (state specific purpose)

Provision of intrastate, interstate and international telecommunications services

(8) The names and respective addresses of its directors and officers are:

Name	Officer Title	Street Address	City	State	Zip
Christine Greene	Dir., Pres., Treas.	1151 Seven Locks Rd.,	Potomac,	MD	20854
James E. Morgan	Secretary	1151 Seven Locks Rd.,	Potomac,	MD	20854

(9) The aggregate number of shares which it has authority to issue, itemized by classes, par value of shares, shares without par value, and series, if any, within a class is:

Number of shares	Class	Series	Par value per share or statement that shares are without par value
1,000	Comon	--	without par value

Filed this 4th day of Sept, 2002
[signature]
SECRETARY OF STATE

(10) The aggregate number of its issued shares, itemized by classes, par value of shares, shares without par value, and series, if any, within a class, is:

Number of shares	Class	Series		Par value per share or statement that shares are without par value
1	Common	---		without par value

(11) The amount of its stated capital is $ 1,000.00
Shares issued times par value equals stated capital. In the case of no par value stock, stated capital is the consideration received for the issued shares.

(12) This application is accompanied by a CERTIFICATE OF FACT or a CERTIFICATE OF GOOD STANDING duly acknowledged by the Secretary of State or other officer having custody of corporate records in the state or country under whose laws it is incorporated.

(13) That such corporation shall not directly or indirectly combine or make any contract with any incorporated company, foreign or domestic, through their stockholders or the trustees or assigns of such stockholders, or with any copartnership or association of persons, or in any manner whatever to fix the prices, limit the production or regulate the transportation of any product or commodity so as to prevent competition in such prices, production or transportation or to establish excessive prices therefor.

(14) That such corporation, as a consideration of its being permitted to begin or continue doing business within the State of South Dakota, will comply with all the laws of the said State with regard to foreign corporations.

The application must be signed, in the presence of a notary public, by the chairman of the board of directors, or by the president or by another officer.

I DECLARE AND AFFIRM UNDER THE PENALTY OF PERJURY THAT THIS APPLICATION IS IN ALL THINGS, TRUE AND CORRECT.

Dated August 27, 2002

(Signature)

Secretary
(Title)

STATE OF MARYLAND
COUNTY OF MONTGOMERY
I, Glenda L Alberstadt, a notary public, do hereby certify that on this 27th day of August 2002, personally appeared before me James E. Morgan who, being by me first duly sworn, declared that he/she is the Secretary of ALL-STAR ACQUISITION CORPORATION that he/she signed the foregoing document as officer of the corporation, and the statements therein contained are true.

August 1, 2003
My Commission Expires

(Notary Public)

GLENDA L. ALBERSTADT NOTARY PUBLIC FREDERICK CO., MD.

Notarial Seal

****

The Consent of Appointment below must be signed by the registered agent listed in number six.

Consent of Appointment by the Registered Agent

I, Ronald D. Olinger, hereby give my consent to serve as the registered
(name of registered agent)
agent for ALL-STAR ACQUISITION CORPORATION.
(corporate name)

Dated 9-4 2002

(signature of registered agent)

<u>EXHIBIT C</u>

Background and Experience of Management Team

Christine Greene - Chief of Staff, Startec Global Communications.

Ms. Greene joined Startec in 1998 Managing the Office of the President, HR and Administration. Prior to joining Startec, Ms. Greene was the Exec. Assoc. to the President of Snyder Communications, Prior to joining Snyder was a Real Estate Agent in the metropolitan area, prior to that was abroad on assignment in Yokosuka, Japan.

James E. Morgan

152 F Street, SE
Washington, DC 20003
w: (301) 610-4646, h: (202) 544-3006

EXPERIENCE

Startec Global Communications Corporation — **Potomac, MD**
Corporate Counsel — *January, 2002 – present*
Associate Corporate Counsel — *December, 2000 – January, 2002*

- Draft, review and negotiate vendor contracts, service agreements, web hosting and affiliate program agreements, loan documents, debt instruments, non-disclosure agreements, licenses, real property leases, and other corporate and commercial documents.
- Manage compliance with state and federal telecommunications regulations; oversee non-US regulatory licensing and compliance matters.
- Maintain corporate books and records for parent entity, domestic and foreign subsidiaries; draft documentation for same.
- Review and revise court filings in civil litigation matters; assist with settlement of same.

Shook, Hardy & Bacon, L.L.P. — **Washington, DC**
Associate, Communications Group — *September, 1998 – December, 2000*

- Represented clients in all aspects of regulatory proceedings before the Federal Communications Commission and Federal Trade Commission.
- Assisted with the drafting of purchase and sale agreements and other corporate law matters.
- Researched various broadcast, wireless and wireline communications law issues.

Federal Communications Commission — **Washington, DC**
Office of Commissioner Gloria Tristani
Legal Intern — *January - April, 1998*

- Prepared summaries of pending Commission decisions and advised Commissioner on same.
- Researched communications policy issues involving each of the Commission's bureaus.
- Responded to inquiries from members of Congress on mass media and common carrier issues.

Ginsburg, Feldman & Bress — **Washington, DC**
Summer Associate — *May - August, 1997*

Federal Communications Commission — **Washington, DC**
Common Carrier Bureau, Network Services Division
Legal Intern — *January - May, 1997*

United States Department of Justice — **Washington, DC**
Criminal Division, Fraud Section
Legal Intern — *June - August, 1996*

Democratic Senatorial Campaign Committee (DSCC) — **Washington, DC**
Deputy Political Director — *January, 1993 - August, 1995*
Press Assistant — *December, 1991 - January, 1993*

EDUCATION

The George Washington University Law School, Washington, DC
J.D., with honors, May 1998
Managing Editor, *The George Washington Journal of International Law & Economics*

University of Pennsylvania
B.A., cum laude, Economics/International Relations, May 1991

Bar Admissions: Maryland (1998), District of Columbia (1999)

EXHIBIT D

Financials

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

QUARTERLY REPORT PURSUANT TO
SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For The Quarterly Period Ended June 30, 2002	**Commission File Number: 0-22832**

ALLIED CAPITAL CORPORATION

(Exact Name of Registrant as Specified in its Charter)

Maryland	**52-1081052**
(State or Jurisdiction of Incorporation or Organization)	*(IRS Employer Identification No.)*

1919 Pennsylvania Avenue, N.W.
Washington, DC 20006
(Address of Principal Executive Offices)

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

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

On August 13, 2002 there were 102,306,364 shares outstanding of the Registrant's common stock, $0.0001 par value.

ALLIED CAPITAL CORPORATION

FORM 10-Q INDEX

PART I: FINANCIAL INFORMATION

Item 1. ***Financial Statements***

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	June 30, 2002 (unaudited)	December 31, 2001
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2002-$512,468; 2001-$451,705)	$ 632,560	$ 505,620
Companies 5% to 25% owned (cost: 2002-$235,879; 2001-$211,030)	264,691	232,399
Companies less than 5% owned (cost: 2002-$832,665; 2001-$891,231)	738,008	857,053
Total private finance	1,635,259	1,595,072
Commercial real estate finance (cost: 2002-$724,240; 2001-$732,636)	745,710	734,518
Total portfolio at value	2,380,969	2,329,590
Other assets	183,328	130,234
Cash and cash equivalents	4,319	889
Total assets	$2,568,616	$2,460,713
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Notes payable and debentures	$ 869,200	$ 876,056
Revolving credit facility	139,750	144,750
Accounts payable and other liabilities	118,213	80,784
Total liabilities	1,127,163	1,101,590
Commitments and Contingencies		
Preferred stock	7,000	7,000
Shareholders' equity:		
Common stock, $0.0001 par value, 200,000,000 shares authorized; 102,296,392 and 99,607,396 shares issued and outstanding at June 30, 2002 and December 31, 2001, respectively	10	10
Additional paid-in capital	1,417,356	1,352,688
Notes receivable from sale of common stock	(28,190)	(26,028)
Net unrealized appreciation on portfolio	64,118	39,981
Distributions in excess of earnings	(18,841)	(14,528)
Total shareholders' equity	1,434,453	1,352,123
Total liabilities and shareholders' equity	$2,568,616	$2,460,713
Net asset value per common share	$ 14.02	$ 13.57

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share amounts)	For the Three Months Ended June 30, 2002	For the Three Months Ended June 30, 2001	For the Six Months Ended June 30, 2002	For the Six Months Ended June 30, 2001
	(unaudited)		(unaudited)	
Interest and related portfolio income:				
Interest and dividends				
Companies more than 25% owned	$ 9,342	$ 5,280	$ 18,806	$ 10,888
Companies 5% to 25% owned	7,305	6,680	14,385	12,911
Companies less than 5% owned	46,045	46,864	94,474	89,900
Total interest and dividends	62,692	58,824	127,665	113,699
Premiums from loan dispositions				
Companies more than 25% owned	—	—	—	511
Companies less than 5% owned	46	910	1,659	1,220
Total premiums from loan dispositions	46	910	1,659	1,731
Fees and other income				
Companies more than 25% owned	6,890	4,284	13,865	8,113
Companies 5% to 25% owned	476	150	476	150
Companies less than 5% owned	3,089	4,571	11,919	10,117
Total fees and other income	10,455	9,005	26,260	18,380
Total interest and related portfolio income	73,193	68,739	155,584	133,810
Expenses:				
Interest	17,515	15,951	34,984	31,881
Employee	8,274	7,610	16,309	14,056
Administrative	4,843	3,060	7,861	6,027
Total operating expenses	30,632	26,621	59,154	51,964
Net investment income before net realized and unrealized gains	42,561	42,118	96,430	81,846
Net realized and unrealized gains (losses):				
Net realized gains (losses)				
Companies more than 25% owned	(630)	(731)	(630)	(731)
Companies 5% to 25% owned	—	4,571	718	4,571
Companies less than 5% owned	(125)	(3)	8,762	1,151
Total net realized gains (losses)	(755)	3,837	8,850	4,991
Net unrealized gains	31,648	151	24,135	11,297
Total net realized and unrealized gains	30,893	3,988	32,985	16,288
Net increase in net assets resulting from operations	$ 73,454	$46,106	$129,415	$ 98,134
Basic earnings per common share	$ 0.72	$ 0.52	$ 1.28	$ 1.12
Diluted earnings per common share	$ 0.71	$ 0.51	$ 1.26	$ 1.10
Weighted average common shares outstanding— basic	101,660	89,356	100,822	87,441
Weighted average common shares outstanding— diluted	103,440	90,848	102,900	88,966

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

(in thousands, except per share amounts)	For the Six Months Ended June 30, 2002	2001
	(unaudited)	
Operations:		
Net investment income before net realized and unrealized gains	$ 96,430	$ 81,846
Net realized gains	8,850	4,991
Net unrealized gains	24,135	11,297
Net increase in net assets resulting from operations	129,415	98,134
Shareholder distributions:		
Common stock dividends	(109,482)	(87,836)
Preferred stock dividends	(110)	(110)
Net decrease in net assets resulting from shareholder distributions	(109,592)	(87,946)
Capital share transactions:		
Sale of common stock	49,920	123,262
Issuance of common stock upon the exercise of stock options	11,626	6,258
Issuance of common stock in lieu of cash distributions	3,123	3,415
Net increase in notes receivable from sale of common stock	(2,162)	(1,154)
Net increase in net assets resulting from capital share transactions	62,507	131,781
Total increase in net assets	$ 82,330	$ 141,969
Net assets at beginning of period	$1,352,123	$1,029,692
Net assets at end of period	$1,434,453	$1,171,661
Net asset value per common share	$ 14.02	$ 12.79
Common shares outstanding at end of period	102,296	91,578

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)	For the Six Months Ended June 30, 2002	2001
	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	$ 129,415	$ 98,134
Adjustments		
Portfolio investments	(195,455)	(299,843)
Repayments of investment principal	67,017	42,544
Proceeds from investment sales	126,280	74,648
Change in accrued or reinvested interest and dividends	(19,463)	(25,493)
Changes in other assets and liabilities	(18,982)	(7,374)
Amortization of loan discounts and fees	(9,284)	(7,722)
Depreciation and amortization	657	479
Realized losses	6,579	1,605
Net unrealized gains	(24,135)	(11,297)
Net cash provided by (used in) operating activities	62,629	(134,319)
Cash flows from financing activities:		
Sale of common stock	49,920	123,262
Sale of common stock upon the exercise of stock options	9,245	2,103
Collections of notes receivable from sale of common stock	220	3,002
Common dividends and distributions paid	(106,359)	(84,422)
Preferred stock dividends paid	(110)	(110)
Net borrowings under (repayments on) notes payable and debentures	(6,856)	11,666
Net borrowings under (repayments on) revolving line of credit	(5,000)	82,750
Other	(259)	(2,948)
Net cash provided by (used in) financing activities	(59,199)	135,303
Net increase in cash and cash equivalents	$ 3,430	$ 984
Cash and cash equivalents at beginning of period	$ 889	$ 2,449
Cash and cash equivalents at end of period	$ 4,319	$ 3,433

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
Companies More Than 25% Owned			
Acme Paging, L.P.	Loan	$ 3,200	$ 3,200
(Telecommunications)	Debt Securities	7,005	7,005
	Equity Interests	3,717	2,261
American Healthcare Services, Inc.	Debt Securities	41,362	41,362
(Healthcare)	Common Stock (79,567,042 shares)	1,000	100
	Guaranty ($915)	—	—
Business Loan Express, Inc.	Loan	6,000	6,000
(Financial Services)	Debt Securities	80,809	80,809
	Preferred Stock (25,111 shares)	25,111	25,111
	Common Stock (25,503,043 shares)	104,641	140,000
	Guaranty ($48,126 — See Note 3)	—	—
	Standby Letters of Credit ($10,550 — See Note 3)	—	—
The Color Factory Inc.	Loan	7,439	7,439
(Consumer Products)	Preferred Stock (1,000 shares)	1,002	1,002
	Common Stock (980 shares)	6,535	8,035
Directory Investment Corporation (Publishing)	Common Stock (470 shares)	112	32
Directory Lending Corporation	Series A Common Stock (34 shares)	—	—
(Publishing)	Series B Common Stock (6 shares)	8	—
	Series C Common Stock (10 shares)	22	—
EDM Consulting, LLC	Debt Securities	1,875	443
(Business Services)	Equity Interests	250	—
Elmhurst Consulting, LLC	Loan	12,530	12,530
(Business Services)	Equity Interests	5,165	5,165
	Guaranty ($2,190)	—	—
Foresite Towers, LLC (Tower Leasing)	Equity Interests	15,522	15,522
Gordian Group, Inc.	Loan	6,965	6,965
(Business Services)	Common Stock (1,000 shares)	1,300	1,300
HealthASPex, Inc.	Preferred Stock (1,451,380 shares)	4,900	2,617
(Business Services)	Preferred Stock (700,000 shares)	700	700
	Common Stock (1,451,380 shares)	4	—
The Hillman Companies Inc.(1)	Debt Securities	41,012	41,012
(Consumer Products)	Common Stock (6,890,937 shares)	57,156	90,000

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
xHMT, Inc.	Debt Securities	$ 9,036	$ 9,036
(Business Services)	Preferred Stock (519,484 shares)	2,078	2,078
	Common Stock (300,000 shares)	3,000	1,694
	Warrants	1,155	651
Monitoring Solutions, Inc.	Debt Securities	1,823	153
(Business Services)	Common Stock (33,333 shares)	—	—
	Warrants	—	—
MVL Group, Inc.	Loan	16,963	16,963
(Business Services)	Debt Securities	16,116	16,116
	Common Stock (650,000 shares)	643	643
Spa Lending Corporation	Preferred Stock (28,625 shares)	409	288
(Recreation)	Common Stock (6,208 shares)	—	—
STS Operating, Inc. (Industrial Products)	Common Stock (3,000,000 shares)	3,177	3,177
Sure-Tel, Inc.	Preferred Stock (1,000,000 shares)	1,000	1,000
(Consumer Services)	Common Stock (37,000 shares)	5,018	5,018
Total Foam, Inc.	Debt Securities	260	125
(Industrial Products)	Common Stock (910 shares)	10	—
WyoTech Acquisition	Debt Securities	12,638	12,638
Corporation	Preferred Stock (100 shares)	3,700	3,700
(Education)	Common Stock (99 shares)	100	60,670
Total companies more than 25% owned		**$512,468**	**$632,560**
Companies 5% to 25% Owned			
Aspen Pet Products, Inc.	Loans	$ 15,111	$ 15,111
(Consumer Products)	Preferred Stock (2,021 shares)	1,981	1,981
	Common Stock (1,400 shares)	140	140
Autania AG(1,3)	Debt Securities	4,487	4,487
(Industrial Products)	Common Stock (250,000 shares)	2,169	2,169
CBA-Mezzanine Capital Finance, LLC (Financial Services)	Loan	313	313
Colibri Holding Corporation	Loans	3,478	3,478
(Consumer Products)	Preferred Stock (237 shares)	248	248
	Common Stock (3,362 shares)	1,250	1,250
	Warrants	290	290
CorrFlex Graphics, LLC	Debt Securities	2,393	2,393
(Business Services)	Warrants	—	17,490
	Options	—	1,510
Csabai Canning Factory Rt(3) (Consumer Products)	Hungarian Quotas (9.2%)	700	—

(1) Public company.
(2) Common stock, preferred stock, warrants, options and equity interests are generally non-income

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(3) Non-U.S. company.
(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
CyberRep	Loan	$ 1,184	$ 1,184
(Business Services)	Debt Securities	14,550	14,550
	Warrants	660	3,310
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,829 shares)	1,250	1,250
Gibson Guitar Corporation	Debt Securities	17,558	17,558
(Consumer Products)	Warrants	525	2,325
International Fiber Corporation	Debt Securities	22,499	22,499
(Industrial Products)	Common Stock (1,029,068 shares)	5,483	6,982
	Warrants	550	700
Liberty-Pittsburgh Systems, Inc.	Debt Securities	3,494	3,494
(Business Services)	Common Stock (123,929 shares)	142	142
Litterer Beteiligungs-GmbH(3)	Debt Securities	1,070	1,070
(Business Services)	Equity Interest	358	358
Logic Bay Corporation (Business Services)	Preferred Stock (1,131,222 shares)	5,000	1,000
Magna Card, Inc.	Debt Securities	153	153
(Consumer Products)	Preferred Stock (1,875 shares)	94	94
	Common Stock (4,687 shares)	—	—
Master Plan, Inc.	Loan	1,204	1,204
(Business Services)	Common Stock (156 shares)	42	42
MortgageRamp.com, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	3,860
Morton Grove	Loan	16,356	16,356
Pharmaceuticals, Inc.	Preferred Stock (106,947 shares)	5,000	12,000
(Consumer Products)			
Nobel Learning Communities,	Debt Securities	9,704	9,704
Inc.(1)	Preferred Stock (1,063,830 shares)	2,000	2,000
(Education)	Warrants	575	296
North American Archery, LLC	Loans	1,390	840
(Consumer Products)	Convertible Debentures	2,248	59
	Guaranty ($1,020)	—	—
Packaging Advantage	Debt Securities	11,635	11,635
Corporation	Common Stock (200,000 shares)	2,000	2,000
(Business Services)	Warrants	963	963
Professional Paint, Inc.	Debt Securities	22,086	22,086
(Consumer Products)	Preferred Stock (15,000 shares)	18,309	18,309
	Common Stock (110,000 shares)	69	4,500

(1) Public company.
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(3) Non-U.S. company.
(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
Progressive International Corporation (Consumer Products)	Debt Securities	$ 3,963	$ 3,963
	Preferred Stock (500 shares)	500	500
	Common Stock (197 shares)	13	13
	Warrants	—	—
Redox Brands, Inc. (Consumer Products)	Debt Securities	9,649	9,649
	Preferred Stock (2,404,086 shares)	6,974	6,974
	Warrants	584	584
Staffing Partners Holding Company, Inc. (Business Services)	Loan	2,500	2,500
	Debt Securities	4,992	4,992
	Preferred Stock (414,600 shares)	2,073	2,073
	Common Stock (50,200 shares)	50	50
	Warrants	10	10
Total companies 5% to 25% owned		**$235,879**	**$264,691**
Companies Less Than 5% Owned			
ACE Products, Inc. (Industrial Products)	Loans	$ 17,164	$ 15,839
Advantage Mayer, Inc. (Business Services)	Debt Securities	10,654	10,654
	Warrants	382	1,455
Alderwoods Group, Inc.(1) (Consumer Services)	Common Stock (357,568 shares)	5,006	2,739
Allied Office Products, Inc. (Business Services)	Debt Securities	7,628	50
	Warrants	629	—
American Barbecue & Grill, Inc. (Retail)	Warrants	125	—
American Home Care Supply, LLC (Consumer Products)	Debt Securities	6,935	6,935
	Warrants	579	1,579
ASW Holding Corporation (Industrial Products)	Warrants	25	25
Avborne, Inc. (Business Services)	Debt Securities	12,959	3,500
	Warrants	1,180	—
Bakery Chef, Inc. (Consumer Products)	Loans	17,604	17,604
Blue Rhino Corporation(1) (Consumer Products)	Debt Securities	13,913	13,913
	Warrants	1,200	13,500
Border Foods, Inc.	Debt Securities	9,347	9,347

(Consumer Products)	Preferred Stock (50,919 shares) Warrants	2,000 665	2,000 665
Camden Partners Strategic Fund II, L.P. (4) (Private Equity Fund)	Limited Partnership Interest	1,879	2,002

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(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
Candlewood Hotel Company(1) (Hospitality)	Preferred Stock (3,250 shares)	$ 3,250	$ 1,300
Celebrities, Inc. (Broadcasting & Cable)	Loan Warrants	230 12	230 492
Component Hardware Group, Inc. (Industrial Products)	Debt Securities Preferred Stock (18,000 shares) Common Stock (2,000 shares)	11,032 1,800 200	11,032 1,800 200
Convenience Corporation of America (Retail)	Debt Securities Preferred Stock (22,301 shares) Warrants	8,355 334 —	2,738 — —
Cooper Natural Resources, Inc. (Industrial Products)	Loan Debt Securities Preferred Stock (6,316 shares) Warrants	299 1,815 1,427 832	299 1,815 1,427 832
Coverall North America, Inc. (Business Services)	Loan Debt Securities	10,418 5,740	10,418 5,740
CPM Acquisition Corporation (Industrial Products)	Loan	9,902	9,902
CTT Holdings (Consumer Products)	Loan	1,478	1,478
Cumulus Media, Inc. (1) (Broadcasting & Cable)	Common Stock (11,037 shares)	198	152
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan Debt Securities Warrants	10,918 1,500 —	348 1,500 —
eCentury Capital Partners, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,875	1,691
El Dorado Communications, Inc. (Broadcasting & Cable)	Loans	306	306
Elexis Beta GmbH(3) (Industrial Products)	Options	426	426

Eparfin S.A.(3) (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities	8,852	1,000
	Warrants	1,157	—
Executive Greetings, Inc. (Business Services)	Debt Securities	17,327	17,327
	Warrants	360	360
ExTerra Credit Recovery, Inc. (Business Services)	Preferred Stock (500 shares)	568	103
	Common Stock (2,500 shares)	—	—
	Warrants	—	—

(1) Public company.
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(3) Non-U.S. company.
(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
Fairchild Industrial Products Company (Industrial Products)	Debt Securities	$ 5,906	$ 5,906
	Warrants	280	1,100
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities	48,433	34,010
	Options	—	—
	Standby Letter of Credit ($750)	—	—
Garden Ridge Corporation (Retail)	Debt Securities	27,070	27,070
	Preferred Stock (1,130 shares)	1,130	1,130
	Common Stock (188,400 shares)	613	613
GC-Sun Holdings II, LP (Kar Products, LP) (Business Services)	Loans	8,167	8,167
Ginsey Industries, Inc. (Consumer Products)	Loans	5,000	5,000
	Convertible Debentures	500	500
	Warrants	—	1,500
Global Communications, LLC (Business Services)	Loan	1,997	1,997
	Debt Securities	15,262	15,262
	Equity Interest	11,067	11,067
	Options	1,639	1,639
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	3,000
Grotech Partners, VI, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,832	1,398
The Hartz Mountain Corporation (Consumer Products)	Debt Securities	27,544	27,544
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	2,613	2,613
Hotelevision, Inc. (Broadcasting & Cable)	Preferred Stock (315,100 shares)	315	315

Icon International, Inc. (Business Services)	Common Stock (35,228 shares)	1,219	2,712
Impact Innovations Group, LLC (Business Services)	Debt Securities	6,727	3,436
	Warrants	1,674	—
Intellirisk Management Corporation (Business Services)	Loans	22,796	22,796
Interline Brands, Inc. (Business Services)	Debt Securities	33,431	33,431
	Preferred Stock (199,313 shares)	1,849	1,849
	Common Stock (15,615 shares)	139	139
	Warrants	1,181	1,181
Jakel, Inc. (Industrial Products)	Loan	23,307	16,047

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
JRI Industries, Inc. (Industrial Products)	Debt Securities	$ 1,981	$ 1,981
	Warrants	74	74
Julius Koch USA, Inc. (Industrial Products)	Debt Securities	453	453
	Warrants	259	8,000
Kirker Enterprises, Inc. (Industrial Products)	Warrants	348	3,501
	Equity Interest	4	4
Kirkland's, Inc. (Retail)	Debt Securities	6,387	6,387
	Preferred Stock (917 shares)	412	412
	Warrants	96	5,816
Kyrus Corporation (Business Services)	Debt Securities	7,380	7,380
	Warrants	348	348
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	359	213
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares)	500	500
	Warrants	—	—
MedAssets.com, Inc. (Business Services)	Debt Securities	15,363	15,363
	Preferred Stock (260,417 shares)	2,049	2,049
	Warrants	136	136
Mid-Atlantic Venture Fund IV, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2,475	1,479
Midview Associates, L.P. (Housing)	Warrants	—	—
Most Confiserie GmbH & Co KG(3) (Consumer Products)	Loan	950	50

