

Tecnoglass Inc.  
Form 10-K  
March 10, 2017

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-K**

**(Mark One)**

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

For the fiscal year ended December 31, 2016

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number **001-35436**

**TECNOGLASS INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Cayman Islands**

**98-1271120**

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(State or Other Jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification Number)

**