(Consumer Products)			
NetCare, AG(3) (Business Services)	Loan Common Stock (262,784 shares)	760 230	50 —
NETtel Communications, Inc. (Telecommunications)	Debt Securities and Receivables	11,334	4,334
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	289	289
Novak Biddle Venture Partners III, L.P. (4) (Private Equity Fund)	Limited Partnership Interest	420	420
Nursefinders, Inc. (Business Services)	Debt Securities Warrants	11,151 900	11,151 3,060
Onyx Television GmbH(3) (Broadcasting & Cable)	Preferred Units (120,000 shares)	201	8

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Private Finance Portfolio Company (in thousands, except number of shares)	**Investment(2)**	**June 30, 2002 (unaudited) Cost**	**Value**
Opinion Research Corporation(1) (Business Services)	Debt Securities Warrants	$14,269 996	$14,269 881
Oriental Trading Company, Inc. (Consumer Products)	Debt Securities Preferred Equity Interest Common Equity Interest Warrants	12,920 1,500 — 13	12,920 1,500 2,000 2,300
Outsource Partners, Inc. (Business Services)	Debt Securities Warrants	24,048 826	24,048 826
Pico Products, Inc. (Industrial Products)	Loan	1,406	1,406
Polaris Pool Systems, Inc. (Consumer Products)	Debt Securities Warrants	10,630 1,145	10,630 1,145
Powell Plant Farms, Inc. (Consumer Products)	Loan	19,095	14,087
Proeducation GmbH(3) (Education)	Loan	321	321
Prosperco Finanz Holding AG(3) (Financial Services)	Convertible Debentures Common Stock (1,528 shares) Warrants	5,492 1,059 —	5,492 1,059 —
Raytheon Aerospace, LLC (Business Services)	Debt Securities Equity Interest	5,130 —	5,130 —
Schwinn Holdings Corporation (Consumer Products)	Debt Securities	10,195	1,835

(Consumer Products)			
Seasonal Expressions, Inc. (Consumer Products)	Preferred Stock (504 shares)	500	—
Simula, Inc.(1) (Industrial Products)	Loan	20,539	20,539
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities	8,807	8,807
	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	200
Southwest PCS, LLC (Telecommunications)	Loan	6,059	6,059
Startec Global Communications Corporation(1) (Telecommunications)	Loan	23,815	23,815
	Debt Securities	21,432	245
	Common Stock (258,064 shares)	3,000	—
	Warrants	—	—
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans	6,062	4,188
	Debt Securities	2,445	—

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
Sydran Food Services II, L.P. (Retail)	Debt Securities	$ 12,973	$ 12,973
	Equity Interests	3,909	3,909
	Warrants	—	—
Tubbs Snowshoe Company, LLC (Consumer Products)	Debt Securities	3,920	3,920
	Equity Interests	500	500
	Warrants	54	54
United Pet Group, Inc. (Consumer Products)	Debt Securities	8,987	8,987
	Warrants	85	85
Updata Venture Partners, II, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2	1,492
Velocita, Inc. (Telecommunications)	Debt Securities	11,718	—
	Warrants	3,540	—
Venturehouse Group, LLC(4) (Private Equity Fund)	Equity Interest	667	380
Walker Investment Fund II, LLLP(4) (Private Equity Fund)	Limited Partnership Interest	1,200	943
Warn Industries, Inc. (Consumer Products)	Debt Securities	11,513	11,513
	Warrants	1,429	3,129
Williams Brothers Lumber Company	Warrants	24	100

Company (Retail)			
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities	15,630	15,630
	Warrants	735	735
Wilton Industries, Inc. (Consumer Products)	Loan	12,000	12,000
Woodstream Corporation (Consumer Products)	Loan	2,621	2,621
	Debt Securities	7,653	7,653
	Equity Interests	1,700	4,547
	Warrants	450	1,203
Total companies less than 5% owned		**$ 832,665**	**$ 738,008**
Total private finance (133 portfolio companies)		**$1,581,012**	**$1,635,259**

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(in thousands, except number of loans)	Stated Interest	Face	June 30, 2002 (unaudited) Cost	Value
Commercial Real Estate Finance				
Commercial Mortgage-Backed Securities				
CMBS Bonds				
Mortgage Capital Funding, Series 1998-MC3	5.5%	$ 54,491	$ 27,330	$ 27,344
Morgan Stanley Capital I, Series 1999-RM1	6.4%	51,046	21,553	21,395
COMM 1999-1	5.6%	74,879	36,316	36,409
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	37,752	16,811	16,804
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	83,210	36,674	36,783
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	34,856	16,301	16,340
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	29,005	11,576	12,188
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	37,430	16,579	17,426
FUNB CMT, Series 1999-C4	6.5%	43,372	18,259	18,865
Heller Financial, HFCMC Series 2000 PH-1	6.8%	45,456	18,516	19,319
SBMS VII, Inc., Series 2000-NL1	7.2%	20,804	10,764	11,309
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	38,685	18,345	19,030
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	39,379	17,523	18,722
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	34,967	12,617	14,000
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	43,288	18,139	19,741
JP Morgan-CIBC-Deutsche 2001	5.8%	46,326	19,788	20,430
Lehman Brothers-UBS Warburg 2001-C4	6.4%	49,582	21,989	24,069
SBMS VII, Inc., Series 2001-C1	6.1%	41,109	16,017	16,774
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	45,218	19,947	20,699
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	59,602	28,245	29,518

JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	42,747	16,142	16,881
SBMS VII, Inc., Series 2001-C2	6.2%	47,353	22,043	24,180
FUNB CMT, Series 2002-C1	6.0%	38,238	16,592	17,630
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	80,490	44,316	48,976
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	62,704	34,643	36,058
Total CMBS bonds		$1,181,989	$537,025	$560,890
Collateralized Debt Obligations				
Crest 2001-1, Ltd.(3)		24,023	24,023	24,023
Crest 2002-1, Ltd.(3)		23,541	23,541	23,541
Crest 2002-IG, Ltd.(3)		4,969	4,969	4,969
Total collateralized debt obligations		$ 52,533	$ 52,533	$ 52,533
Total CMBS		$1,234,522	$589,558	$613,423

	Interest Rate Ranges	Number of Loans	Cost	Value
Commercial Mortgage Loans				
	Up to 6.99%	9	$ 8,108	$ 9,122
	7.00%- 8.99%	19	21,252	20,555
	9.00%-10.99%	10	9,879	9,879
	11.00%-12.99%	10	14,746	14,540
	13.00%-14.99%	6	7,856	7,856
	15.00% and above	1	49	49
Total commercial mortgage loans		55	$ 61,890	$ 62,001
Residual Interest			$ 69,341	$ 69,042
Real Estate Owned			3,451	1,244
Total commercial real estate finance			**$ 724,240**	**$ 745,710**
Total portfolio			**$2,305,252**	**$2,380,969**

(3) Non-U.S. company.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	**Investment(2)**	**December 31, 2001 Cost**	**Value**
Companies More Than 25% Owned			
Acme Paging, L.P. (Telecommunications)	Debt Securities	$ 6,992	$ 6,992
	Equity Interests	3,640	2,184
American Healthcare Services, Inc. (Healthcare)	Debt Securities	40,194	40,194
	Common Stock (79,567,042 shares)	1,000	100
	Guaranty ($195)	—	—
Business Loan Express, Inc. (Financial Services)	Loan	6,000	6,000
	Debt Securities	76,242	76,242
	Preferred Stock (25,111 shares)	25,111	25,111

	Preferred Stock (25,111 shares)	25,111	25,111
	Common Stock (25,503,043 shares)	104,596	120,096
	Guaranty ($51,350 — See Note 3)	—	—
The Color Factory Inc. (Consumer Products)	Loan	5,346	5,346
	Preferred Stock (600 shares)	788	788
	Common Stock (980 shares)	6,535	8,035
Directory Investment Corporation (Publishing)	Common Stock (470 shares)	112	32
Directory Lending Corporation (Publishing)	Series A Common Stock (34 shares)	—	—
	Series B Common Stock (6 shares)	8	—
	Series C Common Stock (10 shares)	22	—
EDM Consulting, LLC (Business Services)	Debt Securities	1,875	443
	Equity Interest	250	—
Elmhurst Consulting, LLC (Business Services)	Loan	7,762	7,762
	Equity Interests	5,157	5,157
	Guaranty ($2,800)	—	—
Foresite Towers, LLC (Tower Leasing)	Equity Interests	15,500	15,500
HealthASPex, Inc. (Business Services)	Preferred Stock (1,451,380 shares)	4,900	3,900
	Preferred Stock (611,923 shares)	612	612
	Common Stock (1,451,380 shares)	4	—
The Hillman Companies, Inc. (Consumer Products)	Debt Securities	40,071	40,071
	Common Stock (6,890,937 shares)	57,156	57,156
HMT, Inc. (Business Services)	Debt Securities	8,995	8,995
	Common Stock (300,000 shares)	3,000	3,000
	Warrants	1,155	1,155
Monitoring Solutions, Inc. (Business Services)	Debt Securities	1,823	153
	Common Stock (33,333 shares)	—	—
	Warrants	—	—

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Private Finance Portfolio Company (in thousands, except number of shares)	**Investment(2)**	**December 31, 2001**	
		Cost	**Value**
Spa Lending Corporation (Recreation)	Preferred Stock (28,625 shares)	$ 485	$ 375
	Common Stock (6,208 shares)	25	18
STS Operating, Inc. (Industrial Products)	Common Stock (3,000,000 shares)	3,177	3,177
Sure-Tel, Inc. (Consumer Services)	Loan	1,207	1,207
	Preferred Stock (1,116,902 shares)	4,642	4,642
	Warrants	662	662
	Options	—	—
Total Foam, Inc.	Debt Securities	263	127

(Industrial Products)	Common Stock (910 shares)	10	—
WyoTech Acquisition Corporation (Education)	Debt Securities Preferred Stock (100 shares) Common Stock (99 shares)	12,588 3,700 100	12,588 3,700 44,100
Total companies more than 25% owned		**$451,705**	**$505,620**
Companies 5% to 25% Owned			
Aspen Pet Products, Inc. (Consumer Products)	Loans Preferred Stock (1,860 shares) Common Stock (1,400 shares)	$ 14,576 1,981 140	$ 14,576 1,981 140
Autania AG(1,3) (Industrial Products)	Debt Securities Common Stock (250,000 shares)	4,762 2,261	4,762 2,261
Colibri Holding Corporation (Consumer Products)	Loans Preferred Stock (237 shares) Common Stock (3,362 shares) Warrants	3,464 237 1,250 290	3,464 237 1,250 290
CorrFlex Graphics, LLC (Business Services)	Debt Securities Warrants Options	2,312 — —	2,312 6,674 576
Csabai Canning Factory Rt(3) (Consumer Products)	Hungarian Quotas (9.2%)	700	—
CyberRep (Business Services)	Loan Debt Securities Warrants	1,109 14,209 660	1,109 14,209 3,310
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,829 shares)	1,250	1,250
FTI Consulting, Inc.(1) (Business Services)	Warrants	—	510
Gibson Guitar Corporation (Consumer Products)	Debt Securities Warrants	17,175 525	17,175 2,325

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Private Finance Portfolio Company (in thousands, except number of shares)	**Investment(2)**	**December 31, 2001**	
		Cost	**Value**
International Fiber Corporation (Industrial Products)	Debt Securities Common Stock (1,029,068 shares) Warrants	$ 22,257 5,483 550	$ 22,257 6,982 700
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities Common Stock (123,929 shares)	3,487 142	3,487 142
Logic Bay Corporation (Business Services)	Preferred Stock (1,131,222 shares)	5,000	5,000
Magna Card, Inc.	Debt Securities	153	153

(Consumer Products)	Preferred Stock (1,875 shares)	94	94
	Common Stock (4,687 shares)	—	—
Master Plan, Inc.	Loan	1,204	1,204
(Business Services)	Common Stock (156 shares)	42	2,042
MortgageRamp.com, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	3,860
Morton Grove	Loan	16,150	16,150
Pharmaceuticals, Inc.	Preferred Stock (106,947 shares)	5,000	9,000
(Consumer Products)			
Nobel Learning Communities,	Debt Securities	9,656	9,656
Inc.(1)	Preferred Stock (265,957 shares)	2,000	2,000
(Education)	Warrants	575	575
North American Archery, LLC	Loans	1,390	840
(Consumer Products)	Convertible Debentures	2,248	2,008
	Guaranty ($270)	—	—
Packaging Advantage	Debt Securities	11,586	11,586
Corporation	Common Stock (200,000 shares)	2,000	2,000
(Business Services)	Warrants	963	963
Professional Paint, Inc.	Debt Securities	21,409	21,409
(Consumer Products)	Preferred Stock (15,000 shares)	17,215	17,215
	Common Stock (110,000 shares)	69	3,069
Progressive International	Debt Securities	3,958	3,958
Corporation	Preferred Stock (500 shares)	500	500
(Consumer Products)	Common Stock (197 shares)	13	13
	Warrants	—	—
Staffing Partners Holding	Debt Securities	4,992	4,992
Company, Inc.	Preferred Stock (414,600 shares)	2,073	2,073
(Business Services)	Common Stock (50,200 shares)	50	50
	Warrants	10	10
Total companies 5% to 25% owned		**$211,030**	**$232,399**

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001 Cost	Value
Companies Less Than 5% Owned			
Ability One Corporation (Consumer Products)	Loans	$10,657	$10,657
ACE Products, Inc. (Industrial Products)	Loans	16,875	16,875
Advantage Mayer, Inc.	Debt Securities	10,945	10,945
(Business Services)	Warrants	—	—

Allied Office Products, Inc. (Business Services)	Debt Securities	7,491	7,491
	Warrants	629	629
American Barbecue & Grill, Inc. (Retail)	Warrants	125	—
American Home Care Supply, LLC (Consumer Products)	Debt Securities	6,906	6,906
	Warrants	579	1,579
ASW Holding Corporation (Industrial Products)	Warrants	25	25
Aurora Communications, LLC (Broadcasting & Cable)	Loans	15,809	15,809
	Equity Interest	2,461	6,050
Avborne, Inc. (Business Services)	Debt Securities	12,750	6,375
	Warrants	1,180	—
Bakery Chef, Inc. (Consumer Products)	Loans	17,018	17,018
Blue Rhino Corporation(1) (Consumer Products)	Debt Securities	13,816	13,816
	Warrants	1,200	2,000
Border Foods, Inc. (Consumer Products)	Debt Securities	9,313	9,313
	Preferred Stock (50,919 shares)	2,000	2,000
	Warrants	665	665
Camden Partners Strategic Fund II, L.P. (4) (Private Equity Fund)	Limited Partnership Interest	1,295	1,295
CampGroup, LLC (Recreation)	Debt Securities	2,702	2,702
	Warrants	220	220
Candlewood Hotel Company(1) (Hospitality)	Preferred Stock (3,250 shares)	3,250	3,250
Celebrities, Inc. (Broadcasting & Cable)	Loan	244	244
	Warrants	12	550
Classic Vacation Group, Inc.(1) (Consumer Products)	Loan	6,399	6,399

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Private Finance Portfolio Company (in thousands, except number of shares)	**Investment(2)**	**December 31, 2001**	
		Cost	**Value**
Component Hardware Group, Inc. (Industrial Products)	Debt Securities	$10,774	$10,774
	Preferred Stock (18,000 shares)	1,800	1,800
	Common Stock (2,000 shares)	200	200
Convenience Corporation of America (Retail)	Debt Securities	8,355	2,738
	Preferred Stock (22,301 shares)	334	—
	Warrants	—	—
Cooper Natural Resources, Inc.	Debt Securities	1,750	1,750

(Industrial Products)	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
Coverall North America, Inc. (Business Services)	Loan	10,309	10,309
	Debt Securities	5,324	5,324
	Warrants	—	—
CPM Acquisition Corporation (Industrial Products)	Loan	9,604	9,604
CTT Holdings (Consumer Products)	Loan	1,388	1,388
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan	10,918	9,262
	Debt Securities	1,500	1,500
	Warrants	—	—
eCentury Capital Partners, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,875	1,800
El Dorado Communications, Inc. (Broadcasting & Cable)	Loans	306	306
Elexis Beta GmbH(3) (Industrial Products)	Options	426	526
Eparfin S.A.(3) (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities	8,852	6,509
	Warrants	1,157	—
Ex Terra Credit Recovery, Inc. (Business Services)	Preferred Stock (500 shares)	568	318
	Common Stock (2,500 shares)	—	—
	Warrants	—	—
Executive Greetings, Inc. (Business Services)	Debt Securities	15,938	15,938
	Warrants	360	360
Fairchild Industrial Products Company (Industrial Products)	Debt Securities	5,872	5,872
	Warrants	280	2,378
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities	48,869	39,217
	Options	—	—
	Standby Letter of Credit ($750)	—	—

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001 Cost	Value
Garden Ridge Corporation (Retail)	Debt Securities	$26,948	$26,948
	Preferred Stock (1,130 shares)	1,130	1,130
	Common Stock (471 shares)	613	613
Ginsey Industries, Inc.	Loans	5,000	5,000

(Consumer Products)	Convertible Debentures	500	500
	Warrants	—	504
Global Communications, LLC (Business Services)	Loan	1,990	1,990
	Debt Securities	14,884	14,884
	Equity Interest	11,067	11,067
	Options	1,639	1,639
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	5,976
Grant Television II LLC (Broadcasting & Cable)	Options	492	492
Grotech Partners, VI, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,463	1,060
The Hartz Mountain Corporation (Consumer Products)	Debt Securities	27,408	27,408
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	2,613	2,613
Hotelevision, Inc. (Broadcasting & Cable)	Preferred Stock (315,100 shares)	315	315
Icon International, Inc. (Business Services)	Common Stock (37,821 shares)	1,219	1,519
Impact Innovations Group, LLC (Business Services)	Debt Securities	6,598	6,598
	Warrants	1,674	1,674
Intellirisk Management Corporation (Business Services)	Loans	22,334	22,334
Interline Brands, Inc. (Business Services)	Debt Securities	32,839	32,839
	Warrants	3,169	3,169
iSolve Incorporated (Business Services)	Preferred Stock (14,853 shares)	874	—
	Common Stock (13,306 shares)	14	—
Jakel, Inc. (Industrial Products)	Loan	22,291	22,291
JRI Industries, Inc. (Industrial Products)	Debt Securities	1,972	1,972
	Warrants	74	74
Julius Koch USA, Inc. (Industrial Products)	Debt Securities	1,066	1,066
	Warrants	259	7,000
Kirker Enterprises, Inc. (Industrial Products)	Warrants	348	3,501
	Equity Interest	4	4

(1) Public company.
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(3) Non-U.S. company.
(4) Non-registered investment company.

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001 Cost	Value
Kirkland's, Inc. (Retail)	Debt Securities	$ 7,676	$ 7,676
	Preferred Stock (917 shares)	412	412
	Warrants	96	96
Kyrus Corporation (Business Services)	Debt Securities	7,810	7,810
	Warrants	348	348
The Loewen Group, Inc.(1) (Consumer Services)	High-Yield Senior Secured Debt	15,150	12,440
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	359	213
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares)	500	500
	Warrants	—	—
MedAssets.com, Inc. (Business Services)	Debt Securities	14,949	14,949
	Preferred Stock (260,417 shares)	2,049	2,049
	Warrants	136	136
Mid-Atlantic Venture Fund IV, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2,475	1,586
Midview Associates, L.P. (Housing)	Warrants	—	—
Most Confiserie GmbH & Co KG(3) (Consumer Products)	Loan	933	933
MVL Group, Inc. (Business Services)	Loan	1,856	1,856
	Debt Securities	14,806	14,806
	Warrants	643	643
	Guaranty ($1,357)	—	—
NetCare, AG(3) (Business Services)	Loan	811	811
NETtel Communications, Inc. (Telecommunications)	Debt Securities and Receivables	11,334	4,334
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	310	310
Novak Biddle Venture Partners III, L.P. (4) (Private Equity Fund)	Limited Partnership Interest	330	330
Nursefinders, Inc. (Business Services)	Debt Securities	11,341	11,341
	Warrants	900	1,500
Onyx Television GmbH(3) (Broadcasting & Cable)	Preferred Units (120,000 shares)	201	201

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001 Cost	Value
Opinion Research Corporation(1) (Business Services)	Debt Securities	$14,186	$14,186
	Warrants	996	996
Oriental Trading Company, Inc. (Consumer Products)	Debt Securities	12,847	12,847
	Preferred Equity Interest	1,500	1,500
	Common Equity Interest	—	—
	Warrants	13	588
Outsource Partners, Inc. (Business Services)	Debt Securities	23,994	23,994
	Warrants	826	826
Pico Products, Inc. (Industrial Products)	Loan	1,406	1,406
Polaris Pool Systems, Inc. (Consumer Products)	Debt Securities	6,581	6,581
	Warrants	1,050	1,050
Powell Plant Farms, Inc. (Consumer Products)	Loan	16,993	16,993
Proeducation GmbH(3) (Education)	Loan	206	206
Prosperco Finanz Holding AG(3) (Financial Services)	Convertible Debentures	4,899	4,899
	Common Stock (1,528 shares)	956	956
	Warrants	—	—
Raytheon Aerospace, LLC (Business Services)	Debt Securities	5,051	5,051
	Equity Interest	—	—
Redox Brands, Inc. (Consumer Products)	Debt Securities	9,462	9,462
	Warrants	584	584
Schwinn Holdings Corporation (Consumer Products)	Debt Securities	10,195	1,835
Seasonal Expressions, Inc. (Consumer Products)	Preferred Stock (504 shares)	500	—
Simula, Inc.(1) (Industrial Products)	Loan	19,914	19,914
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities	8,569	8,569
	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	200
	Warrants	446	446
Southwest PCS, LLC (Telecommunications)	Loan	8,243	8,243
Startec Global Communications Corporation(1) (Telecommunications)	Loan	22,815	22,815
	Debt Securities	21,286	10,301
	Common Stock (258,064 shares)	3,000	—
	Warrants	—	—

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001 Cost	Value
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans	$ 6,062	$ 4,573
	Debt Securities	2,445	877
Sydran Food Services II, L.P. (Retail)	Debt Securities	12,973	12,973
	Equity Interests	3,909	3,909
	Warrants		
Tubbs Snowshoe Company, LLC (Consumer Products)	Debt Securities	3,913	3,913
	Equity Interests	500	500
	Warrants	54	54
United Pet Group, Inc. (Consumer Products)	Debt Securities	4,965	4,965
	Warrants	15	15
Updata Venture Partners, II, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2,300	3,865
Velocita, Inc.(1) (Telecommunications)	Debt Securities	11,677	11,677
	Warrants	3,540	3,540
Venturehouse Group, LLC(4) (Private Equity Fund)	Equity Interest	667	398
Walker Investment Fund II, LLLP(4) (Private Equity Fund)	Limited Partnership Interest	1,000	743
Warn Industries, Inc. (Consumer Products)	Debt Securities	18,624	18,624
	Warrants	1,429	3,129
Williams Brothers Lumber Company (Retail)	Warrants	24	322
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities	15,106	15,106
	Warrants	735	735
Wilton Industries, Inc. (Consumer Products)	Loan	12,000	12,000
Woodstream Corporation (Consumer Products)	Loan	572	572
	Debt Securities	7,631	7,631
	Equity Interests	1,700	4,547
	Warrants	450	1,203
Total companies less than 5% owned		**$ 891,231**	**$ 857,053**
Total private finance (135 portfolio companies)		**$1,553,966**	**$1,595,072**

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

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

(in thousands, except number of loans)	Stated Interest	Face	December 31, 2001 Cost	Value
Commercial Real Estate Finance				
Commercial Mortgage-Backed Securities				
CMBS Bonds				
Mortgage Capital Funding, Series 1998-MC3	5.5%	$ 54,491	$ 26,888	$ 26,888
Morgan Stanley Capital I, Series 1999-RM1	6.4%	51,046	21,462	21,462
COMM 1999-1	5.6%	74,879	35,636	35,636
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	45,527	22,272	22,272
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	96,432	44,732	44,732
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	34,856	16,304	16,304
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	29,005	11,326	11,326
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	43,046	20,535	20,535
FUNB CMT, Series 1999-C4	6.5%	49,287	22,253	22,253
Heller Financial, HFCMC Series 2000 PH-1	6.8%	45,456	18,657	18,657
SBMS VII, Inc., Series 2000-NL1	7.2%	24,230	13,309	13,309
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	40,502	19,481	19,481
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	41,084	19,418	19,418
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	31,471	11,455	11,455
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	58,786	29,050	29,050
JP Morgan-CIBC-Deutsche 2001	5.8%	60,889	29,584	29,584
Lehman Brothers-UBS Warburg 2001-C4	6.4%	65,130	32,326	32,326
SBMS VII, Inc., Series 2001-C1	6.1%	54,780	25,267	25,267
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	57,039	28,103	28,103
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	84,482	46,176	46,176
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	55,432	24,075	24,075
SBMS VII, Inc., Series 2001-C2	6.2%	72,422	40,037	40,037
Total CMBS bonds		1,170,272	558,346	558,346
Collateralized Debt Obligations				
Crest 2001-1, Ltd.(3)		24,207	24,207	24,207
Total CMBS		$1,194,479	$582,553	$582,553

	Interest Rate Ranges	Number of Loans	Cost	Value
Commercial Mortgage Loans				
	Up to 6.99%	7	$ 3,404	$ 5,100
	7.00%- 8.99%	30	34,583	36,589
	9.00%-10.99%	16	13,617	13,618
	11.00%-12.99%	14	11,977	11,979
	13.00%-14.99%	7	12,455	12,251
	15.00% and above	2	84	60
Total commercial mortgage loans		76	$ 76,120	$ 79,597
Residual Interest			$ 70,179	$ 69,879
Real Estate Owned			3,784	2,489
Total commercial real estate finance			**$ 732,636**	**$ 734,518**
Total portfolio			**$2,286,602**	**$2,329,590**

(3) Non-U.S. company.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Information at June 30, 2002 and 2001 and for the three and six months ended June 30, 2002 and 2001 is unaudited)

Note 1. Organization

Allied Capital Corporation, a Maryland corporation, is a closed-end management investment company that has elected to be regulated as a business development company ("BDC") under the Investment Company Act of 1940 ("1940 Act"). Allied Capital Corporation ("ACC") has a subsidiary that has also elected to be regulated as a BDC, Allied Investment Corporation ("Allied Investment"), which is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company ("SBIC"). In addition, ACC has a real estate investment trust subsidiary, Allied Capital REIT, Inc. ("Allied REIT"), and several subsidiaries which are single-member limited liability companies established primarily to hold real estate properties. In April 2001, ACC established a subsidiary, A.C. Corporation ("AC Corp"), which provides diligence and structuring services on private finance and commercial real estate transactions, as well as structuring, transaction, management and advisory services to the Company, its portfolio companies and other third parties.

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

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

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company invests primarily in private companies in a variety of industries and non-investment grade commercial mortgage-backed securities ("CMBS").

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2001 balances to conform with the 2002 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information. Accordingly, the interim financial information does not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial statements of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2002 and December 31, 2001 and the results of operations for the three and six months ended June 30, 2002 and 2001, and changes in net assets and cash flows for the six months ended June 30, 2002 and 2001. The results of operations for the three and six months ended June 30, 2002 are not necessarily indicative of the operating results to be expected for the full year.

Note 2. Summary of Significant Accounting Policies, continued

The private finance portfolio is presented in three categories — companies more than 25% owned which represent portfolio companies where the Company directly or indirectly owns more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by the Company under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where the Company directly or indirectly owns 5% to 25% of the outstanding voting securities of such portfolio company or where the Company holds one or more seats on the portfolio company's board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where the Company directly or indirectly owns less than 5% of the outstanding voting securities of such portfolio company and where the Company has no other affiliations with such portfolio company. The interest and related portfolio income and net realized gains or losses from the commercial real estate finance portfolio and other sources are included in the companies less than 5% owned category on the consolidated statement of operations.

Valuation of Portfolio Investments

The Company, as a BDC, invests primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. The Company's investments are generally subject to restrictions on resale and generally have no established trading market. The Company values substantially all of its investments at fair value as determined in good faith by the board of directors in accordance with the Company's valuation policy. The Company determines fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale.

The Company's valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests. The Company's valuation policy is intended to provide a consistent basis for establishing the fair value of the portfolio. The Company will record unrealized depreciation on investments when it believes that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, the Company will record unrealized appreciation if it believes that the underlying portfolio company has appreciated in value and the Company's equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale.

Loans and Debt Securities

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity,

Note 2. Summary of Significant Accounting Policies, continued

the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

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

Equity Securities

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

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

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

Commercial Mortgage-Backed Securities ("CMBS")

CMBS are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors and the characteristics of the underlying cash flow. The Company's assumption with regard to discount rate is based upon the yield of comparable securities. The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS, as comparable yields in the market change and/or whenever it determines that the value of its CMBS is less than the cost basis due to impairment in the underlying collateral pool.

Residual Interest

The Company values its residual interest from a previous securitization and recognizes income using the same accounting policies used for the CMBS. The residual interest is carried at fair value based on discounted estimated future cash flows. The Company recognizes income from the residual

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Note 2. Summary of Significant Accounting Policies, continued

interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

Net Realized and Unrealized Gains or Losses

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

Fee Income

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

Deferred Financing Costs

Financing costs are based on actual costs incurred in obtaining debt financing and are deferred and amortized as part of interest expense over the term of the related debt instrument.

Derivative Financial Instruments

The Company may or may not use derivative financial instruments to reduce interest rate risk. The Company has established policies and procedures for risk assessment and the approval, reporting and monitoring of derivative financial instrument activities. The Company does not hold or issue derivative financial instruments for trading purposes. All derivative financial instruments are recorded at fair value with changes in value reflected in net unrealized gains or losses during the reporting period.

Cash and Cash Equivalents

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

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations to account for its stock compensation plans. Under this method, the

Company records compensation expense for awards of stock options to employees only if the market price of the stock on the grant date exceeds the amount the employee is required to pay to acquire the stock.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Federal and State Income Taxes

The Company intends to comply with the requirements of the Internal Revenue Code ("Code") that are applicable to regulated investment companies ("RIC") and real estate investment trusts ("REIT"). The Company and its subsidiaries that qualify as a RIC or a REIT intend to annually distribute or retain through a deemed distribution all of their taxable income to shareholders; therefore, the Company has made no provision for income taxes for these entities. AC Corp is a corporation subject to federal and state income taxes and records a provision for income taxes as appropriate.

Per Share Information

Basic earnings per share is calculated using the weighted average number of shares outstanding for the period presented. Diluted earnings per share reflects the potential dilution that could occur if options to issue common stock were exercised into common stock. Earnings per share is computed after subtracting dividends on preferred shares.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

The consolidated financial statements include investments at value of $2,380,969,000 and $2,329,590,000 as of June 30 2002 and December 31, 2001, respectively, (93% and 95%, respectively, of total assets). Substantially all of these investments represent investments whose fair values have been determined by the board of directors in good faith in the absence of readily ascertainable market values. Because of the inherent uncertainty of valuation, the board of directors' estimated values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

Note 3. Portfolio

Private Finance

At June 30, 2002 and December 31, 2001, the private finance portfolio consisted of the following:

	2002			2001		
	Cost	Value	Yield	Cost	Value	Yield
($ in thousands)						
Loans and debt securities	$1,183,308	$1,050,752	13.9%	$1,169,673	$1,107,890	14.8%
Equity interests	397,704	584,507		384,293	487,182	
Total	$1,581,012	$1,635,259		$1,553,966	$1,595,072	

Private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. Private finance investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. Private finance investments are generally issued by

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Portfolio, continued

privately-owned companies and are generally illiquid and subject to restrictions on resale or transferability.

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary. At June 30, 2002 and December 31, 2001, approximately 97% and 98%, respectively, of the Company's private finance loan portfolio was composed of fixed interest rate loans.

Equity interests consist primarily of securities issued by privately-owned companies and may be subject to restrictions on their resale or may be otherwise illiquid. Equity securities generally do not produce a current return, but are held in anticipation of investment appreciation and ultimate gain on sale.

At June 30, 2002 and December 31, 2001, the Company had an investment at value totaling $251,920,000 and $227,449,000, respectively, in Business Loan Express, Inc. ("BLX"), a small business lender that participates in the SBA Section 7(a) Guaranteed Loan Program. The Company owns 94.9% of BLX's common stock. As the controlling shareholder of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest and other fees) on BLX's 3-year unsecured revolving credit facility for $124,000,000. The amount guaranteed by the Company at June 30, 2002 was $48,100,000. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at June 30, 2002. In consideration for providing this guaranty, BLX will pay the Company an annual guaranty fee of approximately $3,100,000 in 2002. BLX is headquartered in New York, NY. The Company has also provided two standby letters of credit in connection with two term securitization transactions completed by BLX in the second quarter of 2002 totaling $10,550,000.

At June 30, 2002 and December 31, 2001, the Company had an investment in The Hillman Companies, Inc. (formerly SunSource, Inc.) totaling $131,012,000 and $97,227,000 at value, respectively. The Company owns 93.2% of Hillman's common stock. Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers and mass merchants. Hillman's primary operations are located in Cincinnati, Ohio.

At June 30, 2002 and December 31, 2001, the Company had an investment in WyoTech Acquisition Corporation at value totaling $77,008,000 and $60,388,000, respectively. The Company owned 91.35% of WyoTech's common stock. WyoTech is a proprietary trade school and its primary operations are in Laramie, Wyoming. WyoTech was sold on July 1, 2002. See Note 13 for the subsequent event.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Portfolio, continued

At June 30, 2002 and December 31, 2001, Grade 4 and 5 loans and debt securities that were not accruing interest at value were as follows:

(in thousands)	2002	2001
Companies more than 25% owned	$ 721	$ 930
Companies 5% to 25% owned	899	2,848
Companies less than 5% owned	103,562	89,966
	$105,182	$93,744

Included in Grade 4 and 5 loans and debt securities not accruing interest were assets valued at

$8.9 million at June 30, 2002 and December 31, 2001 that represented receivables related to companies in liquidation. In addition to Grade 4 and 5 assets that are in workout, we may not accrue interest on loans to companies that are more than 50% owned by the Company if such companies are in need of additional capital and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled $61,331,000 at value at June 30, 2002.

The industry and geographic compositions of the private finance portfolio at value at June 30, 2002 and December 31, 2001 were as follows:

	2002	2001
Industry		
Consumer products	30%	28%
Business services	24	22
Financial services	16	15
Industrial products	10	10
Retail	5	5
Education	5	5
Telecommunications	3	4
Broadcasting & cable	2	4
Other	5	7
Total	100%	100%
Geographic Region		
Mid-Atlantic	42%	43%
West	20	19
Midwest	17	17
Southeast	14	14
Northeast	6	5
International	1	2
Total	100%	100%

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Portfolio, continued

Commercial Real Estate Finance

At June 30, 2002 and December 31, 2001, the commercial real estate finance portfolio consisted of the following:

($ in thousands)	2002 Cost	2002 Value	2002 Yield	2001 Cost	2001 Value	2001 Yield
CMBS	$589,558	$613,423	14.8%	$582,553	$582,553	14.8%
Loans	61,890	62,001	7.9%	76,120	79,597	7.7%
Residual interest	69,341	69,042	9.3%	70,179	69,879	9.4%
Real estate owned	3,451	1,244		3,784	2,489	
Total	$724,240	$745,710		$732,636	$734,518	

CMBS

At June 30, 2002 and December 31, 2001, the CMBS portfolio consisted of the following:

(in thousands)	2002 Cost	2002 Value	2002 Yield	2001 Cost	2001 Value	2001 Yield
CMBS bonds	$537,025	$560,890	14.6%	$558,346	$558,346	14.7%
Collateralized debt obligations	52,533	52,533	17.2%	24,207	24,207	16.9%
Total	$589,558	$613,423		$582,553	$582,553	

CMBS Bonds. At June 30, 2002 and December 31, 2001, the CMBS bonds, which were purchased from the original issuer, consisted of the following:

($ in thousands)	2002	2001
Face	$1,181,989	$1,170,272
Original issue discount	(644,964)	(611,926)
Cost	$ 537,025	$ 558,346
Value	$ 560,890	$ 558,346
Yield	14.6%	14.7%

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, the Company's most subordinate tranch will bear this loss first. At June 30, 2002, the Company's CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of principal, the Company invests in these CMBS bonds at an approximate discount of 50% from the face amount of the bonds.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Portfolio, continued

The underlying rating classes of the CMBS bonds at value at June 30, 2002 and December 31, 2001 were as follows:

	2002		2001	
($ in thousands)	Value	Percentage of Total	Value	Percentage of Total
BB+	$ 28,668	5.1%	$ 24,785	4.4%
BB	40,701	7.3	69,404	12.4
BB-	33,452	6.0	67,460	12.1
B+	123,056	21.9	103,560	18.6
B	158,035	28.2	131,362	23.5
B-	79,664	14.2	73,572	13.2
CCC	9,119	1.6	8,893	1.6
Unrated	88,195	15.7	79,310	14.2
Total	$560,890	100.0%	$558,346	100.0%

At June 30, 2002 and December 31, 2001, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 and 3,800 commercial mortgage loans with a total outstanding principal balance of $22.9 billion and $20.5 billion, respectively. At June 30, 2002 and December 31, 2001, 0.75% and 0.52%, respectively, of the mortgage loans in the underlying collateral pool for the Company's CMBS bonds were over 30 days delinquent or were classified as real estate owned. The property types and the geographic composition of the mortgage loans in the underlying collateral pool calculated using the outstanding principal balance at June 30, 2002 and December 31, 2001 were as follows:

Property Type	2002	2001
Retail	31%	31%
Housing	27	27
Office	21	22
Hospitality	7	7
Other	14	13
Total	100%	100%

Geographic Region		
West	31%	32%
Mid-Atlantic	25	24
Midwest	22	21
Southeast	17	17
Northeast	5	6
Total	100%	100%

The Company's yield on its CMBS bonds is based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples include the timing and magnitude of credit losses on the mortgage loans underlying the CMBS that are a result of the general condition of the real estate market (including competition for tenants and their related credit quality) and changes in market rental rates. The initial yield on each CMBS bond has been computed assuming an approximate 1% loss rate on its entire underlying collateral mortgage pool, with the estimated losses being assumed to occur in three equal installments in years three, six and nine. As each CMBS bond ages, the amount of losses and the expected timing of recognition of such

Note 3. Portfolio, continued

losses will be updated, and the respective yield will be adjusted as necessary. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

Collateralized Debt Obligations. At June 30, 2002, the Company owned preferred shares in three collateralized debt obligations ("CDOs") secured by investment grade unsecured debt issued by various real estate investment trusts ("REITs") and investment and non-investment grade CMBS bonds. The investment grade REIT debt collateral consists of $852,826,000 issued by 39 REITs. The investment grade CMBS collateral consisted of bonds with a face amount of $402,142,000 issued in 26 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of $405,032,000 that were issued in 30 separate CMBS transactions ("CMBS Collateral"). Included in the CMBS Collateral for the CDOs are $393,832,000 of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 22 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, the Company's preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs at June 30, 2002 and

December 31, 2001 was 17.2% and 16.9%, respectively.

The Company acts as the directing certificate holder for the CMBS bonds and as the disposition consultant with respect to two of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. For these services with respect to the CDOs, the Company collects annual fees based on the outstanding collateral pool balance, and for the six months ended June 30, 2002, this fee totaled $160,000.

Loans

The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers.

At June 30, 2002 and December 31, 2001, approximately 75% and 25% and 76% and 24%, of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of June 30, 2002 and December 31, 2001, workout loans, or those loans in Grade 4 and 5, with a value of $15,860,000 and $15,241,000, respectively, were not accruing interest.

The property types and the geographic composition securing the commercial mortgage loan portfolio at value at June 30, 2002 and December 31, 2001 were as follows:

	2002	2001
Property Type		
Office	28%	34%
Hospitality	28	25
Retail	24	21
Recreation	3	4
Other	17	16
Total	100%	100%

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 3. Portfolio, continued

Geographic Region		
Southeast	40%	36%
Mid-Atlantic	17	23
West	23	20
Midwest	13	16
Northeast	7	5
Total	100%	100%

Residual Interest

At June 30, 2002 and December 31, 2001, the residual interest consisted of the following:

	2002		2001	
(in thousands)	**Cost**	**Value**	**Cost**	**Value**
Residual interest	$68,853	$68,853	$68,853	$68,853
Residual interest spread	488	189	1,326	1,026
Total	$69,341	$69,042	$70,179	$69,879

The residual interest primarily consists of a retained interest totaling $68,853,000 from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At June 30, 2002, two classes of bonds rated AAA and AA+ are outstanding, for total bonds outstanding of $29,600,000. The Company has the right to call the bonds when the outstanding bond balance is less than $23,900,000. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to the Company calling the bonds, the remaining loans in the trust will be returned to the Company as payment on the residual interest.

The Company sold $295 million of loans, and received cash proceeds, net of costs, of approximately $223 million in January 1998. The Company retained a trust certificate for its residual interest in a loan pool sold, and will receive interest income from this residual interest as well as the residual interest spread ("Residual") from the interest earned on the loans sold less the interest paid on the bonds over the life of the bonds. As of June 30, 2002 and December 31, 2001, the mortgage loan pool had an approximate weighted average stated interest rate of 9.3%. The outstanding bond classes sold had an aggregate weighted average interest rate of 6.7% and 6.6% as of June 30, 2002 and December 31, 2001, respectively.

The Company uses a discounted cash flow methodology for determining the value of its retained Residual. In determining the cash flow of the Residual, the Company assumes a prepayment speed of 15% after the applicable prepayment lockout period and credit losses of 1% or approximately $1.1 million of the total principal balance of the underlying collateral throughout the life of the collateral. These assumptions result in an expected weighted average life of the bonds of 0.5 years. The value of the resulting Residual cash flows is then determined by applying a discount rate of 9% which, in the Company's view, is commensurate with the market risk of comparable assets.

Note 4. Debt

The Company records debt at cost. At June 30, 2002 and December 31, 2001, the Company had the following debt:

	2002		2001	
(in thousands)	Facility Amount	Amount Drawn	Facility Amount	Amount Drawn
Notes payable and debentures:				
Unsecured long-term notes payable	$ 694,000	$ 694,000	$ 694,000	$ 694,000
SBA debentures	101,800	94,500	101,800	94,500
Auction rate reset note	75,000	75,000	81,856	81,856
OPIC loan	5,700	5,700	5,700	5,700
Total notes payable and debentures	876,500	869,200	883,356	876,056
Revolving line of credit	527,500	139,750	497,500	144,750
Total	$1,404,000	$1,008,950	$1,380,856	$1,020,806

Notes Payable and Debentures

Unsecured Long-Term Notes Payable. The Company issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At June 30, 2002, the notes had remaining maturities of one to four years. The weighted average fixed interest rate on the notes was 7.6% at June 30, 2002 and December 31, 2001. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

SBA Debentures. At June 30, 2002 and December 31, 2001, the Company had debentures payable to the SBA with terms of ten years and at fixed interest rates ranging from 5.9% to 8.2% and 2.4% to 8.2%, respectively. At June 30, 2002, the debentures had remaining maturities of three to ten years. The weighted average interest rate was 7.0% and 6.7% at June 30, 2002 and December 31, 2001, respectively. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to maturity. At June 30, 2002, the Company has a commitment from the SBA to borrow up to an additional $7,300,000 above the amount outstanding. The commitment expires on September 30, 2005.

Auction Rate Reset Note. The Company has an Auction Rate Reset Senior Note Series A that matures on December 2, 2002, and bears interest at the three-month London Interbank Offered Rate ("LIBOR") plus 1.75%, which adjusts quarterly. Interest is due quarterly and the Company, at its option, may pay or defer such interest payments. The amount outstanding on the note will increase as interest due is deferred. Deferred interest may be repaid at any time without penalties.

As a means to repay the note, the Company has entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of $75.0 million of debt, equity or other securities in one or more public or private transactions. Alternatively, the Company may repay the note in cash without conducting a capital raise. If the Company chooses to pay in cash without conducting a capital raise, the Company will incur additional expense of approximately $2,063,000.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 4. Debt, continued

Scheduled future maturities of notes payable and debentures at June 30, 2002, are as follows:

Year	Amount Maturing (in thousands)
2002	$ 75,000
2003	140,000
2004	221,000
2005	179,000
2006	180,700
Thereafter	73,500
Total	$869,200

Revolving Line of Credit

The Company has an unsecured revolving line of credit for $527,500,000. The facility may be expanded up to $600,000,000 at the Company's option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The interest rate adjusts at the beginning of each new interest period, usually every thirty days. The interest rates were 4.1% and 3.2% at June 30, 2002 and December 31, 2001, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The line expires in August 2003, and may be extended under substantially similar terms for one additional year at the Company's sole option. The line of credit requires monthly interest payments and all principal is due upon its expiration.

The average debt outstanding on the revolving line of credit was $67,710,000 and $106,338,000 for the six months ended June 30, 2002 and for the year ended December 31, 2001, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the six months ended June 30, 2002 and for the year ended December 31, 2001, were $145,250,000 and $213,500,000, and 3.2% and 5.4%, respectively.

The Company has various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of June 30, 2002, the Company was in compliance with these covenants.

Note 5. Preferred Stock

Allied Investment has outstanding a total of 60,000 shares of $100 par value, 3% cumulative preferred stock and 10,000 shares of $100 par value, 4% redeemable cumulative preferred stock issued to the SBA pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended. The 3% cumulative preferred stock does not have a required redemption date. Allied Investment has the option to redeem in whole or in part the preferred stock by paying the SBA the par value of such securities and any dividends accumulated and unpaid to the date of redemption. The 4% redeemable cumulative preferred stock has a required redemption date in June 2005.

Note 6. Shareholders' Equity

Sales of common stock for the six months ended June 30, 2002, and the year ended December 31, 2001 were as follows:

(in thousands)	2002	2001
Number of common shares	1,946	13,286
Gross proceeds	$51,800	$301,539
Less costs including underwriting fees	(1,880)	(14,651)
Net proceeds	$49,920	$286,888

In addition, the Company issued 204,855 shares of common stock with a value of $5,157,000 to acquire one portfolio investment in a stock-for-stock exchange during 2001.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive days immediately prior to the dividend payment date.

Dividend reinvestment plan activity for the six months ended June 30, 2002 and for the year ended December 31, 2001 was as follows:

(in thousands, except per share amounts)	2002	2001
Shares issued	128	271
Average price per share	$24.34	$23.32

Note 7. Earnings Per Common Share

Earnings per common share for the three and six months ended June 30, 2002 and 2001 were as follows:

(in thousands, except per share amounts)	For the Three Months Ended June 30, 2002	For the Three Months Ended June 30, 2001	For the Six Months Ended June 30, 2002	For the Six Months Ended June 30, 2001
Net increase in net assets resulting from operations	$ 73,454	$46,106	$129,415	$98,134
Less preferred stock dividends	(55)	(55)	(110)	(110)
Income available to common shareholders	$ 73,399	$46,051	$129,305	$98,024
Basic shares outstanding	101,660	89,356	100,822	87,441
Dilutive options outstanding to officers	1,780	1,492	2,078	1,525
Diluted shares outstanding	103,440	90,848	102,900	88,966
Basic earnings per common share	$ 0.72	$ 0.52	$ 1.28	$ 1.12
Diluted earnings per common share	$ 0.71	$ 0.51	$ 1.26	$ 1.10

Note 8. Dividends and Distributions

The Company's Board of Directors declared and the Company paid dividends of $0.53 and $0.55 per common share for the first and second quarters of 2002, respectively. The dividends totaled $56,223,000 and $109,482,000 for the three and six months ended June 30, 2002, respectively. The

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 8. Dividends and Distributions, continued

Company's Board of Directors also declared a dividend of $0.56 per common share for the third quarter of 2002.

Note 9. Supplemental Disclosure of Cash Flow Information

For the six months ended June 30, 2002 and 2001, the Company paid $34,055,000, and $31,916,000, respectively, for interest. For the six months ended June 30, 2002 and 2001, the Company's non-cash financing activities totaled $5,498,000 and $7,569,000, respectively, and includes stock option exercises and dividend reinvestment.

Note 10. Hedging Activities

The Company invests in BB+, BB and BB- CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate. The Company has entered into transactions with two financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved the Company receiving the proceeds from the sale of the borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities as of June 30, 2002 and December 31, 2001 consisted of the following:

(in thousands)	June 30, 2002		December 31, 2001	
Description of Issue	Cost	Value	Cost	Value
10-year Treasury, due August 2011	$ 2,074	$ 2,008	$19,175	$17,989
10-year Treasury, due August 2011	1,010	1,040	5,693	5,656
10-year Treasury, due August 2011	7,585	7,917	23,636	23,618
5-year Treasury, due February 2006	5,590	5,746	—	—
10-year Treasury, due August 2011	19,404	19,903	—	—
10-year Treasury, due February 2012	2,624	2,665	—	—
10-year Treasury, due February 2012	25,351	26,445	—	—
10-year Treasury, due February 2012	18,990	19,065	—	—
	$82,628	$84,789	$48,504	$47,263

Obligations to replenish borrowed Treasury securities as of June 30, 2002 and December 31, 2001 were $84,789,000 and $47,263,000, respectively, and are recorded as other liabilities. As of June 30, 2002, the total obligations on the hedge had increased since the original sale date due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligations of $2,161,000. The net proceeds related to the sales of the borrowed Treasury securities of $82,628,000 and $48,504,000 have been recorded as an other asset at June 30, 2002 and December 31, 2001, respectively.

Note 11. Financial Highlights

	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,				
	2002(5)	2001(5)	2001	2000	1999	1998	1997
Per Common Share Data							
Net asset value, beginning of period	$ 13.57	$ 12.11	$ 12.11	$ 10.20	$ 8.79	$ 8.07	$ 8.34
Net investment income before income tax benefit (expense) and net realized and unrealized gains(1)	0.94	0.92	1.92	1.53	1.18	1.06	0.94
Income tax benefit (expense)(1)	—	—	0.01	—	—	(0.01)	(0.03)
Net realized and unrealized gains(1)	0.32	0.18	0.23	0.41	0.46	0.45	0.36
Minority interests(1)	—	—	—	—	—	—	(0.03)
Net increase in net assets resulting from operations	1.26	1.10	2.16	1.94	1.64	1.50	1.24
Net decrease in net assets from shareholder distributions(2)	(1.08)	(0.99)	(2.01)	(1.82)	(1.60)	(1.43)	(1.71)
Net increase in net assets from capital share transactions	0.27	0.57	1.31	1.79	1.37	0.65	0.20
Net asset value, end of period	$ 14.02	$ 12.79	$ 13.57	$ 12.11	$ 10.20	$ 8.79	$ 8.07
Market value, end of period	$ 22.65	$ 23.15	$ 26.00	$ 20.88	$ 18.31	$ 17.31	$ 22.25
Total return	(9.18)%	15.56%	35.43%	25.47%	14.99%	(15.74)%	77.76%
Ratios and Supplemental Data ($ and shares in thousands, except per share amounts)							
Ending net assets	$1,434,453	$1,171,661	$1,352,123	$1,029,692	$667,513	$491,358	$420,060
Common shares outstanding at end of period(3)	102,296	91,578	99,607	85,057	65,414	55,919	52,047
Diluted weighted average shares outstanding	102,900	88,966	93,003	73,472	60,044	51,974	49,251
Employee and administrative expenses/ average net assets	1.74%	1.85%	3.80%	4.98%	6.25%	7.09%	4.66%
Total expenses/average net assets(4)	4.26%	4.79%	9.31%	11.88%	12.44%	11.86%	12.43%
Net investment income/ average net assets(4)	6.94%	7.54%	15.15%	13.55%	12.61%	12.72%	11.15%
Portfolio turnover rate	8.33%	6.27%	10.04%	28.92%	34.19%	63.53%	42.72%
Average debt outstanding	$ 940,357	$ 812,500	$ 847,121	$ 707,400	$461,500	$261,300	$336,800
Average debt per share	$ 9.14	$ 9.13	$ 9.11	$ 9.63	$ 7.69	$ 5.03	$ 6.84

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

(2) For the year ended December 31, 1997, shareholder distributions include $0.51 of merger-related dividends.

(3) Excludes 234,977, 516,779 and 810,456 common shares held in the deferred compensation trust at or for the years ended December 31, 2000, 1999, and 1998, respectively.

(4) For the purpose of calculating the ratios, total expenses and net investment income for the year ended December 31, 1997 exclude merger expenses of $5,159,000.

(5) The results for the six months ended June 30, 2002 and 2001, respectively, are not necessarily indicative of the operating results to be expected for the full year.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 12. Litigation

As of August 13, 2002, the Company is aware of seven class action lawsuits that have been filed in the United States District Court for the Southern District of New York against it, certain of its directors and officers and its former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. All of the actions essentially duplicate one another, pleading essentially the same allegations. The complaints filed in the lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically alleging, among other things, that the Company misstated the value of certain portfolio investments in its financial statements, which allegedly resulted in the purchase of its common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The lawsuits seek compensatory and other damages, and costs and expenses associated with the litigation. The Company believes that each of the lawsuits is without merit, and it intends to defend each of these lawsuits vigorously. While the Company does not expect these matters to materially affect its financial condition or results of operations, there can be no assurance of any particular outcome.

The Company also is party to certain other lawsuits in the normal course of business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that these proceedings will have a material effect upon its financial condition or results of operations.

Note 13. Subsequent Events

On July 1, 2002, the Company completed the sale of WyoTech Acquisition Corporation for approximately $84.4 million in cash. The Company's total cash proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our 91% common equity ownership, were approximately $77.0 million, resulting in a realized gain of $60.6 million in the third quarter of 2002 on the transaction. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions. Total interest and related portfolio income earned from WyoTech for the three months ended June 30, 2002 was $1.8 million, which will no longer occur due to the sale of the investment on July 1, 2002.

On July 31, 2002, the Company completed the sale of $82.7 million of CMBS, which resulted in a realized gain of approximately $12 million. The bonds sold had an effective yield of 12%. Additionally, the Company reversed previously recorded net unrealized appreciation of approximately $5 million related to these bonds.

Independent Accountants' Review Report

The Board of Directors and Shareholders
Allied Capital Corporation and Subsidiaries:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of June 30, 2002, and the related consolidated statements of operations for the three- and six-month periods ended June 30, 2002, changes in net assets and cash flows for the six-month period ended June 30, 2002, and financial highlights (included in Note 11) for the six-month period ended June 30, 2002. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

The consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the statement of investments, as of December 31, 2001, and financial highlights (included in note 11) for the year then ended, were audited by other auditors whose report dated February 20, 2002 expressed an unqualified opinion on those statements.

/s/ KPMG LLP

Washington, D.C.

July 22, 2002, except as to notes 12 and 13 which are
as of August 13, 2002 and July 31, 2002, respectively

Item 2. ***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, 2001.

Financial or other information presented for private finance portfolio companies has been obtained from the portfolio company, 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 accounting principles generally accepted in the United States of America 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 accounting principles generally accepted in the United States of America.

OVERVIEW

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

Our portfolio composition at June 30, 2002 and December 31, 2001 was as follows:

	At June 30, 2002	At December 31, 2001
Private Finance	69%	68%
Commercial Real Estate Finance	31%	32%
Small Business Finance	—%	—%

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

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the three and six months ended June 30, 2002 and 2001 and at and for the year ended December 31, 2001 were as follows:

($ in millions)	At and for the Three Months Ended June 30, 2002	2001	At and for the Six Months Ended June 30, 2002	2001	At and for the Year Ended December 31, 2001
	(unaudited)		(unaudited)		
Portfolio at value	$2,381.0	$2,000.6	$2,381.0	$2,000.6	$2,329.6
Investments funded	$ 115.5	$ 149.0	$ 195.5	$ 299.8	$ 680.3
Change in accrued or reinvested interest and dividends	$ 6.2	$ 10.9	$ 19.5	$ 25.5	$ 51.6
Repayments	$ 36.0	$ 12.2	$ 67.0	$ 42.5	$ 74.5
Sales	$ 1.2	$ 39.4	$ 126.3	$ 74.6	$ 130.0
Yield*	13.8%	14.2%	13.8%	14.2%	14.3%

* The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing interest-bearing investments, 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, investment activity and yields at and for the three and six months ended June 30, 2002 and 2001 and at and for the year ended December 31, 2001 were as follows:

($ in millions)	At and for the Three Months Ended June 30, 2002	2001	At and for the Six Months Ended June 30, 2002	2001	At and for the Year Ended December 31, 2001
	(unaudited)		(unaudited)		
Portfolio at value:					
Loans and debt securities	$1,050.8	$1,044.5	$1,050.8	$1,044.5	$1,107.9
Equity interests	584.5	360.9	584.5	360.9	487.2
Total portfolio	$1,635.3	$1,405.4	$1,635.3	$1,405.4	$1,595.1
Investments funded	$ 32.2	$ 93.3	$ 69.8	$ 113.9	$ 287.7
Change in accrued or reinvested interest and dividends	$ 7.0	$ 12.2	$ 19.1	$ 24.4	$ 48.9
Repayments	$ 27.2	$ 6.1	$ 56.0	$ 23.1	$ 43.8
Yield*	13.9%	14.6%	13.9%	14.6%	14.8%

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

Private finance new investment activity across the industry slowed during 2001, largely due to a lack of available senior debt capital and the state of the economy in general. We believe the level of merger and acquisition activity throughout the U.S. has continued to be depressed into 2002, and we have seen fewer opportunities for mezzanine or equity investment in the first six months of 2002 as compared to 2001. We believe the environment for private finance investing appears to be improving and, although the merger and acquisition environment remains slow, we are seeing more new investment opportunities related to recapitalization and growth financings. In the third quarter of 2002, we have completed two financings totaling $51 million to date. We are also beginning to see increasing activity within our own portfolio as there are several companies in the private finance portfolio that are in the process of exploring sale, initial public offering or recapitalization events. This means that we may see opportunities to continue our involvement with some of these companies by financing the buyout or recapitalization transactions. This activity could also result in additional potential realized or unrealized gains for the remainder of 2002 and into 2003.

Investments funded during the three and six month periods ended June 30, 2002 and the year ended December 31, 2001 consisted of the following:

($ in thousands)	Loans and Debt Securities	Equity Interests	Total
For the three months ended June 30, 2002(1)			
Companies more than 25% owned	$ 12,550	$ 3,378	$ 15,928
Companies 5% to 25% owned	5,400	7,000	12,400
Companies less than 5% owned	3,359	463	3,822
Total	$ 21,309	$10,841	$ 32,150

For the six months ended June 30, 2002(1)			
Companies more than 25% owned	$ 15,962	$ 3,759	$ 19,721
Companies 5% to 25% owned	7,494	7,046	14,540
Companies less than 5% owned	34,023	1,506	35,529
Total	$ 57,479	$12,311	$ 69,790
For the year ended December 31, 2001(1)			
Companies more than 25% owned	$ 47,860	$78,260	$126,120
Companies 5% to 25% owned	8,203	3,721	11,924
Companies less than 5% owned	142,144	7,548	149,692
Total	$198,207	$89,529	$287,736

(1) The private finance portfolio is presented in three categories—companies more than 25% owned which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and therefore are deemed controlled by us under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company's board of directors and, therefore are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company.

At June 30, 2002, we had outstanding funding commitments of $69.0 million to portfolio companies, including $31.6 million committed to private venture capital funds.

We fund new investments using cash, through the issuance of our common equity, the reinvestment of previously accrued interest and dividends in debt or equity securities, or the current reinvestment of interest and dividend income through the receipt of a debt or equity security (payment-in-kind income). From time to time we may opt to reinvest accrued interest receivable in a new debt or equity security, in lieu of receiving such interest in cash and providing a subsequent growth investment.

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional capital and, therefore, we may defer current debt service. Our most significant investments acquired through control buyout transactions at June 30, 2002 were The Hillman Companies, Inc., (formerly SunSource, Inc.), acquired in 2001, Business Loan Express, Inc., acquired in 2000 and WyoTech Acquisition Corporation, acquired in 1998.

The Hillman Companies, Inc. During 2001, we acquired 93.2% of the common equity of SunSource, Inc. for $71.5 million in cash. Subsequently, SunSource completed the sale of its STS business unit and distributed $16.5 million in cash to us, reducing our common stock cost basis to

$57.2 million at December 31, 2001. As part of the STS sale, we invested $3.2 million in the new STS. During the third quarter of 2001, we received fees from SunSource of $2.8 million related to transaction assistance for the SunSource sale and STS sale, and $1.6 million for the syndication of SunSource's senior credit facilities. In addition, we realized a gain of $2.5 million from the sale of warrants prior to the buyout transaction. During the first quarter of 2002, SunSource changed its name to The Hillman Companies, Inc., also referred to as Hillman. At June 30, 2002, our investment in Hillman totaled $131.0 million at value, or 5% of total assets. The value of our investment in Hillman increased by $32.8 million during the second quarter of 2002 as discussed below.

Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers and mass merchants. Hillman has certain patent-protected products including key duplication technology that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

For the six months ended June 30, 2002, Hillman had total revenue of $139 million, earnings before interest, taxes, depreciation, amortization and management fees, or EBITDAM, of $23 million, and profits before taxes of $3 million. Hillman is above plan for the year and as of June 30, 2002, is projected to achieve revenues of approximately $276 million, EBITDAM of approximately $50 million, and profits before taxes of approximately $7 million for the year ending December 31, 2002. Hillman had total assets of $360 million and total debt of $141 million at June 30, 2002. Hillman is current on all of its debt obligations and is in compliance with all debt covenants.

Business Loan Express, Inc. On December 31, 2000, we acquired 94.9% of BLC Financial Services, Inc. in a "going private" buyout transaction for $95.2 million. We issued approximately 4.1 million shares of our common stock, or $86.1 million of new equity, and paid $9.1 million in cash to acquire BLC, which thereafter changed its name to Business Loan Express, Inc.

As part of the transaction, we recapitalized Allied Capital Express, our small business lending operation, as an independently managed private portfolio company and merged it into Business Loan Express. We contributed certain assets, including our online rules-based underwriting technology and fixed assets, and transferred 37 employees to the private portfolio company. Upon completion of the transaction, our investment in Business Loan Express as of December 31, 2000 totaled $204.1 million and consisted of $74.5 million of subordinated debt, $25.1 million of preferred stock, and $104.5 million of common stock. At June 30, 2002, our investment in Business Loan Express totaled $251.9 million at value, or 9.8% of our total assets. During the second quarter of 2002, the value of our investment in Business Loan Express increased by $19.9 million, and as of June 30, 2002, we have recorded total unrealized appreciation of $35.4 million on this investment.

Business Loan Express is the nation's second largest non-bank government guaranteed lender utilizing the Small Business Administration's 7(a) Guaranteed Loan Program and is licensed by the Small Business Administration as a Small Business Lending Company (SBLC). Therefore, changes in the laws or regulations that govern SBLCs or the Small Business Administration's 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material impact on Business Loan Express or its operations. Business Loan Express is a preferred lender as designated by the Small Business Administration in 67 markets across the United States, and originates, sells and services small business loans. In addition to the 7(a) Guaranteed Loan Program, Business Loan Express originates loans under the USDA Business and Industry Guaranteed Loan Program and originates conventional small business loans. Business Loan Express has offices in 35 cities and is headquartered in New York, New York.

Unaudited financial data for Business Loan Express at and for the year ended June 30, 2002 was as follows:

($ in millions)	At and for the Year Ended June 30, 2002(1) (unaudited)
Operating Data	
Total revenue	$ 84.6
Profits before taxes	$ 3.6
Earnings before interest, taxes and management fees (EBITM)	$ 43.0
Balance Sheet Data	
Total assets(2)	$ 276.2
Total debt	$ 183.0
Total shareholders' equity	$ 59.0
Other Data	
Total loan originations	$ 565.1
Serviced loan portfolio	$1,372.6
Number of loans	2,083
Loan delinquencies(3)	9.4%

(1) Financial results at and for the year ended June 30, 2002 are preliminary and not audited and are therefore subject to adjustment prior to completion of the audit.

(2) Included in total assets is $6 million of goodwill. There is no other goodwill on BLX's balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. "Push-down" accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.

(3) Represents the percentage of loans in the serviced portfolio that are greater than 30 days delinquent, which includes loans in workout status. Delinquencies for the types of small business loans made by BLX typically range between 8% and 12%.

The loans originated by Business Loan Express, or BLX, are generally secured by commercial real estate. Loans originated under the 7(a) Guaranteed Loan Program also require the personal guarantee of the borrower and, in many cases, the loans are also secured by additional real estate collateral. Because the loans are secured by collateral, Business Loan Express' annual loan losses for its SBA 7(a) loans, computed using the unguaranteed balance of the SBA 7(a) serviced portfolio, were 0.6% on average for the last five years.

Business Loan Express sells or securitizes substantially all of the loans it originates. BLX currently sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee

generally between 1% and 1.6% of the guaranteed loan amount. Alternatively, BLX may sell the guaranteed piece of SBA 7(a) guaranteed loans at par and retain an annual servicing spread, at current prices, of generally between 4.0% and 4.8%. BLX securitizes the unguaranteed piece of the SBA 7(a) loans and other loans it originates. Typically, BLX retains between 0% and 2.7% of the loan securitization pools and receives a spread from the excess of loan interest received on the loans sold over the interest cost on the securities issued in the securitization generally between 4.7% and 4.8%.

As a result of BLX's guaranteed loan sales and as a result of securitization transactions, BLX had assets at June 30, 2002 totaling approximately $106 million representing the residual interests in and servicing assets for loans sold or securitized, together referred to as Residual Interests. These Residual Interests represent the discounted present value of future cash flow streams to be received from loans sold or securitized after making allowances for prepayments, losses and loan delinquencies.

If loan payments on all loans were to be received as stated in the loan agreements, estimated future cash flows to BLX from loans sold or securitized would total approximately $412 million in the aggregate over the remaining term of these loans. Of the approximate $412 million, estimated cash flows for the years ended June 30, 2003, 2004, 2005, and 2006 would be approximately $33 million, $31 million, $30 million and $29 million, respectively.

Business Loan Express has a three-year $124 million revolving credit facility. As the controlling shareholder of Business Loan Express, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest and other fees) of Business Loan Express under the revolving credit facility. The amount guaranteed by us at June 30, 2002 was $48.1 million. This guaranty can be called by the lenders only in the event of a default by Business Loan Express. Business Loan Express was in compliance with the terms of the revolving credit facility at June 30, 2002. We have also provided two standby letters of credit in connection with two term securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling $10.6 million.

Business Loan Express is currently contemplating a corporate restructure and recapitalization whereby the company would convert from a corporation to a limited liability company. This restructure would enable the company to have greater flexibility as it grows. Upon such restructure and recapitalization our equity interests would be converted to membership units and the earnings of Business Loan Express would pass through to its members as dividends. There can be no assurance when or if the corporate restructure and recapitalization will occur.

WyoTech Acquisition Corporation. On July 1, 2002, we sold WyoTech Acquisition

Corporation for $84.4 million in cash. We acquired WyoTech in December of 1998 and owned 91% of the common equity of WyoTech. At June 30, 2002, our investment had a cost basis of $16.4 million, which represented all of the debt ($12.6 million), preferred stock ($3.7 million) and 91% of the common equity capital ($0.1 million) of WyoTech. Our total cash proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our 91% common equity ownership, were approximately $77.0 million, resulting in a realized gain of approximately $60.6 million on the transaction. At June 30, 2002, we determined the fair value of our investment in WyoTech to be $77.0 million, which resulted in an increase in fair value during the second quarter of

$6.6 million. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions.

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity and yields at and for the three and six months ended June 30, 2002 and 2001 and at and for the year ended December 31, 2001 were as follows:

($ in millions)	At and for the Three Months Ended June 30, 2002	2001	At and for the Six Months Ended June 30, 2002	2001	At and for the Year Ended December 31, 2001
	(unaudited)		(unaudited)		
Portfolio at value:					
CMBS bonds	$560.9	$405.5	$560.9	$405.5	$558.3
Collateralized debt obligations	52.5	24.9	52.5	24.9	24.2
Total CMBS	613.4	430.4	613.4	430.4	582.5
Commercial mortgage loans	62.0	87.8	62.0	87.8	79.6
Residual interest	69.0	74.9	69.0	74.9	69.9
Real estate owned	1.3	2.1	1.3	2.1	2.5
Total Portfolio	$745.7	$595.2	$745.7	$595.2	$734.5
Investments funded	$ 83.3	$ 55.7	$125.7	$185.9	$392.6
Change in accrued or reinvested interest	$ (0.8)	$ (1.3)	$ 0.4	$ 1.1	$ 2.7
Repayments	$ 8.8	$ 6.1	$ 11.0	$ 19.4	$ 30.7
Sales	$ 1.2	$ 39.4	$126.3	$ 74.6	$130.0
Yield*	13.7%	13.6%	13.7%	13.6%	13.5%

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

Our primary commercial real estate investment activity is the investment in non-investment grade commercial mortgage-backed securities, or CMBS. In 1998, we began to take advantage of a unique market opportunity to acquire non-investment grade CMBS bonds at significant discounts from the face amount of the bonds. We believe that CMBS is an attractive asset class because of the yields that can be earned on a security that is secured by commercial mortgage loans, and ultimately commercial real estate properties. We plan to continue our CMBS investment activity, however, in order to maintain a balanced portfolio, we expect that CMBS will continue to represent approximately 20% to 25% of our total assets. Our CMBS investment activity level will be dependent upon our ability to invest in CMBS at attractive yields.

Our commercial real estate investment activity for the three and six months ended June 30, 2002 and for the year ended December 31, 2001 was as follows:

	Amount Invested			
($ in millions)	Face Amount	Discount	Amount Funded	Yield(1)
For the three months ended June 30, 2002				
CMBS bonds	$143.3	$(65.0)	$78.3	13.9%
CDOs	4.9	—	4.9	16.6%
Commercial mortgage loans	0.1	—	0.1	10.0%
Total	$148.3	$(65.0)	$83.3	14.0%

	Amount Invested			
($ in millions)	Face Amount	Discount	Amount Funded	Yield(1)
For the six months ended June 30, 2002				
CMBS bonds	$181.4	$ (83.8)	$ 97.6	14.7%
CDOs	28.0	—	28.0	17.5%
Commercial mortgage loans	0.1	—	0.1	10.0%
Total	$209.5	$ (83.8)	$125.7	15.2%
For the year ended December 31, 2001				
CMBS bonds	$661.4	$(295.6)	$365.8	14.0%
CDOs	24.6	—	24.6	16.9%
Commercial mortgage loans	2.2	—	2.2	10.0%
Total	$688.2	$(295.6)	$392.6	14.2%

(1) The yield on new CMBS bond investments will vary from period to period depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds purchased in that period to the total amount invested.

CMBS Bonds. The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At June 30, 2002, our CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal, we invest in these CMBS bonds at an approximate discount of 50% from the face amount of the bonds.

The underlying pools of mortgage loans that are collateral for our new CMBS bond investments for the six months ended June 30, 2002 and for the year ended December 31, 2001 had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

	For the Six Months Ended June 30, 2002		For the Year Ended December 31, 2001	
Loan to Value Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**
Less than 60%	$ 401.9	16%	$1,259.7	15%
60-65%	178.7	7	941.6	11
65-70%	264.1	11	1,140.6	14
70-75%	799.5	32	2,400.4	29
75-80%	812.7	33	2,466.4	30
Greater than 80%	12.0	1	119.6	1
Total	$2,468.9	100%	$8,328.3	100%
Weighted average loan to value	70.4%		69.7%	

	For the Six Months Ended June 30, 2002		For the Year Ended December 31, 2001	
Debt Service Coverage Ratio(1) Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**
Greater than 2.00	$ 103.3	4%	$ 484.8	6%
1.76-2.00	84.2	3	158.2	2
1.51-1.75	240.3	10	855.0	10
1.26-1.50	1,631.8	66	5,008.3	60
1.00-1.25	409.3	17	1,822.0	22
Total	$2,468.9	100%	$8,328.3	100%
Weighted average debt service coverage ratio	1.41		1.48	

(1) Defined as annual net cash flow before debt service divided by annual debt service payments.

As a part of our strategy to maximize our return on equity capital, we sold CMBS bonds rated

BB+, BB and BB- during the six months ended June 30, 2002, and during 2001 totaling $123.3 million and $124.5 million, respectively. These bonds had an effective yield of 11.2% and 10.3%, and were sold for $128.8 million and $126.8 million, respectively, resulting in realized gains on the sales. The sales of these lower-yielding bonds increased our overall liquidity. We did not sell any CMBS bonds during the second quarter of 2002.

The effective yield on our CMBS portfolio at June 30, 2002 and December 31, 2001 was 14.6% and 14.7%, respectively. The yield on the CMBS portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds held in the portfolio. At June 30, 2002 and December 31, 2001, the unamortized discount related to the CMBS portfolio was $645.0 million and $611.9 million, respectively. At June 30, 2002, the CMBS bond portfolio had a fair value of $560.9 million, which included net unrealized appreciation on the CMBS bonds of $23.9 million.

At June 30, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 commercial mortgage loans with a total outstanding principal balance of $22.9 billion. At June 30, 2002 and December 31, 2001, 0.75% and 0.52%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

On July 31, 2002, we sold $129.8 million of face amount of CMBS bonds, with a cost basis of $82.7 million, and recognized a gain on the sale of approximately $12 million. The CMBS bonds sold represent a strip of BB+ through B from our portfolio and had a weighted average yield to maturity of 12%. The CMBS bonds were sold to institutional investors. We had recorded approximately $5 million in net unrealized appreciation, which is net of unrealized depreciation on the related hedge of approximately $1 million, related to these CMBS bonds in the second quarter of 2002. Therefore, this sale will contribute earnings of approximately $7 million to the third quarter of 2002. Upon completion of the CMBS bond sale, we continue to own $471.3 million of non-investment grade CMBS bonds at value with a yield to maturity of 15.2%.

Collateralized Debt Obligations. During the six months ended June 30, 2002, and the year ended December 31, 2001, we invested in the preferred shares of two and one, respectively, collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT debt

collateral consists of $852.8 million issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of $402.1 million issued in 26 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of $405.0 million that were issued in 30 separate CMBS transactions. Included in the CMBS collateral for the CDOs are $393.8 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 22 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, our preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs was 17.2% and 16.9% at June 30, 2002, and December 31, 2001, respectively.

Commercial Mortgage Loans. We have been liquidating much of our whole commercial mortgage loan portfolio so that we can redeploy the proceeds into higher yielding assets. For the three and six months ended June 30, 2002, and for the year ended December 31, 2001, we sold $1.2 million, $3.0 million and $5.5 million, respectively, of commercial mortgage loans. At June 30, 2002, our whole commercial real estate loan portfolio had been reduced to $62.0 million from $79.6 million at December 31, 2001.

Residual Interests. The residual interest primarily consists of a retained interest totaling $68.9 million from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At June 30, 2002, two classes of bonds rated AAA and AA+ are outstanding, for total bonds outstanding of $29.6 million. On August 9, 2002, the bonds rated AA+ were upgraded to AAA. We have the right to call the bonds when the outstanding bond balance is less than $23.9 million. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to us calling the bonds, the remaining loans in the trust will be returned to us as payment on the residual interest. At June 30, 2002, the residual interest had a fair value of $69.0 million.

Portfolio Asset Quality

We employ a standard grading system for the 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 interest or principal is expected. Grade 4 is used for investments that are in workout and for which some loss of current interest 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 and the investment is written down to net realizable value.

At June 30, 2002 and December 31, 2001, our portfolio was graded as follows:

Grade	2002 Portfolio at Value	2002 Percentage of Total Portfolio	2001 Portfolio at Value	2001 Percentage of Total Portfolio
($ in millions)				
1	$ 793.6	33.3%	$ 603.3	25.9%
2	1,400.0	58.8	1,553.8	66.7
3	46.7	2.0	79.5	3.4
4	43.6	1.8	44.5	1.9
5	97.1	4.1	48.5	2.1

	$2,381.0	100.0%	$2,329.6	100.0%

Total Grades 4 and 5 assets as a percentage of the total portfolio at value at June 30, 2002 and December 31, 2001 were 5.9% and 4.0%, respectively. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate significantly from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected full amount of the potential loss when such exposure is identified.

For the total investment portfolio, workout loans not accruing interest, or those loans in Grade 4 and 5, were $121.4 million at value at June 30, 2002, or 5.1% of the total portfolio. Included in this category at June 30, 2002, were assets valued at $8.9 million that represent receivables related to companies in liquidation and loans of $16.2 million that were secured by commercial real estate. Workout loans not accruing interest were $109.0 million at value at December 31, 2001 or 4.7% of the total portfolio of which $8.9 million represented receivables related to companies in liquidation, and $15.2 million represented loans secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, we may not accrue interest on loans to companies which are more than 50% owned by us from time to time if such companies are in need of additional capital and, therefore, we may defer current debt service. Loans and debt securities to such companies totaled $61.3 million at value at June 30, 2002. Loans greater than 90 days delinquent were $89.4 million at value at June 30, 2002, or 3.8% of the total portfolio. Included in this category are loans valued at $22.0 million that are secured by commercial real estate. Loans greater than 90 days delinquent were $39.1 million at value at December 31, 2001 or 1.7% of the total portfolio. Included in this category are loans valued at $14.1 million that were secured by commercial real estate.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from quarter to quarter. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to amend the terms of payment to us or to restructure their debt and equity capital. During such restructuring, we may not receive or accrue interest or dividend payments. The investment portfolio is priced to provide current

returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans greater than 90 days delinquent or on non-accrual status is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment principal (Grade 5 assets).

At June 30, 2002 and December 31, 2001, 0.75% and 0.52% of the loans in the underlying collateral pool for our CMBS bond portfolio were over 30 days delinquent or were classified as real estate owned. We closely monitor the performance of all of the loans in the underlying collateral pools securing our CMBS investments.

Other Assets and Other Liabilities

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of the borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price.

The total obligations to replenish borrowed Treasury securities were $84.8 million and $47.3 million at June 30, 2002 and December 31, 2001, respectively, which included unrealized depreciation on the obligations of $2.2 million and unrealized appreciation on the obligations of $1.2 million, respectively, due to changes in the yield on the borrowed Treasury securities. The obligations have been recorded as an other liability. The proceeds related to the sales of the borrowed Treasury securities were $82.6 million and $48.5 million at June 30, 2002 and December 31, 2001, respectively, and have been recorded as an other asset.

RESULTS OF OPERATIONS

Comparison of Three Months Ended June 30, 2002 and 2001

The following table summarizes our condensed operating results for the three months ended June 30, 2002 and 2001.

($ in thousands, except per share amounts)	For the Three Months Ended June 30, 2002	2001	Change	Percent Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$ 62,692	$58,824	$ 3,868	7%
Premiums from loan dispositions	46	910	(864)	(95%)
Fees and other income	10,455	9,005	1,450	16%
Total interest and related portfolio income	73,193	68,739	4,454	6%
Expenses				
Interest	17,515	15,951	1,564	10%
Employee	8,274	7,610	664	9%
Administrative	4,843	3,060	1,783	58%
Total operating expenses	30,632	26,621	4,011	15%

Net investment income before net realized and unrealized gains	42,561	42,118	443	1%
Net Realized and Unrealized Gains				
Net realized gains (losses)	(755)	3,837	(4,592)	*
Net unrealized gains	31,648	151	31,497	*
Total net realized and unrealized gains	30,893	3,988	26,905	*
Net increase in net assets resulting from operations	$ 73,454	$46,106	$27,348	59%
Diluted earnings per share	$ 0.71	$ 0.51	$ 0.20	39%
Weighted average shares outstanding — diluted	103,440	90,848	12,592	14%

* Net realized and net unrealized gains and losses can fluctuate significantly from quarter to quarter. As a result, quarterly comparisons of net realized and net unrealized gains and losses may not be meaningful.

Net increase in net assets resulting from operations, or net income, results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus net realized and unrealized gains or losses.

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

	For the Three Months Ended June 30,	
($ in millions, except per share amounts)	**2002**	**2001**
Total Interest and Related Portfolio Income	$73.2	$68.7
Per share	$0.71	$0.76

The increase in interest income earned results primarily from the growth of our investment portfolio. Our investment portfolio, excluding non-interest bearing equity

interests in portfolio companies, increased by 10% to $1,796.5 million at June 30, 2002 from $1,639.7 million at June 30, 2001. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2002 and 2001 was as follows:

	June 30,	
	2002	**2001**
Private Finance	13.9%	14.6%
Commercial Real Estate Finance	13.7%	13.6%
Total Portfolio	13.8%	14.2%

Included in premiums from loan dispositions are prepayment premiums of $0 and $0.1 million for the three months ended June 30, 2002 and 2001, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, management services to portfolio companies, guaranties and other advisory services. We generate fee income for the transaction services and management services that we provide. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance and risk management.

Fees and other income for the quarter ended June 30, 2002 included fees of $2.6 million related to structuring and diligence, fees of $1.8 million related to transaction services provided to portfolio companies, and fees of $6.0 million related to management services provided to portfolio companies, guaranty and other advisory services. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Business Loan Express, Hillman and WyoTech are our most significant portfolio investments and together represent 17.9% of our total assets at June 30, 2002. Total interest and related portfolio income earned from these investments for the three months ended June 30, 2002 and 2001 was $14.0 million and $10.2 million, respectively. Total interest and related portfolio income earned from WyoTech for the three months ended June 30, 2002 was $1.8 million, which will no longer occur due to the sale of the investment on July 1, 2002.

Operating Expenses. Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the three months ended June 30, 2002 and 2001 are attributable to changes in the level of our borrowings under various notes payable and debentures and

our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

($ in millions)	At and for the Three Months Ended June 30, 2002	2001
Total Outstanding Debt	$1,009.0	$881.1
Average Outstanding Debt	$ 942.3	$812.5

Weighted Average Cost	7.2%	7.4%
BDC Asset Coverage*	256%	247%

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

Employee expenses include salaries and employee benefits. The increase in salaries and employee benefits for the periods presented reflects wage increases and the experience level of employees hired. Total employees were 103 and 101 at June 30, 2002 and 2001, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors' fees, legal and accounting fees, insurance premiums and various other expenses. The increase in administrative expenses as compared to the same period in 2001 includes approximately $1.2 million from legal, consulting and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately $0.1 million due to increased costs for corporate liability insurance, $0.3 million due to outsourced technology assistance, and $0.2 million due to travel costs, including corporate aircraft depreciation.

Realized Gains and Losses. Net realized gains (losses) resulted from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans, commercial mortgage loans and CMBS bonds, offset by losses on investments. Net realized and unrealized gains and losses were as follows:

	For the Three Months Ended June 30,	
	2002	**2001**
($ in millions)		
Realized Gains	$ 2.5	$ 4.7
Realized Losses	(3.3)	(0.9)
Net Realized Gains (Losses)	$ (0.8)	$ 3.8
Net Unrealized Gains	$31.6	$ 0.2

Realized gains and losses for the three months ended June 30, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the three months ended June 30, 2002, primarily resulted from transactions involving two

private finance portfolio companies, Cumulus Media, Inc. ($0.5 million) and Alderwoods Group, Inc. ($0.1 million), and one commercial real estate investment ($1.3 million). We reversed previously recorded unrealized appreciation totaling $2.1 million and $2.9 million when gains were realized for the three months ended June 30, 2002 and 2001, respectively.

Realized losses for the three months ended June 30, 2002, primarily resulted from transactions involving three private finance portfolio companies, iSolve Incorporated ($0.9 million), Sure-Tel, Inc. ($0.5 million) and Soff-Cut Holdings, Inc. ($0.5 million), and one commercial real estate investment ($1.1 million). We reversed previously recorded unrealized depreciation totaling $2.0 million and $1.5 million when losses were realized for the three months ended June 30, 2002 and 2001, respectively.

Unrealized Gains and Losses. We determine the fair value of each investment in our portfolio on a quarterly basis, and changes in fair value result in unrealized gains or losses being recognized. At June 30, 2002, $2,381.0 million, or 93% of our total assets, represented investments recorded at value. 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 ready market for the investments in our portfolio, we value substantially all of our investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily ascertainable 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 must determine the fair value of 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. 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 are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition and market changing events that impact valuation.

Valuation Methodology — Private Finance. Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based upon 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 monthly 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 upon multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. 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, or acquisition, recapitalization or restructuring related items.

In determining a multiple to use for valuation purposes, we 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 private relative to a peer group, but 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 upon 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 are determined based upon various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other pertinent factors such as recent offers to purchase a portfolio company's equity interest or other potential liquidity events. The determined equity values are generally discounted when we have a minority position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

Valuation Methodology — CMBS Bonds. CMBS bonds are carried at fair value, which is based upon a discounted cash flow model which utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors and the characteristics of the underlying cash flow. Our assumption with regard to discount rate is based upon the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our

CMBS bonds, as comparable yields in the market change and/or whenever we determine that the value of our CMBS bonds is less than the cost basis due to impairment in the underlying collateral pool.

Net unrealized gains for the second quarter of 2002 were $31.6 million, which included $113.8 million of unrealized gains and $82.2 million of unrealized losses.

Private Finance. We increased the fair value of our investment in The Hillman Companies, Inc. by $32.8 million in the second quarter of 2002. The fair value of our investment in Hillman is based upon our estimate of Hillman's enterprise value of approximately $350 million, including all debt. As discussed above, there is no one methodology to determine enterprise value. As multiples or EBITDAM fluctuate over time, this may or may not impact our estimate of Hillman's enterprise value. The following is a simplified summary of the methodology that we used to determine the fair value of our investment in Hillman.

Since Hillman's results can be affected by seasonal changes, we believe using projected 2002 results for valuation purposes is most appropriate. Hillman is performing better than Hillman's originally projected 2002 revenue and EBITDAM estimates, resulting in part from the closing of a former corporate headquarters for cost savings, the completion of an acquisition and successful expansion into Canada. Hillman is above its original projections for the year as of June 30, 2002, and its 2002 revenue and EBITDA is expected to exceed revenue and EBITDA for 2001.

We believe the current enterprise value for Hillman is approximately $350 million, or approximately 7 times 2002 projected EBITDAM of $50 million. The 7 times multiple was determined by obtaining the average multiple of enterprise value to EBITDA for comparable public companies in Hillman's peer group and discounting that average multiple to arrive at a private company multiple. We then subtracted Hillman's debt (including $41.0 million of subordinated debt owed to us) and Hillman's trust preferred securities estimated to be currently outstanding to arrive at a common equity value of approximately $102 million. We then took our 78% fully diluted share of the resulting equity value and added to it the cost basis of our share of two securities, including a note receivable from GC-Sun Holdings II, LP (Kar Products, LP) and preferred stock of STS Operating, Inc., owned by Hillman that are anticipated to be distributed to us in the third quarter of 2002. We arrived at a total fair value of our common equity of approximately $90 million. We compared the $90 million fair value to our basis in Hillman's common equity of $57.2 million and recorded an unrealized gain of $32.8 million.

We increased the fair value of our investment in Business Loan Express, or BLX, by $19.9 million in the second quarter of 2002 or just slightly under 10% of the total amount invested. BLX has just completed its first full fiscal year of operations since our acquisition of the company in December 2000. During 2002, BLX achieved most of its goals, including launching a conventional small business loan product. The fair value for our investment in BLX is based upon our estimate of BLX's enterprise value of approximately $390 million, including all debt. As discussed above, there is no one methodology to determine enterprise value. The following is a simplified summary of the methodology that we used to determine the fair value of our investment in BLX.

To determine the enterprise value of BLX, we determined that financial services companies are generally valued using multiples of net income. We have capitalized BLX with $87 million of subordinated debt. For purposes of valuation, we assumed in a sale transaction that a portion of this $87 million would be considered equity and that BLX would increase the size of its senior debt facility to approximately $155 million. Given this

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assumption, we then computed a pro forma net income for BLX taking its preliminary, unaudited 2002 earnings before interest, taxes and management fees, and subtracting pro forma interest, assuming the higher level of senior debt and no outstanding subordinated debt. We then computed taxes at a rate of 40 percent, which resulted in pro forma net income for BLX of approximately $23 million for fiscal year 2002 and a projected pro forma net income for fiscal year 2003 of approximately $26 million. We then performed three valuation analyses to determine the fair value of BLX — assuming an initial public offering of BLX, assuming the sale of BLX, and, lastly, considering discounted trading ranges for similar companies in the public markets. In performing these analyses, we used a publicly traded peer group and reviewed merger and acquisition transactions that occurred in the last five years in the commercial finance sector. These analyses resulted in a range of estimated enterprise values, and we selected $390 million, which was at the low end of the range. After deducting outstanding debt and preferred stock from the enterprise value to reach an equity value, we determined the value of our 92.8% fully diluted common equity interest to be approximately $140.0 million. We compared the $140.0 million fair value to the fair value of our common equity at March 31, 2002 of $120.1 million, and recorded an unrealized gain of $19.9 million in the second quarter of 2002. As multiples or pro forma net income fluctuate over time, this may or may not impact our determination of the fair value of our investment in BLX.

During the second quarter of 2002, we also increased the fair value of: WyoTech Acquisition Corporation by $6.6 million based on the proceeds received from the sale of this investment in July 2002; Blue Rhino and Kirkland's by $7.8 million and $5.7 million, respectively, based on the public market valuations of each company's stock; and CorrFlex Graphics LLC by $11.8 million based on strong earnings growth and upon indicative valuation estimates received from third parties. In addition, we recorded unrealized appreciation totaling $14.0 million on nine other investments in our portfolio.

During the second quarter of 2002, we decreased the fair value of our investment in Startec Global Communications Corporation by $10.2 million to reflect the current plan of reorganization filed with the bankruptcy court this quarter. We also decreased the fair value of our investment in Velocita, Inc. by $4.3 million. Velocita filed for bankruptcy under Chapter 11 in June 2002, and, based upon the assessment of an independent third party regarding Velocita's liquidation value, we do not expect to recover our investment. Our investment has a fair value of zero at June 30, 2002.

We also recorded $69.9 million in unrealized losses during the second quarter of 2002, largely due to conditions in the manufacturing, technology and media sectors, and the continuing effects of the events of September 11th, 2001. Portfolio companies for which unrealized depreciation was recorded this quarter include five companies in the portfolio that have been affected by weakness in the manufacturing sector for which we decreased fair value by $20.6 million; five companies that have been affected by lower levels of technology spending for which we decreased fair value by $14.7 million; two companies in the media sector that have declined in fair value due to declining values in this sector for which we decreased fair value by $7.7 million; and two companies that continued to endure difficulties during the second quarter of 2002 as a result of the attacks of September 11th that have declined in fair value by $11.3 million. As the economy improves, the financial performance of these portfolio companies may also improve. However, there can be no assurance when or if these companies' performance may improve.

CMBS Bonds. We recorded a net increase in the fair value of our CMBS bond portfolio by $20.7 million in the second quarter of 2002. We determined the fair value of our CMBS bond portfolio using a discounted cash flow model based upon (i) the current performance of the underlying collateral loans, which utilizes prepayment and loss assumptions based upon historical and projected experience, economic factors and the characteristics of the underlying cash flow, and (ii) current market yields for comparable CMBS bonds, based upon Treasury rates and market spreads.

Cash flow assumptions. With respect to the cash flows of the underlying collateral loans securing the CMBS bonds, the performance of the collateral loans to date is generally consistent with our original assumptions. We continue to assume no prepayments on the collateral loans prior to maturity, as prepayments on the loans prior to maturity are generally prohibited or there are significant penalties, such as prepayment premiums, yield maintenance and/or defeasance requirements. Our credit loss assumptions for the underlying collateral loans at the time of investment in the CMBS bonds were generally estimated to assume that approximately 1% of the underlying collateral loan principal would be lost, and that one-third of the losses would be realized in year three, one-third in year six, and one-third in year nine. We believe that this is an appropriate approach to setting loss assumptions, as losses are expected to occur throughout the life of the CMBS bonds. As of June 30, 2002, total estimated losses in the underlying collateral pools over the life of the CMBS bonds were assumed to total approximately $220 million.

Through June 30, 2002, $0.5 million in actual losses have been realized, and we have specifically identified approximately $25.1 million of additional potential losses. The actual losses and potential expected losses of approximately $25.6 million to date as of June 30, 2002 are less than the losses originally estimated to have been realized by this point, which were estimated at approximately $51.8 million. While the losses identified as of June 30, 2002 are less than our originally estimated losses, we have not reduced the original estimates of the total expected losses over the life of the CMBS bonds as we continue to believe they are reasonable. Loss assumptions affecting future cash flows are updated quarterly to reflect the estimated current and expected performance of the collateral loans on a loan-by-loan basis.

Yield assumptions. During the second quarter of 2002, the overall yields on newly-issued CMBS bonds rated BB+ through B declined due to the decline in Treasury yields combined with the narrowing of spreads, resulting in market yields for these bond classes being lower than the yields-to-maturity on our CMBS bonds for the same classes. More buyers of CMBS bonds have recently entered the market, particularly buyers for BB+ through BB rated CMBS bonds, which has contributed to the decline in spreads for these bond classes during the second quarter. Historically, we have found yields on new issuances to be in the same range as the CMBS bonds we own. We confirmed our CMBS bond portfolio pricing estimates with respect to spreads for our BB+ through B rated bonds with other CMBS bond market participants. Lower yields imply an increase in the value of our BB+ through B rated CMBS bond portfolio. The yields on B- through the non-rated classes have generally remained relatively consistent with the yields on our CMBS bonds in these classes. Pricing for these deeply subordinated classes of bonds are generally much more a function of the credit quality of a single issuance than market conditions.

Fair Value. We have determined the fair value of our CMBS bonds based upon a discounted cash flow model using expected future cash flows and current market yields, as discussed above, to be approximately $560.9 million, and as a result have recorded net unrealized appreciation on the CMBS bonds of $23.9 million at June 30, 2002.

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the 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. The net proceeds related to the sales of the borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities totaled $82.6 million and $84.8 million, respectively, and have been included in other assets and other liabilities, respectively, at June 30, 2002. As of June 30, 2002, the total obligations on the hedge had increased to $84.8 million due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligation of $2.2 million. The decrease in the value of the hedge during the three months ended June 30, 2002 was $3.2 million and was recorded as an unrealized loss.

The net unrealized gain on the CMBS bonds of $23.9 million, net of the unrealized loss on the hedge of $3.2 million, resulted in a net unrealized gain from the CMBS bond portfolio of $20.7 million for the three months ended June 30, 2002.

Given that Treasury yields fluctuate, it is possible that there may be future adjustments to the fair value of the CMBS bonds. As a result, we have not classified the appreciated CMBS bonds as Grade 1 assets at June 30, 2002, since they may not result in any future capital gain. Therefore, CMBS bonds remain in Grade 2.

Other Matters. All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 103.4 million and 90.8 million for the three months ended June 30, 2002 and 2001, respectively.

We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net increase in net assets resulting from operations for the fiscal year due to timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

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

RESULTS OF OPERATIONS

Comparison of Six Months Ended June 30, 2002 and 2001

The following table summarizes our condensed operating results for the six months ended June 30, 2002 and 2001.

($ in thousands, except per share amounts)	For the Six Months Ended June 30, 2002	2001	Change	Percent Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$127,665	$113,699	$13,966	12%
Premiums from loan dispositions	1,659	1,731	(72)	(4%)
Fees and other income	26,260	18,380	7,880	43%
Total interest and related portfolio income	155,584	133,810	21,774	16%
Expenses				
Interest	34,984	31,881	3,103	10%
Employee	16,309	14,056	2,253	16%
Administrative	7,861	6,027	1,834	30%
Total operating expenses	59,154	51,964	7,190	14%

Net investment income before net realized and unrealized gains	96,430	81,846	14,584	18%
Net Realized and Unrealized Gains				
Net realized gains	8,850	4,991	3,859	*
Net unrealized gains	24,135	11,297	12,838	*
Total net realized and unrealized gains	32,985	16,288	16,697	*
Net increase in net assets resulting from operations	$129,415	$ 98,134	$31,281	32%
Diluted earnings per share	$ 1.26	$ 1.10	$ 0.16	15%
Weighted average shares outstanding — diluted	102,900	88,966	13,934	16%

* Net realized and net unrealized gains and losses can fluctuate significantly from period to period. As a result, yearto-date comparisons of net realized and net unrealized gains and losses may not be meaningful.

Net increase in net assets resulting from operations, or net income, results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus net realized and unrealized gains or losses.

Total interest and related portfolio income. Total interest and related portfolio income includes interest income, premiums from loan dispositions and fees and other income.

	For the Six Months Ended June 30,	
	2002	2001
($ in millions, except per share amounts)		
Total Interest and Related Portfolio Income	$155.6	$133.8
Per share	$ 1.51	$ 1.50

The increase in interest income earned results primarily from the growth of our investment portfolio. Our investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 9% to $1,794.3 million at June 30, 2002 from $1,639.7 million at June 30, 2001. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2002 and 2001 was as follows:

	June 30,	
	2002	2001
Private Finance	13.9%	14.6%
Commercial Real Estate Finance	13.7%	13.6%
Total Portfolio	13.8%	14.2%

Included in net premiums from loan dispositions are prepayment premiums of $1.6 million and $1.0 million for the six months ended June 30, 2002 and 2001, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, management services to portfolio companies, guaranty and other advisory services. We generate fee income for the transaction services and management services that we provide. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance and risk management.

Fees and other income for the six months ended June 30, 2002 included fees of $10.6 million related to structuring and diligence, fees of $3.8 million related to transaction services provided to portfolio companies, and fees of $11.7 million related to management services provided to portfolio companies, other advisory services and guaranty fees. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Business Loan Express, Hillman and WyoTech are our most significant portfolio investments and together represent 17.9% of our total assets at June 30, 2002. Total interest and related portfolio income earned from these investments for the six months ended June 30, 2002 and 2001 was $28.1 million and $17.8 million, respectively. Total interest and related portfolio income earned from WyoTech for the six months ended June 30, 2002 was $3.6 million, which will no longer occur due to the sale of the investment.

Operating Expenses. Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the six months ended June 30, 2002 and 2001 are attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

	At and for the Six Months Ended June 30,	
($ in millions)	**2002**	**2001**
Total Outstanding Debt	$1,009.0	$881.1
Average Outstanding Debt	$ 940.4	$801.3
Weighted Average Cost	7.2%	7.4%

BDC Asset Coverage*	256%	247%

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

Employee expenses include salaries and employee benefits. The increase in salaries and employee benefits for the periods presented reflects wage increases and the experience level of employees hired. Total employees were 103 and 101 at June 30, 2002 and 2001, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors' fees, legal and accounting fees, insurance premiums and various other expenses. The increase in administrative expenses as compared to the same period in 2001 includes approximately $1.2 million from legal, consulting and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately $0.1 million due to increased costs for corporate liability insurance and $0.5 million due to outsourced technology assistance.

Realized Gains and Losses. Net realized gains result from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans,

commercial mortgage loans and CMBS bonds, offset by losses on investments. Net realized and unrealized gains and losses were as follows:

	For the Six Months Ended June 30,	
($ in millions)	**2002**	**2001**
Realized Gains	$15.4	$ 6.6
Realized Losses	(6.5)	(1.6)
Net Realized Gains	8.9	5.0
Net Unrealized Gains	$24.1	$11.3

Realized gains and losses for the six months ended June 30, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the six months ended June 30, 2002, primarily resulted from transactions involving three private finance portfolio companies, Aurora Communications, LLC ($4.9 million), Cumulus Media, Inc. ($0.5 million) and Alderwoods Group, Inc. ($0.1 million), the sale of CMBS bonds ($7.1 million, including a realized gain from the related hedge of $1.6 million) and one commercial real estate investment ($1.3 million). For the six months ended June 30, 2002 and 2001, we reversed previously recorded unrealized appreciation totaling $7.3 million and $4.0 million, respectively, when gains were realized.

Realized losses for the six months ended June 30, 2002 primarily resulted from transactions involving four private finance portfolio companies, The Loewen Group, Inc. ($2.7 million), iSolve Incorporated ($0.9 million), Sure-Tel, Inc. ($0.5 million) and Soff-Cut Holdings, Inc. ($0.5 million), and one commercial real estate investment ($1.1 million). In January 2002, The Loewen Group, Inc. emerged from bankruptcy and as a result, we exchanged our debt securities for new debt securities and publicly traded common stock in the reorganized company, which resulted in a realized loss. The Loewen Group, Inc. changed its name to Alderwoods Group, Inc. For the six months ended June 30, 2002 and 2001, we reversed previously recorded unrealized depreciation totaling $5.2 million and $2.2 million, respectively, when losses were realized.

Unrealized Gains and Losses. For a discussion of our fair value methodology and how it affects unrealized gains and losses, see "Unrealized Gains and Losses" included in the "Comparison of Three Months Ended June 30, 2002 and 2001."

Net unrealized gains for the six months ended June 30, 2002 were $24.1 million, which included $121.2 million of unrealized gains, and $97.1 million of unrealized losses. Unrealized gains and losses for the six months ended June 30, 2002 included those discussed under the caption "Unrealized Gains and Losses" included in the "Comparison of Three Months Ended June 30, 2002 and 2001." In addition, unrealized gains in the first quarter of 2002 were $13.8 million related to unrealized appreciation in our investments in WyoTech ($10.0 million) and Blue Rhino ($3.8 million). Unrealized losses in the first quarter of 2002 were $15.9 million primarily related to unrealized depreciation in our investment in Velocita, Inc. ($10.9 million) and Alderwoods Group, Inc. ($2.0 million).

Other Matters. All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were

102.9 million and 89.0 million for the six months ended June 30, 2002 and 2001, respectively.

We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net increase in net assets resulting from operations for the fiscal year due to timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

In order to maintain our status as a regulated investment company, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet investment diversification requirements as defined in the Internal Revenue Code;

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

At June 30, 2002, and December 31, 2001, we had $4.3 million and $0.9 million, respectively, in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit.

Debt and Other Commitments

We had outstanding debt at June 30, 2002 and December 31, 2001, as follows:

($ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost(1)
At June 30, 2002			
Notes payable and debentures:			
Unsecured long-term notes	$ 694.0	$ 694.0	7.8%
Small Business Administration debentures	101.8	94.5	8.2%
Auction rate reset note	75.0	75.0	3.7%
Overseas Private Investment Corporation loan	5.7	5.7	6.6%
Total notes payable and debentures	$ 876.5	$ 869.2	7.4%
Revolving line of credit	527.5	139.8	4.1%(2)
Total debt	$1,404.0	$1,009.0	7.2%
At December 31, 2001			
Notes payable and debentures:			
Unsecured long-term notes	$ 694.0	$ 694.0	7.8%
Small Business Administration debentures	101.8	94.5	7.7%
Auction rate reset note	81.9	81.9	3.9%
Overseas Private Investment Corporation loan	5.7	5.7	6.6%
Total notes payable and debentures	$ 883.4	$ 876.1	7.4%
Revolving line of credit	497.5	144.7	3.2%(2)
Total debt	$1,380.9	$1,020.8	7.0%

(1) The annual interest cost includes the cost of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings.
(2) The current interest rate payable on the revolving line of credit was 4.1% and 3.2% at June 30, 2002 and December 31, 2001, respectively, which excludes the annual cost of commitment fees and other facility fees of $2.0 million.

Unsecured Long-Term Notes. We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2003. The notes require payment of interest only semi-annually, and all principal is due upon maturity.

Small Business Administration Debentures. We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with terms of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to $111.7 million from the Small Business Administration. At June 30, 2002, the Small Business Administration has a commitment to lend up to an additional $7.3 million above the amount outstanding. The commitment expires on September 30, 2005.

Auction Rate Reset Note. We have an Auction Rate Reset Senior Note Series A that matures on December 2, 2002 and bears interest at the three-month London Inter-Bank Offered Rate ("LIBOR") plus 1.75%, which adjusts quarterly. Interest is due quarterly, and we, at our option, may pay or defer and capitalize such interest payments. The amount outstanding on the note will increase as interest due is deferred and

capitalized. As a means to repay the note, we have entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of $75.0 million of debt, equity or other securities in one or more public or private transactions. Alternatively, we may repay the note in cash without conducting a capital raise. If we choose to pay in cash without conducting a capital raise, we will incur additional expense of approximately $2.1 million.

Revolving Line of Credit. As of June 30, 2002, we have a $527.5 million unsecured revolving line of credit that expires in August 2003, with the right to extend maturity for one additional year at our sole option under substantially similar terms. This facility was increased by $30.0 million during the first quarter of 2002 from $497.5 million at December 31, 2001, and may be further expanded up to $600 million. As of June 30, 2002, $382.4 million remains unused and available, net of amounts committed for standby letters of credit of $5.3 million issued under the line of credit facility. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The credit facility requires monthly payments of interest, and all principal is due upon maturity.

We have various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of June 30, 2002, we were in compliance with these covenants.

The following table shows our significant contractual obligations as of June 30, 2002.

($ in millions) Contractual Obligations	Total	Payments Due By Year 2002	2003	2004	2005	2006	After 2006
Notes payable and debentures:							
Unsecured long-term notes	$ 694.0	$ —	$140.0	$214.0	$165.0	$175.0	$ —
Small Business Administration debentures	94.5	—	—	7.0	14.0	—	73.5
Auction rate reset note	75.0	75.0	—	—	—	—	—
Overseas Private Investment Corporation loan	5.7	—	—	—	—	5.7	—
Revolving line of credit(1)	139.8	—	—	139.8	—	—	—
Operating leases	22.3	1.3	2.6	2.7	2.7	2.6	10.4
Total contractual cash obligations	$1,031.3	$76.3	$142.6	$363.5	$181.7	$183.3	$83.9

(1) The revolving line of credit expires in August 2003, and may be extended under substantially similar terms for one additional year at our sole option. We assume that we would exercise our option to extend the revolving line of credit, resulting in an assumed maturity of August 2004.

The following table shows, as of June 30, 2002, our contractual commitments that may have the effect of creating, increasing or accelerating our liabilities.

($ in millions) Commitments	Total	Amount of Commitment Expiration Per Year 2002	2003	2004	2005	2006	After 2006
Standby letters of credit	$11.3	$—	$ —	$ 5.3	$—	$ —	$6.0
Guarantees	52.2	1.0	—	50.3	0.2	—	0.7
Total commitments	$63.5	$1.0	$ —	$55.6	$0.2	$ —	$6.7

Equity Capital and Dividends

Because we are a regulated investment company, we distribute income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity capital ratio.

To support our growth during the three and six months ended June 30, 2002 and for the year ended December 31, 2001, we raised $30.0 million, $49.9 million and $286.9 million, respectively, in new equity capital through the sale of shares from our shelf registration statement. We issue equity from time to time when we have attractive investment opportunities. In addition, during the three and six months ended June 30, 2002 and for the year ended December 31, 2001, we raised $1.5 million, $3.1 million and $6.3 million, respectively, in new equity capital through the issuance of shares through our dividend reinvestment plan. At June 30, 2002, total shareholders' equity had increased to $1,434.5 million.

Our board of directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first and second quarters of 2002, the board of directors declared a dividend of $0.53 and $0.55 per common share, respectively. The board of directors has recently declared a dividend of $0.56 per common share for the third quarter of 2002, which will be paid on September 27, 2002 to shareholders of record on September 13, 2002. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our board of directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains that exceed a normal capital gains distribution level, and therefore avoid any unusual spike in dividends in any one year. The dividend policy also enables the board of directors to selectively retain gains to support future growth.

We plan to maintain a strategy of financing our business with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. Cash flow from operations before new investments was $258.1 million for the six months ended June 30, 2002, and $330.8 million for the year ended December 31, 2001. Cash flow from operations before new investments has historically been sufficient to finance our operations.

We maintain a matched-funding philosophy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our short-term credit facilities as a means to bridge to long-term financing, which may or may not result in temporary differences in the matching of estimated maturities. We evaluate our interest rate exposure on an ongoing basis. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

At June 30, 2002, our debt to equity ratio was 0.70 to 1 and our weighted average cost of funds was 7.2%. We had $382.4 million available under our revolving line of credit. As a result of the receipt of $77.0 million from the sale of WyoTech on July 1, 2002 and the receipt of $94.7 million from the sale of CMBS bonds on July 31, 2002, there were no amounts drawn on the revolving line of credit as of August 1, 2002. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $522.2 million on August 1, 2002. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management's most difficult, complex or subjective judgments. Our critical accounting policies are those applicable to the valuation of investments and certain revenue recognition matters as discussed below.

Valuation of Portfolio Investments. As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. Our investments are generally subject to restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the board of directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for establishing the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and our equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale.

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date. Prepayment premiums are recorded on loans when received.

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

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

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

Commercial Mortgage-Backed Securities ("CMBS"). CMBS are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors and the characteristics of the underlying cash flow. Our assumption with regard to discount rate is based upon the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS as comparable yields in the market change and/or whenever we determine that the value of our CMBS is less than the cost basis due to impairment in the underlying collateral pool.

Residual Interest. We value our residual interest from a previous securitization and recognize income using the same accounting policies used for the CMBS. The residual interest is carried at fair value based on discounted estimated future cash flows. We recognize income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

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

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

INVESTMENT CONSIDERATIONS

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

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

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

Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our board of directors and, as a result, there is uncertainty regarding the value of our portfolio investments. At June 30, 2002, $2,381.0 million, or 93% of our total assets, represented investments recorded at value. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our board of directors on a quarterly basis. Since there is typically no ready market for the investments in our portfolio, our board of directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our security has also appreciated in value, where appropriate. Without a readily ascertainable market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

We adjust quarterly the valuation of our portfolio to reflect the board of directors' estimate of the fair value of each investment in our portfolio. Any changes in estimated fair value are recorded in our statement of operations as "Net unrealized gains (losses)."

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

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

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

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

Our financial results could be negatively affected if Business Loan Express fails to perform as expected. Business Loan Express, Inc. is our largest portfolio investment. Our financial results could be negatively affected if Business Loan Express, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At June 30, 2002, the investment totaled $251.9 million at value, or 9.8% of total assets.

In addition, as controlling shareholder of Business Loan Express, we have provided an unconditional guaranty to Business Loan Express' senior credit facility lenders in an amount equal to 50% of Business Loan Express' total obligations on its $124.0 million revolving credit facility. The amount we have guaranteed at June 30, 2002, was $48.1 million. This guaranty can only be called in the event of a default by Business Loan Express. We have also provided two standby letters of credit in connection with two term loan securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling $10.6 million.

Investments in non-investment grade commercial mortgage-backed securities may be illiquid, may have a higher risk of default and may not produce current returns. The

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

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200% which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of June 30, 2002, our asset coverage for senior indebtedness was 256%.

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

At June 30, 2002, we had $1,009.0 million of outstanding indebtedness, bearing a weighted average annual interest cost of 7.2%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.8%.

Changes in interest rates may affect our cost of capital and net investment income. Because we borrow money to make investments, our net investment income before net realized and unrealized gains or losses, or net investment income, is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of sharply rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our short-term credit facilities as a means to bridge to long-term financing. Our long-term fixed-rate

investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act.

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

Loss of pass-through tax treatment would substantially reduce net assets and income available for dividends. We have operated so as to qualify as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. If we meet source of income, diversification and distribution requirements, we will qualify for effective pass-through tax treatment. We would cease to qualify for such pass-through tax treatment if we were unable to comply with these requirements. In addition, we may have difficulty meeting the requirement to make distributions to our shareholders because in certain cases we may recognize income before or without receiving cash representing such income. If we fail to qualify as a regulated investment company, we will have to pay corporate-level taxes on all of our income whether or not we distribute it, which would substantially reduce the amount of income available for distribution to our stockholders. Even if we qualify as a regulated investment company, we generally will be subject to a corporate-level income tax on the income we do not distribute. Moreover, if we do not distribute at least 98% of our income, we generally will be subject to a 4% excise tax.

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

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

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

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

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

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

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

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

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

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

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

- general economic conditions and trends;

- loss of a major funding source; or

- departures of key personnel.

Recently, the trading price of our common stock has been volatile. Due to the continued potential volatility of our stock price, we may be the target of securities litigation

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in the future. Securities litigation could result in substantial costs and divert management's attention and resources from our business. For information about current securities class action lawsuits filed against us, see Note 12 to the financial statements.

Disclosure Regarding Forward-Looking Statements

Information contained in this Form 10-Q 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 or similar words or phrases. The matters described in "Investment Considerations" and certain other factors noted throughout this Form 10-Q constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

Although we believe that the assumptions on which these forward-looking statements are based are reasonable, any of those assumptions could prove to be inaccurate, and as a result, the forward-looking statements based on those assumptions also could be incorrect. Important assumptions include our ability to originate new investments, maintain certain margins and levels of profitability, access the capital markets for debt and equity capital, the ability to meet regulatory requirements and the ability to maintain certain debt to asset ratios. In light of these and other uncertainties, the inclusion of a projection or forward-looking statement in this Form 10-Q should not be regarded as a representation by us that our plans and objectives will be achieved. These risks and uncertainties include those described in "Investment Considerations" and elsewhere in this Form 10-Q. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this Form 10-Q.

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

Our business activities contain elements of risk. We consider the principal types of risk to be fluctuations in interest rates and portfolio valuations. We consider the management of risk essential to conducting our businesses. Accordingly, our risk management systems and procedures are designed to identify and analyze our risks, to set appropriate policies and limits and to continually monitor these risks and limits by means of reliable administrative and information systems and other policies and programs.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. Our investments are generally subject to restrictions on resale and generally have no established trading market. Since there is typically no ready market for the investments in our portfolio, our board of directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process. We value substantially all of our investments at fair value as determined in good faith by the board of directors in accordance with our valuation policy. 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.

We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our

valuation policy is intended to provide a consistent basis for establishing the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and our equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale. Without a readily ascertainable market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material. See "Management's Discussion and Analysis of Financial Conditions and Results of Operations — Critical Accounting Policies" and "— Results of Operations — Comparison of Three Months Ended June 30, 2002 and 2001 — Unrealized Gains and Losses."

In addition, the illiquidity of our investments may adversely affect our ability to dispose of loans and securities at times when it may be otherwise advantageous for us to liquidate such investments. In addition, if we were required to liquidate some or all of the investments in the portfolio, the proceeds of such liquidation would be significantly less than the current value of such investments.

Because we borrow money to make investments, our net investment income before net realized and unrealized gains or losses, or net investment income, is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of sharply rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our short-term credit facilities as a means to bridge to long-term financing. Our long-term fixed-rate investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act. We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected the net increase in net assets resulting from operations, or net income, by less than 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

PART II. OTHER INFORMATION

Item 1. ***Legal Proceedings***

As of August 13, 2002, we are aware of seven class action lawsuits that have been filed in the United States District Court for the Southern District of New York against us, certain of our directors and officers and our former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. All of the actions essentially duplicate one another, pleading essentially the same allegations. The complaints filed in the lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically alleging, among other things, that we misstated the value of certain portfolio investments in our financial statements, which allegedly resulted in the purchase of our common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The lawsuits seek compensatory and other damages, and costs and expenses associated with the litigation. We believe that each of the lawsuits is without merit, and we intend to defend each of these lawsuits vigorously. While we do not expect these matters to materially affect out financial condition or results of operations, there can be no assurance of any particular outcome.

We also are party to certain other lawsuits in the normal course of business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, we do not expect that these proceedings will have a material effect upon our financial condition or results of operations.

Item 2. ***Changes in Securities and Use of Proceeds***

During the three months ended June 30, 2002, we issued a total of 71,285 shares of common stock under our dividend reinvestment plan pursuant to an exemption from the registration requirements of the Securities Act of 1933. The aggregate offering price for the shares of common stock sold under the dividend reinvestment plan was approximately $1.5 million.

Item 3. ***Defaults Upon Senior Securities***

Not applicable.

Item 4. ***Submission of Matters to a Vote of Security Holders***

On May 7, 2002, we held our Annual Meeting of Shareholders in Washington, DC. Shareholders voted on three matters; the substance of these matters and the results of the voting of each such matter are described below. There were no broker non-votes for items 1 and 2 below.

1. Election of Directors: Shareholders elected four directors of the Company, who will serve for three years, or until their successors are elected and qualified. Votes were cast as follows:

	For	Withheld
John D. Firestone	92,267,940	958,842
Anthony T. Garcia	92,276,707	950,075
Lawrence I. Hebert	92,267,765	959,017
Laura W. van Roijen	92,263,048	963,735

The following directors are continuing as directors of the Company for their respective terms — William L. Walton, Brooks H. Browne, John I. Leahy, Robert E. Long,

Warren K. Montouri, Guy T. Steuart II, T. Murray Toomey, Esq., and George C. Williams, Jr.

2. Ratification of the selection of KPMG LLP to serve as independent public accounts for the year ending December 31, 2002. Votes were cast as follows:

For	Against	Abstain
91,908,127	938,936	379,717

3. Shareholders approved an amendment to our Stock Option Plan to increase the number of shares of common stock authorized for issuance under the Stock Option Plan by 13,600,000 shares. Broker non-votes were not included in the tabulation for this matter. Votes were cast as follows:

For	Against	Abstain
42,552,664	14,900,645	1,378,014

Item 5. ***Other Information***

Not applicable.

Item 6. ***Exhibits and Reports on Form 8-K***

(a) List of Exhibits

Exhibit Number	Description
3.1	Restated Articles of Incorporation. *(Incorporated by reference to Exhibit a.1 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).*
3.2	Amended and Restated Bylaws. *(Incorporated by reference to Exhibit b. filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).*
4.1	Specimen Certificate of Allied Capital's Common Stock, par value $0.0001 per share. *(Incorporated by reference to Exhibit d. filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
4.2	Form of debenture between certain subsidiaries of Allied Capital and the U.S. Small Business

	Administration. *(Incorporated by reference to Exhibit 4.2 filed by a predecessor entity to Allied Capital on Form 10-K for the year ended December 31, 1996).*
10.1	Dividend Reinvestment Plan, as amended. *(Incorporated by reference to Exhibit e. filed with Allied Capital's registration statement on Form N-2 (File No. 333-87862) filed on May 8, 2002).*
10.2	Second Amended and Restated Credit Agreement, dated August 3, 2001. *(Incorporated by reference to Exhibit f.2.g filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).*
10.3	Note Agreement, dated as of April 30, 1998. *(Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 10-Q for the period ended June 30, 1998).*

Exhibit Number	Description
10.4	Loan Agreement between a predecessor entity to Allied Capital and Overseas Private Investment Corporation, dated April 10, 1995. *(Incorporated by reference to Exhibit f.7 filed by a predecessor entity to Allied Capital to Pre-Effective Amendment No. 2 to the registration statement on Form N-2 (File No. 33-64629) filed on January 24, 1996).* Letter, dated December 11, 1997, evidencing assignment of Loan Agreement from the predecessor entity of Allied Capital to Allied Capital. *(Incorporated by reference to Exhibit 10.3 of Allied Capital's Form 10-K for the year ended December 31, 1997).*
10.5	Note Agreement, dated as of May 1, 1999. *(Incorporated by reference to Exhibit 10.5 filed with Allied Capital's Form 10-Q for the period ended June 30, 1999).*
10.6	Amendment and Consent Agreement, dated December 11, 2000, to the Amended and Restated Credit Agreement, dated May 17, 2000. *(Incorporated by reference to Exhibit f.6 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).*
10.7	Sale and Servicing Agreement, dated as of January 1, 1998, among Allied Capital CMT, Inc., Allied Capital Commercial Mortgage Trust 1998-1, Allied Capital Corporation, LaSalle National Bank and ABN AMRO Bank N.V. *(Incorporated by reference to Exhibit f.7.a filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
10.8	Indenture, dated as of January 1, 1998, between Allied Capital Commercial Mortgage Trust 1998-1 and LaSalle National Bank. *(Incorporated by reference to Exhibit f.7.b filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
10.9	Amended and Restated Trust Agreement, dated January 1, 1998, between Allied Capital CMT, Inc., LaSalle National Bank Inc. and Wilmington Trust Company. *(Incorporated by reference to Exhibit f.7.c filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
10.10	Guaranty, dated as of January 1, 1998, by Allied Capital. *(Incorporated by reference to Exhibit f.7.d filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
10.11	Note Agreement, dated as of November 15, 1999. *(Incorporated by reference to Exhibit 10.4a of Allied Capital's Form 10-K for the year ended December 31, 1999).*
10.12	Note Agreement, dated as of October 15, 2000. *(Incorporated by reference to Exhibit 10.4b filed with Allied Capital's Form 10-Q for the period ended September 30, 2000).*
10.13	Note Agreement, dated as of October 15, 2001. *(Incorporated by reference to Exhibit f.10 filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).*

Exhibit Number	Description
10.14	Auction Rate Reset Note Agreement, dated as of August 31, 2000, between Allied Capital and Intrepid Funding Master Trust; Forward Issuance Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC; Remarketing and Contingency Purchase Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC. *(Incorporated by reference to Exhibit f.12 filed with Allied Capital's Pre-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on September 12, 2000).*
10.15	Control Investor Guaranty Agreement, dated as of March 28, 2001, between Allied Capital and Fleet National Bank and Business Loan Express, Inc. *(Incorporated by reference to Exhibit f.14 filed with Allied Capital's Post-Effective Amendment No. 3 to registration statement on Form N-2 (File No. 333-43534) filed on May 15, 2001).*
10.16	Amended and Restated Deferred Compensation Plan, dated December 30, 1998. *(Incorporated by reference to Exhibit 10.11 of Allied Capital's Form 10-K for the year ended December 31, 1998).*
10.17	Amendment to Deferred Compensation Plan, dated October 18, 2000. *(Incorporated by reference to Exhibit i.2.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).*
10.18	Amended and Restated Deferred Compensation Plan, dated May 15, 2001. *(Incorporated by reference to Exhibit i.2.b filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).*
10.19	Amended Stock Option Plan. *(Incorporated by reference to Exhibit A of Allied Capital's definitive proxy statement for Allied Capital's 2002 Annual Meeting of Stockholders filed on April 3, 2002).*
10.20	Allied Capital Corporation 401(k) Plan, dated September 1, 1999. *(Incorporated by reference to Exhibit 4.4 filed with Allied Capital's registration statement on Form S-8 (File No. 333-88681) filed on October 8, 1999).*
10.21	Amendment to Allied Capital Corporation 401(k) Plan, dated December 31, 2000. *(Incorporated by reference to Exhibit i.5.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).*
10.22	Employment Agreement, dated June 15, 2000, between Allied Capital and William L. Walton. *(Incorporated by reference to Exhibit f.9 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).*
10.23	Employment Agreement, dated June 15, 2000, between Allied Capital and Joan M. Sweeney. *(Incorporated by reference to Exhibit f.10 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).*
10.24	Employment Agreement, dated June 15, 2000, between Allied Capital and John M. Scheurer. *(Incorporated by reference to Exhibit f.10 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).*

Exhibit Number	Description
10.25	Form of Custody Agreement with Riggs Bank N.A. *(Incorporated by reference to Exhibit j.1 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
10.26	Form of Custody Agreement with LaSalle National Bank. *(Incorporated by reference to Exhibit j.2 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
10.27	Custodian Agreement with LaSalle National Bank Association dated July 9, 2001. *(Incorporated by reference to Exhibit j.3 filed with Allied Capital's registration statement on Form N-2 (File*

	by reference to Exhibit j.3 filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).
10.28	Code of Ethics. *(Incorporated by reference to Exhibit r. filed with Allied Capital's Pre-Effective Amendment No. 1 to the registration statement on Form N-2 (File No. 333-43534) on September 12, 2000).*
15*	Letter regarding Unaudited Interim Financial Information
99.1*	Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.2*	Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith.

(b) Reports on Form 8-K.

On April 3, 2002, we filed a Form 8-K reporting that we had selected KPMG LLP to serve as our independent public accountants for the fiscal year December 31, 2002 and dismissed Arthur Andersen LLP as our public accountants effective upon completion of the December 31, 2001 audit.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunder duly authorized.

ALLIED CAPITAL CORPORATION
(Registrant)
/s/ WILLIAM L. WALTON

Chairman and Chief Executive Officer

Dated: August 14, 2002

/s/ PENNI F. ROLL

Chief Financial Officer

Exhibit 15

The Board of Directors and Shareholders
Allied Capital Corporation and Subsidiaries:

Re: Registration Statement Nos. 333-45525 and 333-13584

Ladies and Gentlemen:

With respect to the subject registration statements, we acknowledge our awareness of the use therein of our report dated July 22, 2002 (except as to Notes 12 and 13 which are as of August 13, 2002 and July 31, 2002, respectively) related to our review of interim financial information.

Pursuant to Rule 436 under the Securities Act of 1933 (the Act), such report is not considered part of a registration statement prepared or certified by an accountant, or a report prepared or certified by an accountant within the meaning of Sections 7 and 11 of the Act.

/s/ KPMG LLP

Washington, D.C.
August 14, 2002

Exhibit 99.1

Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350,
As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report on Form 10-Q for the period ended June 30, 2002 (the "Report") of Allied Capital Corporation (the "Registrant"), as filed with the Securities and Exchange Commission on the date hereof, I, William L. Walton, the Chief Executive Officer of the Registrant, certify, to the best of my knowledge, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ William L. Walton
Name: William L. Walton
Date: August 14, 2002

Exhibit 99.2

Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350,
As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report on Form 10-Q for the period ended June 30, 2002 (the "Report") of Allied Capital Corporation (the "Registrant"), as filed with the Securities and Exchange Commission on the date hereof, I, Penni F. Roll, the Chief Financial Officer of the Registrant, certify, to the best of my knowledge, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

/s/ Penni F. Roll
Name: Penni F. Roll
Date: August 14, 2002

<u>EXHIBIT E</u>

EXHIBIT E

Tariff

SOUTH DAKOTA TELECOMMUNICATIONS TARIFF

This Tariff contains the descriptions, regulations, and rates applicable to the furnishing of service and facilities for telecommunications services within the State of South Dakota by ALL-STAR ACQUISITION CORPORATION ("Company"). This Tariff is on file with the South Dakota Public Utilities Commission, and copies may also be inspected, during normal business hours, at the following location: 1151 Seven Locks Road, Potomac, MD 20854.

CHECK SHEET

The title page and pages 1-38 inclusive of this Tariff are effective as of the date shown. Original and revised sheets, as named below, comprise all changes from the original Tariff in effect on the date indicated.

SHEET	REVISION	SHEET	REVISION	SHEET	REVISION
1	Original	18	Original	35	Original
2	Original	19	Original	36	Original
3	Original	20	Original	37	Original
4	Original	21	Original	38	Original
5	Original	22	Original		
6	Original	23	Original		
7	Original	24	Original		
8	Original	25	Original		
9	Original	26	Original		
10	Original	27	Original		
11	Original	28	Original		
12	Original	29	Original		
13	Original	30	Original		
14	Original	31	Original		
15	Original	32	Original		
16	Original	33	Original		
17	Original	34	Original		

* New or Revised Sheets

Issued by: Christine Greene, President
ALL-STAR ACQUISITION CORPORATION
1151 Seven Locks Road
Potomac, MD 20854

CONCURRING, CONNECTING AND OTHER PARTICIPATING CARRIERS

CONCURRING CARRIERS:

No Concurring Carriers

CONNECTING CARRIERS:

No Connecting Carriers

OTHER PARTICIPATING CARRIERS:

No Participating Carriers

TARIFF FORMAT

Sheet Numbering - Sheet numbers appear in the upper right hand corner of the page. Sheets are numbered sequentially and from time to time new pages may be added to the Tariff. When a new page is added between existing pages, a decimal is added to the preceding page number. For example, a new page added between Sheets 3 and 4 would be numbered 3.1.

Paragraph Numbering Sequence - There are nine levels of paragraph coding. Each level of coding is subservient to its next higher level:

2.
2.1.
2.1.1.
2.1.1.A.
2.1.1.A.1.
2.1.1.A.1.(a).
2.1.1.A.1.(a).I.
2.1.1.A.1.(a).I.(i).
2.1.1.A.1.(a).I.(i).(1).

Check Sheets - When a Tariff filing is made with the Commission, an updated check sheet accompanies the Tariff filing. The check sheet lists the pages contained in the Tariff, with a cross reference to the current revision number. When new pages are added, the check sheet is changed to reflect the revision, all revisions made in a given filing are designed by an asterisk (*). There will be no other symbols used on this page if these are the only changes made to it. The Tariff user should refer to the latest check sheet to find out if a particular page is the most current on file with the Commission.

APPLICABILITY

This Tariff contains the Service offerings, rates, terms and conditions applicable to the furnishing of intrastate interexchange telecommunications services within the State of South Dakota by ALL-STAR ACQUISITION CORPORATION ("Company").

EXPLANATION OF SYMBOLS

(D) To signify discontinued material

(I) To signify a rate or charge increase

(M) To signify material relocated without change in text or rate

(N) To signify new material

(R) To signify a reduction

(T) To signify a change in text but no change in rate or regulation

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Sheet

1. TECHNICAL TERMS AND ABBREVIATIONS

For the purpose of this Tariff, the following definitions will apply:

Access Coordination

Provides for the design, ordering, installation, coordination, pre-service testing, service turn-up and maintenance on a Company or Customer provided Local Access Channel.

Administrative Change

A change in Customer billing address or contact name.

Alternate Access

Alternate Access is a form of Local Access except that the provider of the Service is an entity, other than the Local Exchange Carrier, authorized or permitted to provide such Service. The charges for Alternate Access may be subject to private agreement rather than published or special tariff if permitted by applicable governmental rules.

Application for Service

A standard Company order form which includes all pertinent billing, technical and other descriptive information which will enable the Company to provide a communication Service as required.

ASR

ASR (Access Service Request) means an order placed with a Local Access Provider for Local Access.

Authorized User

A person, firm, corporation or other entity that either is authorized by the Customer to receive or send communications or is placed in a position by the Customer, either through acts or omissions, to send or receive communications.

Bandwidth

The total frequency band, in hertz, allocated for a channel.

Bill Date

The date on which billing information is compiled and sent to the Customer.

Call

A completed connection between the Calling and Called Stations.

Called Station

The telephone number called.

Calling Station

The telephone number from which a Call originates.

Cancellation of Order

A Customer initiated request to discontinue processing a Service order, either in part or in its entirety, prior to its completion. Cancellation charges will be assessed for each Circuit-end or Dedicated Access line canceled from an order prior to its completion by the Company, under the following circumstances: (1) if the LEC has confirmed in writing to the Company that the Circuit-end or Dedicated Access line will be installed; or (2) if the Company has already submitted facilities orders to and interconnecting telephone company.

Channel or Circuit

A dedicated communications path between two or more points having a Bandwidth or Transmission Speed specified in this Tariff and selected by a Customer.

Commission

South Dakota Public Utilities Commission

Company

ALL-STAR ACQUISITION CORPORATION

Company Recognized National Holidays

The following are Company Recognized National Holidays determined at the bcation of the originator of the Call: New Year's Day, Martin Luther King Day, President's Day, Memorial Day, Independence Day, Labor Day, Columbus Day, Veteran's Day, Thanksgiving Day, Christmas Day.

The evening rate is used unless a lower rate would normally apply. When a Call begins in one rate period and ends in another, the rate in effect in each rate period applies to the portion of the Call occurring within that rate period. In the event that a minute is split between two rate periods, the rate in effect at the start of that minute applies.

Customer

The person, firm, corporation or governmental unit which orders Service and which is responsible for the payment of charges and for compliance with the Company's Tariff regulations. A Customer is considered to be an account for billing purposes. The term Customer also includes an entity that remains presubscribed to the Company Service after its account(s) are removed from the Company's billing system, subsequently continues to use Company's network, and is billed by a local exchange carrier for such use, or otherwise uses Service for which no other Customer is obligated to compensate Company.

Customer Premises/Customer's Premises

Locations designated by a Customer where Service is originated/terminated whether for its own communications needs or for the use of its resale customers.

DCS

DCS means Digital Cross-Connect System.

Dedicated Access/Special Access

Dedicated Local Access between the Customer's Premises or serving wire center and the Company's Point-of-Presence for origination or termination of Calls.

DS-0

DS-0 means Digital Signal Level 0 Service and is a 64 Kbps signal.

DS-1

DS-1 means Digital Signal Level 1 Service and is a 1.544 Mbps signal.

DS-0 with VF Access

DS-0 Service with VF Local Access facilities provides for the transmission of analog voice and/or data within 300 Hz to 3000 Hz frequency range.

DS-0 with DDS Access

DS-0 Service with VF Local Access facilities provides for the transmission of digital data at speeds 2.4, 4.8, 9.6 or 56 Kbps.

Due Date

The Due Date is the date on which payment is due.

Expedite

A Service order initiated at the request of the Customer that is processed in a time period shorter than the Company's standard Service interval.

FCC

Federal Communications Commission

Individual Case Basis (ICB)

Individual Case Basis (ICB) determinations involve situations where complex Customer-specific Company arrangements are required to satisfactorily serve the Customer. The nature of such Service requirements makes it difficult or impossible to establish general tariff provisions for such circumstances. When it becomes possible to determine specific terms and conditions for such offerings, they will be offered pursuant to such terms and conditions.

Installation

The connection of a Circuit, Dedicated Access line, or port for new, changed or an additional Service.

Interexchange Service

Interexchange Service means that portion of a communications channel between a Company-designated Point-of-Presence in one exchange and a Point-of-Presence in another exchange.

Interruption

Interruption shall mean a condition whereby the Service or a portion thereof is inoperative, beginning at the time of notice by the Customer to Company that such Service is inoperative and ending at the time of restoration.

Kbps

Kilobits per second.

LATA (Local Access Transport Area)

A geographical area established for the provision and administration of communications Service of a local exchange company.

Issued by: Christine Greene, President
ALL-STAR ACQUISITION CORPORATION
1151 Seven Locks Road
Potomac, MD 20854

Local Access

Local Access means the Service between a Customer Premises and a Company designated Point-of-Presence.

Local Access Provider

Local Access Provider means an entity providing Local Access.

Local Exchange Carrier (LEC)

The local telephone utility that provides telephone exchange services.

Mbps

Megabits per second.

Multiplexing

Multiplexing is the sequential combining of lower bit rate Private Line Services onto a higher bit rate Private Line Service for more efficient facility capacity usage or vice versa.

N/A

Not available.

Nonrecurring Charges

Nonrecurring Charges are one-time charges.

Payment Method

The manner that the Customer designates as the means of billing charges for Calls using the Company's Service.

Physical Change

The modification of an existing Circuit, Dedicated Access line or port, at the request of the Customer, requiring some Physical Change or retermination.

Point-of-Presence (POP)

A Company-designated location where a facility is maintained for the purpose of providing access to its Service.

Primary Route

The route that in the absence of Customer-designated routing or temporary re-routing would be used by the Company in the provision of Service.

Private Line

A dedicated transmission channel furnished to a customer without intermediate switching arrangements for full-time customer use.

Private Line Service

A dedicated full-time transmission Service utilizing dedicated access arrangements.

Rate Center

A specified geographical location used for determining mileage measurements.

Requested Service Date

The Requested Service Date is the date requested by the Customer for commencement of Service and agreed to by the Company.

Restore

To make Service operative following an interruption by repair, reassignment, re-routing, substitution of component parts, or otherwise, as determined by the carrier(s) involved.

Route Diversity

Two channels that are furnished partially or entirely over two physically separate routes.

Service

Service means any or all Service(s) provided pursuant to this Tariff.

Service Commitment Period

The term elected by the Customer and stated on the Service order during which the Company will provide the Services subscribed to by the Customer. The term can be monthly or in the case of Private Line Services for a period of up to 5 years.

Special Promotional Offerings

Special trial offerings, discounts, or modifications of its regular Service offerings that the Company may, from time to time, offer to its Customers for a particular Service. Such offerings may be limited to certain dates, times, and locations. Such offerings will be filed with the SDPUC.

Start of Service Date

The Requested Service Date or the date Service first is made available by the Company whichever is later.

Tariff

The current Intrastate Services Tariff and effective revisions thereto filed by the Company with the Commission.

Transmission Speed

Data transmission speed or rate, in bits per seconds (bps).

Two-Way Conversation

A Two-Way Conversation is a telephone conversation between or among two or more parties.

VF

VF is voice frequency or voice-grade Service designed for private-line Service. Normal transmission is in the 300 hertz to 3000-hertz frequency band.

2. RULES AND REGULATIONS

2.1. Description and Limitations of Services

2.1.1. Intrastate Telecommunications Service ("Service") is the furnishing of Company communication Services contained herein between specified locations under the terms of this Tariff.

2.1.2. Any member of the general public (including any natural person or legally organized entity such as a corporation, partnership, or governmental body) is entitled to obtain Service under this Tariff, provided that the Company reserves the right to deny Service: (A) to any Customer that, in the Company's reasonable opinion, presents an undue risk of nonpayment, (B) in circumstances in which the Company has reason to believe that the use of the Service would violate the provisions of this Tariff or any applicable law or if any applicable law restricts or prohibits provision of the Service, or (C) if insufficient facilities are available to provide the Service (in such cases Company shall make best efforts to accommodate the needs of all potential Customers by means of facility improvements or purchases, of capacity, if such efforts will, in the Company's opinion, provide the Company with a reasonable return on its expenditures), but only for so long as such unavailability exists.

2.1.3. Company, when acting at the Customer's request and as its authorized agent, will make reasonable efforts to arrange for Service requirements, such as special routing, Diversity, Alternate Access, or circuit conditioning.

2.1.4. Service is offered in equal access exchanges subject to the availability of facilities and the provisions of this Tariff. Company reserves the right to refuse to provide Service to or from any location where the necessary facilities and/or equipment are not available.

2.1.5. Service may be discontinued after five business days written notice to the Customer if:

2.1.5.A. the Customer is using the Service in violation of this Tariff; or

2.1.5.B. the Customer is using the Service in violation of the law or Commission regulation.

2.1.6. Service begins on the date that billing becomes effective and is provided on the basis of a minimum period of at least one month, 24 hours per day. For the purposes of computing charges in this Tariff, a month is considered to have 30 days.

2.1.7. Service will be provided until canceled, by the Customer on not less than thirty (30) days' written notice from the date of postmark on the letter giving notice of cancellation.

2.1.8. Nothing herein, or in any other provision of this Tariff, or in any marketing materials issued by the Company shall give any person any ownership, interest, or proprietary right in any code or 800 number issued by the Company to its Customers.

2.1.9. The Company reserves the right to discontinue furnishing Services or billing options, upon written notice, when necessitated by conditions beyond its control. Conditions beyond the Company's control include, but are not limited to, a Customer's having Call volume or a calling pattern that results, or may result, in network blockage or other Service degradation which adversely affects Service to the calling party, the Customer,or other Customers of the Company.

2.1.10. Except as otherwise provided in this Tariff or as specified in writing by the party entitled to receive Service, notice may be given orally or in writing to the persons whose names and business addresses appear on the executed Service order and the effective date of any notice shall be the date of delivery of such notice, not the date of mailing. By written notice, Company or Customer may change the party to receive notice and/or the address to which such notice is to be delivered. In the event no Customer or Company address is provided in the executed Service order, notice shall be given to the last known business address of Customer or, as appropriate.

2.2. Other Terms and Conditions

2.2.1. The name(s) of the Customer(s) desiring to use the Service must be stipulated in the Application for Service.

2.2.2. The Customer agrees to operate the Company provided equipment in accordance with instructions of the Company or the Company's agent. Failure to do so will void the Company liability for interruption of Service and may make Customer responsible for damage to equipment pursuant to Section 2.2.3 below.

2.2.3. Customer agrees to return to the Company all Company-provided equipment delivered to Customer within five (5) days of termination of the Service in connection with which the equipment was used. Said equipment shall be in the same condition as when delivered to Customer, normal wear and tear only excepted. Customer shall reimburse the Company, upon demand, for any costs incurred by the Company due to Customer's failure to comply with this provision.

2.2.4. A Customer shall not use any service-mark or trademark of the Company or refer to the Company in connection with any product, equipment, promotion, or publication of the Customer without prior written approval of the Company.

2.2.5. In the event suit is brought or any attorney is retained by the Company to enforce the terms of this Tariff, the Company shall be entitled to recover, in addition to any other remedy, reimbursement for reasonable attorneys' fees, court costs, costs of investigation and other related expenses incurred in connection therewith.

2.2.6. The provision of Service will not create a partnership or joint venture between the Company and the Customer nor result in joint Service offerings to their respective Customers.

2.2.7. The rate or volume discount level applicable to a Customer for a particular Service or Services shall be the rate or volume discount level in effect at the beginning of the monthly billing period applicable to the Customer for the particular Service or Services. When a Service is subject to a minimum monthly charge, account charge, port charge or other recurring charge or Nonrecurring Charge for both intrastate and interstate Service, only one such charge shall apply per account and that charge shall be the interstate charge.

2.2.8. Service requested by Customer and to be provided pursuant to this Tariff shall be requested on Company Service Order forms in effect from time to time or Customer's forms accepted in writing by an authorized headquarters representative of the Company (collectively referred to as "Service Orders").

2.2.9. If an entity other than the company (e.g., another carrier or a supplier) imposes charges on the Company in connection with a Service that entity's charges will be passed through to the Customer also.

2.2.10. The Service Commitment Period for any Service shall be established by the Service Order relevant thereto and commence on the Start of Service Date. Upon expiration, each Service Commitment Period for such Service shall automatically be extended subject to written notice of termination by either Company or Customer as of a date not less than thirty (30) days after delivery of said notice to the other. The charges for Interexchange Service during any such extension shall not exceed the then current Company month-to-month charges applicable to such Service.

2.3. Liability

2.3.1. Except as provided otherwise in this Tariff, the Company shallnot be liable to Customer or any other person, firm or entity for any failure of performance hereunder if such failure is due to any cause or causes beyond the reasonable control of the Company. Such causes shall include, without limitation, acts of God, fire, explosion, vandalism, cable cut, storm or other similar occurrence, any law, order, regulation, direction, action or request of the United States government or of any other government or of any civil or military authority, national emergencies, insurrections, riots, wars, strikes, lockouts or work stoppages or other labor difficulties, supplier failures, shortages, breaches or delays, or preemption of existing Services to restore service in compliance with Part 64, Subpart D, Appendix A, of the FCC's Rules and Regulations.

2.3.2. With respect to the Services contained herein and except as otherwise provided herein, the Company's liability shall be determined by the Commission or a court of competent jurisdiction pursuant to SDCL 49-13-1 and 49-13-1.1. If the initial minute rate is higher than the additional minute rate, the higher rate shall apply. For those Services with monthly recurring charges, the Company's liability is limited to an amount equal to the proportionate monthly recurring charges forthe period during which Service was affected.

2.3.3. The Company is not liable for any act or omission of any other company or companies (including any Company affiliate that is a participating or concurring carrier) furnishing a portion of the Service orfacilities, equipment, or Services associated with such Service.

2.3.4. The Customer is responsible for taking all necessary legal steps for interconnecting the Customer provided terminal equipment with the Company facilities. The Customer shall ensure that the signals emitted into the Company's network do not damage Company equipment, injure personnel or degrade Service to other Customers. The Customer is responsible for securing all licenses, permits, rights-of-way, and other arrangements necessary forsuch interconnection. In addition, the customer shall comply with applicable LEC signal power limitations.

2.3.5. The Company may rely on Local Exchange Carriers or other third parties for the performance of other Services such as Local Access. Upon Customer request and execution and delivery of appropriate authorizing documents, the Company may act as agent for Customer in obtaining such other Services. Customer's liability for charges hereunder shall not be reduced by untimely Installation or non-operation of Customer provided facilities and equipment.

2.3.6. The failure to give notice of default, to enforce or insist upon compliance with any of the terms or conditions herein, the waiver of any term or conditions herein, or the granting of an extension of time for performance by the Company or the Customer shall not constitute the permanent waiver of any term or condition herein. Each of the provisions shall remain at all times in full force and effect until modified in writing.

2.3.7. In the event parties other than Customer (e.g., Customer's customers) shall have use of the Service directly or indirectly through Customer, then Customer agrees to forever indemnify and hold Company and any affiliated or unaffiliated third-party, third-party provider or operator of facilities employed in provision of the Service harmless from and against any and all claims, demands, suits, actions, losses, damages, assessments or payments which may be asserted by said parties arising out of or relating to any Defects.

2.3.8. In the event that Company is required to perform a Circuit redesign due to inaccurate information provided by the Customer; or, circumstances in which such costs and expenses are caused by the Customer or reasonably incurred by the Company for the benefit of the Customer, the Customer is responsible for the payment of all such charges.

2.4. Cancellation of Service by a Customer

2.4.1. If a Customer cancels a Service Order before the Service begins, before completion of the Minimum Period, or before completion of some other period mutually agreed upon by the Customer and the Company, a charge will be levied upon the Customer for the nonrecoverable portions of expenditures or liabilities incurred expressly on behalf of the Customer by the Company and not fully reimbursed by Installation and monthly charges. If, based on a Service order by a Customer, any construction has either begun or been completed, but no Services provided, the nonrecoverable costs of such construction shall be borne by the Customer.

2.4.2. Upon thirty (30) days' prior written notice, either Customer or Company shall have the right, without cancellation charge or other liability, to cancel the affected portion of the Service, if the Company is prohibited by governmental authority from furnishing said portion, or if any material rate or term contained herein and relevant to the affected Service is substantially changed by order of the highest court of competent jurisdiction to which the matter is appeal, the Federal Communications Commission, or other local, state or federal government authority.

2.5. Cancellation for Cause by the Company

2.5.1. Upon nonpayment of any sum owing to the Company, or upon a violation of any of the provisions governing the furnishing of Service under this Tariff, the Company may, upon five business days written notification to the Customer, except in extreme cases, without incurring any liability, immediately discontinue the furnishing of such Service. The written notice may be separate and

Apart from the regular monthly bill for service, Customer shall be deemed to have canceled Service as of the date of such disconnection and shall be liable for any cancellation charges set forth in this Tariff.

2.5.2. Without incurring any liability, the Company may discontinue the furnishing of Service(s) to a Customer upon five business days written notice if the Company deems that such action is necessary to prevent or to protect against fraud or to otherwise protect its personnel, agents, facilities or Services under the following circumstances, except under extreme cases where the customer may be disconnected immediately and without notice:

2.5.2.A. if the Customer refuses to furnish information to the Company regarding the Customer's credit-worthiness, its past or current use of common carrier communications Services or its planned use of Service(s);

2.5.2.B. if the Customer provides false information to the Company regarding the Customer's identity, address, credit-worthiness, past or current use of Customer communications Services, or its planned use of the Company Service(s);

2.5.2.C. if the Customer states that it will not comply with a request of the Company for reasonable security for the payment for Service(s);

2.5.2.D. if the Customer has been given five business days written notice in a separate mailing by the Company of any past due amount (which remains unpaid in whole or in part) for any of the Company's communications Services to which the Customer either subscribes or had subscribed or used;

2.5.2.E. in the event of unauthorized use.

2.5.2.F. Following the disconnection of service for any of these reasons, the Company or the local exchange utility acting as Company agent, will notify the telephone user/customer that service was disconnected and why. The notice will include all reasons for the disconnection and will include a toll-free number where an end user/customer can obtain additional information. Notice shall be deemed given upon deposit, postage prepaid, in the U.S. Mail to the end user's/customer's last known address and in compliance with the Commission's rules.

2.5.3. The discontinuance of Service(s) by the Company pursuant to this Section does not relieve the Customer of any obligations to pay the Company for charges due and owing for Service(s) furnished up to the time of discontinuance. The remedies set forth herein shall not be exclusive and the Company shall at all times be entitled to all rights available to it under either law or equity.

2.6. Credit Allowance

2.6.1. Credit allowance for the interruption of Service is subject to the general liability provisions set forth in this Tariff. Customers shall receive no credit allowance for the interruption of service that is due to the Company's testing or adjusting, negligence of the Customer, or to the failure of channels or equipment provided by the Customer. The Customer should notify the Company when the Customer is aware of any interruption in Service for which a credit allowance is desired. Before giving such notice, the Customer shall ascertain that the trouble is not being caused by any action or omission within Customer's control, or is not in wiring or equipment, if any, furnished by the Customer in connection with the Company's Services.

2.6.2. No credit is allowed in the event service must be interrupted in order to provide routine service quality or related investigations.

2.6.3. No credit shall be allowed:

2.6.3.A. For failure of services or facilities of Customer; or

2.6.3.B. For failure of services or equipment caused by the negligence or willful acts of Customer.

2.6.4. Credit for an interruption shall commence after Customer notifies Company of the interruption and ceases when services have been restored.

2.6.5. Credits are applicable only to that portion of Service interrupted.

2.6.6. For purposes of credit computation, every month shall be considered to have 720 hours.

2.6.7. No credit shall be allowed for an interruption of a continuous duration of less than two hours.

2.6.8. The Customer shall be credited for an interruption of two hours or more at a rate of 1/720th of the monthly recurring charge for the service affected for each hour or major fraction thereof that the interruption continues. Calculations of the credit shall be made in accordance with the following formula.

Credit Formula:

$$\text{Credit} = \frac{A}{720} \times B$$

"A" = outage time in hours
"B" = total monthly charge for affected facility

2.7. Use of Service

2.7.1 The Services offered herein may be used for any lawful purpose, including residential, business, governmental, or other use. There are no restrictions on sharing or resale of Services. However, the Customer remains liable for all obligations under this Tariff notwithstanding such sharing or resale and regardless of the Company's knowledge of same. The Company shall have no liability to any person or entity other than the Customer and only as set forth in Section 2.3. The Customer shall not use nor permit others to use the Service in a manner that could interfere with Services provided to others or that could harm the facilities of the Company or others.

2.7.2. Service furnished by the Company may be arranged for joint use or authorized use. The joint user or Authorized User shall be permitted to use such Service in the same manner as the Customer, but subject to the following:

2.7.2.A. One joint user or Authorized User must be designated as the Customer.

2.7.2.B. All charges for the Service will be computed as if the Service were to be billed to one Customer. The joint user or Authorized User that has been designated as the Customer will be billed for all components of the Service and will be responsible for all payments to the Company. In the event that the designated Customer fails to pay the Company, each joint user or Authorized User shall be liable to the Company for all charges incurred as a result of its use of the Company's Service.

2.7.3. In addition to the other provisions in this Tariff, Customers reselling Company Services shall be responsible for all interaction and interface with their own subscribers or customers. The provision of the Service will not create a partnership or joint venture between Company and Customer nor result in a joint communications Service offering to the Customers of either the Company or the Customer.

2.7.4. Service furnished by the Company shall not be used for any unlawful or fraudulent purposes.

2.7.5. The Customer will be billed directly by the LEC for certain Dedicated Access arrangements selected by the Customer for the provisioning of direct access arrangements. In those instances where the Company at the Customer's request may act as agent in the ordering of such arrangements, the Company will bill the Customer Local Access charges.

2.8. Payment Arrangements

2.8.1. The Customer is responsible for payment of all charges for Services furnished to the Customer or its joint or Authorized Users. This responsibility is not changed due to any use, misuse, or abuse of the Customer's Service or Customer provided equipment by third parties, the Customer's employees, or the public.

2.8.2. The Company's bills are due upon receipt. Amounts not paid within 30 days from the Bill Date of the invoice will be considered past due. Customers will be assessed a late fee on past due amounts in the amount not to exceed the maximum lawful rate under applicable state law. If a Customer presents an undue risk of nonpayment at any time, the Company may require that Customer to pay its bills within a specified number of days and to make such payments in cash or the equivalent of cash.

2.8.3. In determining whether a Customer presents an undue risk of nonpayment, the Company shall consider the following factors: (A) the Customer's payment history (if any) with the Company and its affiliates, (B) Customer's ability to demonstrate adequate ability to pay for the Service, (C) credit and related information provided by Customer, lawfully obtained from third parties or publicly available, and (D) information relating to Customer's management, owners and affiliates (if any).

2.8.4. Disputes with respect to charges must be presented to the Company in writing within the applicable contract law statute of limitations or such invoice will be deemed to be correct and binding on the Customer.

2.8.5. If a LEC has established or establishes a Special Access surcharge, the Company will bill the surcharge beginning on the effective date of such surcharge for Special Access arrangements presently in Service. The Company will cease billing the Special Access surcharge upon receipt of an Exemption Certificate or if the surcharge is removed by the LEC.

2.8.6. In the event the Company incurs fees or expenses, including attorney's fees, in collecting, or attempting to collect, any charges owed the Company, the Customer will be liable to the Company for the payment of all such fees and expenses reasonably incurred.

2.8.7. Company will not require deposits or advance payments by Customers for Services.

2.9. <u>Assignment</u>

2.9.1. The obligations set forth in this Tariff shall be binding upon and inure to the benefit of the parties hereto and their respective successors or assigns, provided, however, the Customer shall not assign or transfer its rights or obligations without the prior written consent of the Company.

2.10. <u>Tax and Fee Adjustments</u>

2.10.1. All state and local taxes (i.e., gross receipts tax, sales tax, municipal utilities tax) are listed as separate line items and are not included in the quoted rates.

2.10.2. If at any future time a municipality acquires the legal right to impose an occupation tax, license tax, permit fee, franchise fee or other similar charge upon the Carrier, and imposes the same by ordinance or otherwise, such taxes, fees or charges shall be billed to the end users receiving service within the territorial limits of such municipality. Such billing shall allocate the tax, fee or charge among end users uniformly on the basis of each end user's monthly charges for the types of service made subject to such tax, fee or charge.

2.10.3. If at any future time a county or other local taxing authority acquires the legal right to impose an occupation tax, license tax, permit fee, franchise fee or other similar charge upon the Carrier, and imposes the same by ordinance or otherwise, such taxes, fees or charges shall be billed to the end users receiving service within the territorial limits of such county or other taxing authority. Such billing shall allocate the tax, fee or charge among end users uniformly on the basis of each end user's monthly charges for the types of service made subject to such tax, fee or charge.

2.10.4. When utility or telecommunications assessments, franchise fees, or privilege, license, occupational, excise, or other similar taxes or fees, based on interstate or intrastate receipts are imposed by certain taxing jurisdictions upon the Company or upon local exchange companies and passed on to the Company through or with interstate or intrastate access charges, the amounts of such taxes or fees will be billed to Customers in such a taxing jurisdiction on a prorated basis. The amount of charge that is prorated to each Customer's bill is determined by the interstate or intrastate telecommunications service provided to and billed to an end user/customer service location in such a taxing jurisdiction with the aggregate of such charges equal to the amount of the tax or fee imposed upon or passed on to the Company.

2.10.5. When any municipality, or other political subdivision, local agency of government, or department of public utilities imposes upon and collects from the Company a gross receipts tax, occupation tax, license tax, permit fee, franchise fee or regulatory fee, such taxes and fees shall, insofar as practicable, be billed pro rata to the Company's Customers receiving service within the territorial limits of such municipality, other political subdivision, local agency of government, or public utility commission.

2.10.6. The Company may adjust its rates and charges or impose additional rates and charges on its Customers in order to recover amount it is required by governmental or quasi-government authorities to collect from or pay to others in support of statutory or regulatory programs. Examples of such programs include, but are not limited to, the Universal Service Fund, the Primary Interexchange Carrier Charge, and compensation to payphone service providers for use of their payphones to access the Company's services.

2.11. Method for Calculation of Airline Mileage

2.11.1. The airline mileage between two cities can be calculated using the Vertical (V) and Horizontal (H) coordinates of the serving wire centers associated with the Company's POP locations. The method for calculating the airline mileage is obtained by reference to AT&T's Tariff F.C.C. No. 10 in accordance with the following formula:

the square root of: $$\frac{(V1-V2)^2 + (H1-H2)^2}{10}$$

where V1 and H1 correspond to the V&H coordinates of City 1 and V2 and H2 correspond to the V&H coordinates of City 2.

Example:

	V	H
City 1	5004	1406
City 2	5987	3424

the square root of: $$\frac{(5004-5987)^2 + (1406-3424)^2}{10}$$

The result is 709.83 miles. Any fractional miles are rounded to the next higher whole number; therefore, the airline mileage for this example is 710 miles.

2.12. Time of Day Rate Periods

2.12.1. Time of Day Rate Periods are determined by the timeof day at the location of the Calling Station.

The rates shown in Section 4 apply as follows:

DAY:	From 8:01 AM to 5:00 PM Monday - Friday
EVENING:	From 5:01 PM to 11:00 PM Monday - Friday and Sunday
NIGHT/ WEEKEND:	From 11:01 PM to 8:00 AM Everyday From 8:01 AM to 11:00 PM Saturday From 8:01 AM to 5:00 PM Sunday

2.13. Special Customer Arrangements

2.13.1. In cases where a Customer requests a special or unique arrangement which may include engineering, conditioning, Installation, construction, facilities, assembly, purchase or lease of facilities and/or other special Services not offered under this Tariff, the Company, at this option, may provide the requested Services. Appropriate recurring charges and/or Nonrecurring Charges and other terms and conditions will be developed for the Customer for the provisioning of such arrangements.

2.14. Inspection

2.14.1. The Company may, upon notice, make such tests and inspections as may be necessary to determine that the requirements of this Tariff are being complied with in the Installation, operation or maintenance of Customer or the Company equipment. The Company may interrupt the Service at any time, without penalty to the Company, should Customer violate any provision herein.

2.15. Customer Inquires and Complaints

2.15.1. Customers may direct inquiries and complaints to the Company or the Commission by using the address and toll free number set forth below:

All-Star Acquisition Corporation
151 South Rose Street, Suite 900
Kalamazoo, MI 49007
(888) 328-5407

South Dakota Public Utilities Commission
1st Floor State Capitol Building
500 East Capitol Avenue
Pierre, SD 57501
(800) 332-1782
TTY Through Relay South Dakota
(800) 877-1113

3. DESCRIPTION OF SERVICES

3.1. Wide Area ("WATS") and Message ("MTS") Toll Services

3.1.1. The Company offers WATS and MTS intrastate interexchange long distance service utilizing switched or dedicated access arrangements between the Customer's Premises and the Company's facilities for call origination. Call termination is completed through a combination of Company facilities and LEC switched access arrangements.

3.2. Switched Inbound Service

3.2.1. Switched inbound service permits inward calling (via 800 codes) to a specific location utilizing premium switched, Feature Group D access on both ends.

3.3. Dedicated Inbound Service

3.3.1. Dedicated inbound service permits inward calling (via 800 codes) to a specific location featuring the use of a dedicated, special access type connection on the terminating end. The Customer shall be responsible for all LEC charges in addition to the Recurring, Non-recurring and Usage charges set forth hereinafter.

3.4. Switched Outbound Service

3.4.1. Switched outbound services permits outward calling utilizing premium switched Feature Group D access on both the originating and terminating ends.

3.5. Dedicated Outbound Service

3.5.1 Dedicated outbound service permits outward calling to stations in diverse service areas. Dedicated outbound service is distinguished from other services by the existence of a dedicated, special access connection on one end. The Customer shall be responsible for all LEC charges in addition to the Recurring, Non-recurring and Usage charges set forth hereinafter.

3.6. Calling Card Service

3.6.1. The Company's Calling Card Service permits Customers to place long distance calls utilizing Company issued Calling Cards for billing purposes.

3.7. Timing of Calls

3.7.1. Long distance usage charges are based on the actual usage of the Company network. Chargeable time begins when a connection is established between the Calling Station and the Called Station. Chargeable time ends when either party "hangs up" thereby releasing the network connection.

3.7.2. Unless otherwise specified in this Tariff, the minimum call duration for billing purposes is six (6) seconds. In addition, unless otherwise specified in this Tariff, usage is measured thereafter in six (6) second increments and rounded to the next higher six (6) second period.

3.8. Minimum Call Completion Rate

3.8.1. A Customer can expect a call completion rate of not less than 90% during peak use periods for all Feature Group D services.

4. RATES AND CHARGES

4.1. Usage Rates

4.1.1. The following are the per minute usage charges which apply to all calls. These charges are in addition to the Non-recurring Charges and Recurring Charges referred to herein.

4.2. Switched Inbound Usage Rates

BUSINESS DAY
EVENING/NIGHT/WEEKEND

Mileage	Initial 6 Seconds	Additional 6 Seconds
ALL	$0.01	$0.01

Issued by: Christine Greene, President
ALL-STAR ACQUISITION CORPORATION
1151 Seven Locks Road
Potomac, MD 20854

4.3. Dedicated Inbound Usage Rates

4.3.1. Reserved for future use.

4.4. Switched Outbound Usage Rates

BUSINESS DAY
EVENING/NIGHT/WEEKEND

Mileage	Initial 6 Seconds	Additional 6 Seconds
ALL	$0.01	$0.01

4.5. Dedicated Outbound Usage Rates

4.5.1 Reserved for future use.

Issued by: Christine Greene, President
ALL-STAR ACQUISITION CORPORATION
1151 Seven Locks Road
Potomac, MD 20854

4.6. Calling Card Usage Rates

4.6.1. Customers using the Company's Calling Card to place long distance calls incur a $0.30 per call charge in addition to the per minute usage charge set forth hereinafter.

BUSINESS DAY
EVENING/NIGHT/WEEKEND

Mileage	Initial 6 Seconds	Additional 6 Seconds
ALL	$0.01	$0.01

4.7. Recurring Charges

4.7.1. Customers will incur the following monthly Recurring Charges:

Billing Fee	$5.95

4.8. Non-recurring Charges

4.8.1. Reserved for future use.

4.9. Special Promotional Offering

4.9.1. The Company may from time to time engage in Special Promotional Offerings or Trial Service Offerings limited to certain dates, times or locations designed to attract new subscribers or increase subscriber usage when approved by Commission. Company will not have special promotional offerings for more than 90 days in any 12-month period. In all such cases, the rates charged will not exceed those specified in Section 4 hereof. Such promotions will be filed with the Commission.

4.10. Emergency Calls

4.10.1. Customer shall configure its PBX or other switch vehicle from which a customer places a call so that 911 emergency calls, where available, and similar emergency calls will be automatically routed to the emergency answering point for the geographical location where the call originated without the intervention of Company.

4.11. Payphone Use Service Charge

4.11.1. A Payphone Use Service Charge applies to each completed interLATA and intraLATA non-sent paid message made over a pay phone owned bya utility or Customer Owned Pay Telephone (COPT) Service. This includes calling card service, collect calls, calls billed to a third number, completed calls to Directory Assistance and Prepaid Card Service calls. This charge is collected on behalf of the pay phone owner. All Customers will pay the Company a per call service charge of $.29.

4.12. Universal Connectivity Charge

4.12.1. Services provided pursuant to this tariff are subject to an undiscountable monthly Universal Connectivity Charge. This monthly service charge is equal to 10% of the Customer's total net intrastate, interstate and international charges, after application of all applicable discounts and credits.

4.12.1.A. The Company will waive the Universal Connectivity Charge with respect to specifically identified Company charges to the extent that the Customer demonstrates to the Company's reasonable satisfaction that:

1. the Customer has filed a Universal Service Worksheet with the Universal Service Administrator covering the twelfth month prior to the month for which the Customer seeks the waiver;

2. the charges with respect to which the waiver is sought are for services purchased by Customer for resale; and

3. the Customer will file a Universal Service Worksheet with the Universal Service Administrator in which the reported billed revenues will include all billed revenues associated with the Customer's resale of services purchased from the Company.

4.12.1.B. The Universal Connectivity Charge will not be waived with respect to:

1. charges for services purchased by the Customer for its own use as an end user; or

2. charges for which the bill date is on, prior to, or within fifteen days after, the date on which the Customer applies for a waiver with respect to those charges.

Security enhanced document. See back for details.

4689

EARLY LENNON CROCKER & BARTOSIEWICZ PLC
IOLTA ACCOUNT
900 COMERICA BLDG.
KALAMAZOO, MI 49007

DATE 9/18/02

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PAY TO THE ORDER OF South Dakota Public Utilities Commission $250.00

Two hundred fifty and 00/100 DOLLARS

Security features are included. Details on back.

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Kalamazoo, Michigan
www.comerica.com

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South Dakota Public Utilities Commission

WEEKLY FILINGS

For the Period of September 19, 2002 through September 25, 2002

If you need a complete copy of a filing faxed, overnight expressed, or mailed to you, please contact Delaine Kolbo within five business days of this report. Phone: 605-773-3705 Fax: 605-773-3809

TELECOMMUNICATIONS

TC02-160 In the Matter of the Application of All-Star Acquisition Corporation for a Certificate of Authority to Provide Interexchange Telecommunications Services in South Dakota.

All-Star Acquisition Corporation has filed an application for a Certificate of Authority to provide interexchange telecommunications services in South Dakota. The applicant intends to provide resold intrastate telecommunications services, including MTS, in-WATS, out-WATS, and Calling Card services throughout South Dakota.

Staff Analyst: Michele Farris
Staff Attorney: Kelly Frazier
Date Docketed: 09/19/02
Intervention Deadline: 10/11/02

TC02-161 In the Matter of the Filing for Approval of an Amendment to an Interconnection Agreement between Qwest Corporation and McLeodUSA Telecommunications Services, Inc.

On September 20, 2002, the Commission received for approval a Filing of Amendment to the Interconnection Agreement between McLeodUSA Telecommunications Services, Inc. (McLeodUSA) and Qwest Corporation (Qwest) f/k/a U S WEST Communications, Inc. According to the parties, this is an Amendment to the negotiated Interconnection Agreement which was approved by the Commission effective July 23, 1999, in Docket No. TC99-057. The filing is intended to amend the Amendment approved on or about January 24, 2001, by adding language to the end of section 1.11 and by replacing the platform recurring rates column with the chart which was attached to the filing. Any party wishing to comment on the agreement may do so by filing written comments with the Commission and the parties to the agreement no later than October 10, 2002. Parties to the agreement may file written responses to the comments no later than twenty days after the service of the initial comments.

Staff Attorney: Kelly Frazier
Date Docketed: 09/20/02
Initial Comments Due: 10/10/02

TC02-162 In the Matter of the Filing by Qwest Corporation for Approval of Revisions to its Access Services Tariff.

On September 23, 2002, Qwest Corporation filed revised pages from its Access Services Tariff. The revisions introduce Managed Long Distance Service (MLD) for interexchange carriers. MLD is a wholesale platform service offered by Qwest to IXCs to monitor and control long distance spending of end-users. Qwest requests an effective date of October 14, 2002.

Staff Analyst: Heather Forney
Staff Attorney: Karen Cremer
Date Docketed: 09/23/02
Intervention Deadline: 10/11/02

TC02-163 In the Matter of the Application of Buyers United Inc. for a Certificate of Authority to Provide Interexchange Telecommunications Services in South Dakota.

Buyers United Inc. has filed an application for a Certificate of Authority to provide interexchange telecommunications services in South Dakota. The applicant will provide service under Buyers United Inc., BuyersOnline, and United Carrier Networks. The applicant intends to resell intrastate long distance and provide in a limited capacity, internet services throughout South Dakota.

Staff Analyst: Michele Farris
Staff Attorney: Kelly Frazier
Date Docketed: 09/23/02
Intervention Deadline: 10/11/02

TC02-164 In the Matter of the Application of NobelTel, LLC for a Certificate of Authority to Provide Interexchange Telecommunications Services in South Dakota.

NobelTel LLC is seeking a Certificate of Authority to provide interexchange telecommunications services in South Dakota. The Applicant intends to offer a full range of interexchange services on a resale basis. Services include direct and dial-around outbound dialing, toll free inbound dialing, directory assistance, data services, travel card services and prepaid calling card services.

Staff Analyst: Keith Senger
Staff Attorney: Kelly Frazier
Date Docketed: 09/24/02
Intervention Deadline: 10/11/02

TC02-165 In the Matter of the Filing for Approval of Amendments to Interconnection Agreements between Qwest Corporation and Covad Communications Company and Qwest Corporation and McLeodUSA Telecommunications Services, Inc.

On September 25, 2002, the Commission received a Petition for Approval of Amendments to Interconnection Agreements regarding the following Agreements: 1) U S WEST Service Level Agreement with Covad Communications Co. dated April 19, 2000; 2) Confidential Billing Settlement Agreement Between U S WEST and McLeodUSA dated April 28, 2000; 3) Confidential Settlement Agreement Between U S WEST and McLeodUSA dated May 1, 2000; and 4) Confidential Agreement Between McLeodUSA and Qwest dated October 26, 2000. According to Qwest, the company is petitioning the Commission to approve the attached agreements such that, to the extent any active provisions of such agreements relate to Section 251(b) or (c), they are formally available to other CLECs under Section 252(i) of the 1996 Telecommunications Act. Qwest reserved the right to demonstrate that one or more of these agreements need not have been filed in the event of an enforcement action in this area. Any party wishing to comment on the agreement may do so by filing written comments with the Commission and the parties to the agreement no later than October 15, 2002. Parties to the agreement may file written responses to the comments no later than twenty days after the service of the initial comments.

Staff Attorney: Kelly Frazier
Date Docketed: 09/25/02
Initial Comments Due: 10/15/02

You may receive this listing and other PUC publications via our website or via internet e-mail. You may subscribe or unsubscribe to the PUC mailing lists at http://www.state.sd.us/puc

TC02-163 In the Matter of the Application of Buyers United Inc. for a Certificate of Authority to Provide Interexchange Telecommunications Services in South Dakota.

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Staff Analyst: Michele Farris
Staff Attorney: Kelly Frazier
Date Docketed: 09/23/02
Intervention Deadline: 10/11/02

TC02-164 In the Matter of the Application of NobelTel, LLC for a Certificate of Authority to Provide Interexchange Telecommunications Services in South Dakota.

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Staff Analyst: Keith Senger
Staff Attorney: Kelly Frazier
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Staff Attorney: Kelly Frazier
Date Docketed: 09/25/02
Initial Comments Due: 10/15/02

EARLY, LENNON, CROCKER & BARTOSIEWICZ, P.L.C.
ATTORNEYS AT LAW
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STEVEN M. BROWN
KRISTEN L. GETTING

OF COUNSEL

THOMPSON BENNETT
JOHN T. PETERS, JR.

VINCENT T. EARLY
(1922 - 2001)
JOSEPH J. BURGIE
(1926 - 1992)

October 22, 2002

RECEIVED
OCT 23 2002
SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

Debra Elofson, Executive Director
South Dakota Public Utilities Commission
State Capitol Building
500 East Capital Avenue
Pierre, SD 57501

RE: Application of All-Star Acquisition Corporation for a Certificate of Authority
Docket No. TC02-160

Dear Ms. Elofson:

In accordance with the request of staff member Michele Farris, we offer the following:

> The Applicant in the above-referenced docket will rely on the financial resources of the parent company, Allied Capital Corporation. Furthermore, Applicant is willing to take restrictions from offering prepaid services, such as deposits and advance payments and prepaid calling cards.

Should you have any questions, please contact me.

Sincerely,

EARLY, LENNON, CROCKER & BARTOSIEWICZ, P.L.C.

Patrick D. Crocker

PDC/bmr

enc

c: Kelly Frazier, Staff Attorney

EARLY, LENNON, CROCKER & BARTOSIEWICZ, P.L.C.

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VINCENT T. EARLY
(1922 - 2001)
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(1926 - 1992)

RECEIVED

OCT 25 2002

SOUTH DAKOTA PUBLIC
UTILITIES COMMISSION

October 24, 2002

Debra Elofson, Executive Director
South Dakota Public Utilities Commission
State Capitol Building
500 East Capital Avenue
Pierre, SD 57501

RE: Application of All-Star Acquisition Corporation for a Certificate of Authority
Docket No. TC02-160

Dear Ms. Elofson:

In accordance with the request of staff member Michele Farris,enclosed for filing with the Commission, please find a Request for Waiver of ARSD 20:10:24:02(8).

Should you have any questions, please contact me.

Sincerely,

EARLY, LENNON, CROCKER & BARTOSIEWICZ, P.L.C.

Patrick D. Crocker

PDC/bmr

enc

c: Kelly Frazier, Staff Attorney

BEFORE THE
PUBLIC UTILITIES COMMISSION
OF THE STATE OF SOUTH DAKOTA

RECEIVED
OCT 25 2002
SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

IN THE MATTER OF:

THE APPLICATION OF **All-Star Acquisition Corporation** FOR A CERTIFICATE OF PUBLIC CONVENIENCE AND NECESSITY TO TRANSACT THE BUSINESS OF A RESELLER OF INTEREXCHANGE TELECOMMUNICATIONS SERVICES AND FOR APPROVAL OF ITS INITIAL TARIFF	) SDPUC Docket No. TC02-160

REQUEST FOR WAIVER OF ARSD 20:10:24:02(8)

All-Star Acquisition Corporation (hereinafter "Applicant") respectfully requests that the Public Utilities Commission of the State of South Dakota ("Commission") grant Applicant a waiver of the requirement set forth in ARSD 20:10:24:02(8) regarding financial statements.

Applicant is a start-up company whose parent company, Allied Capital Corporation, is funding the rollout of the regulatory framework. As such, Applicant has not prepared financial statements.

Respectfully submitted,

ALL-STAR ACQUISITION CORPORATION

Dated: October 24, 2002 By: ______________________________

Patrick D. Crocker
Early, Lennon, Crocker & Bartosiewicz, P.L.C.
900 Comerica Building
Kalamazoo, MI 49007-4752
Its: Attorneys

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF SOUTH DAKOTA

IN THE MATTER OF THE APPLICATION OF ALL-STAR ACQUISITION CORPORATION FOR A CERTIFICATE OF AUTHORITY TO PROVIDE INTEREXCHANGE TELECOMMUNICATIONS SERVICES IN SOUTH DAKOTA	))))))	**ORDER GRANTING CERTIFICATE OF AUTHORITY** **TC02-160**

On September 19, 2002, the Public Utilities Commission (Commission), in accordance with SDCL 49-31-3 and ARSD 20:10:24:02, received an application for a certificate of authority from All-Star Acquisition Corporation (All-Star).

All-Star proposes to provide resold intrastate telecommunications services, including MTS, in-WATS, out-WATS and calling card services throughout South Dakota. A proposed tariff was filed by All-Star. The Commission has classified long distance service as fully competitive.

On September 26, 2002, the Commission electronically transmitted notice of the filing and the intervention deadline of October 11, 2002, to interested individuals and entities. No petitions to intervene or comments were filed and at its November 20, 2002, meeting, the Commission considered All-Star's request for a certificate of authority. Commission Staff recommended granting a certificate of authority, subject to the condition that All-Star not offer a prepaid calling card or require or accept deposits or advance payments without prior approval of the Commission. Commission Staff further recommended a waiver of ARSD 20:10:24:02(8).

The Commission finds that it has jurisdiction over this matter pursuant to SDCL Chapter 49-31, specifically 49-31-3 and ARSD 20:10:24:02 and 20:10:24:03. The Commission finds that All-Star has met the legal requirements established for the granting of a certificate of authority. All-Star has, in accordance with SDCL 49-31-3, demonstrated sufficient technical, financial and managerial capabilities to offer telecommunications services in South Dakota. Further, the Commission finds that there is good cause to waive ARSD 20:10:24:02(8). The Commission approves All-Star's application for a certificate of authority, subject to the condition that All-Star not offer a prepaid calling card or require or accept deposits or advance payments without prior approval of the Commission. As the Commission's final decision in this matter, it is therefore

ORDERED, that All-Star's application for a certificate of authority to provide interexchange telecommunications services is hereby granted, subject to the condition that All-Star not offer a prepaid calling card or require or accept deposits or advance payments without prior approval of the Commission. It is

FURTHER ORDERED, that the Commission waives ARSD 20:10:24:02(8). It is

FURTHER ORDERED, that All-Star shall file informational copies of tariff changes with the Commission as the changes occur.

Dated at Pierre, South Dakota, this 2nd day of December, 2002.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that this document has been served today upon all parties of record in this docket, as listed on the docket service list, by first class mail, in properly addressed envelopes, with charges prepaid thereon.

By: Delaine Kolbo

Date: 12/3/02

(OFFICIAL SEAL)

BY ORDER OF THE COMMISSION:

James A. Burg

JAMES A. BURG, Chairman

Pam Nelson

PAM NELSON, Commissioner

Robert K. Sahr

ROBERT K. SAHR, Commissioner

SOUTH DAKOTA PUBLIC UTILITIES COMMISSION

CERTIFICATE OF AUTHORITY

To Conduct Business As A Telecommunications Company
Within The State of South Dakota

Authority was Granted as of the date of the
Order Granting Certificate of Authority
Docket No. TC02-160

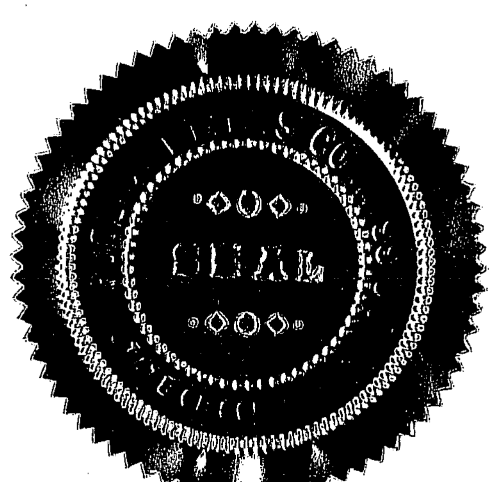
This is to certify that

ALL-STAR ACQUISITION CORPORATION

is authorized to provide interexchange telecommunications services in South Dakota, subject to the condition that it not offer a prepaid calling card or require or accept deposits or advance payments without prior approval of the Commission.

This certificate is issued in accordance with SDCL 49-31-3 and ARSD 20:10:24:02, and is subject to all of the conditions and limitations contained in the rules and statutes governing its conduct of offering telecommunications services.

Dated at Pierre, South Dakota, this 2nd day of December, 2002.



SOUTH DAKOTA PUBLIC UTILITIES COMMISSION:

James A. Burg
JAMES A. BURG, Chairman

Pam Nelson
PAM NELSON, Commissioner

Robert K. Sahr
ROBERT K. SAHR, Commissioner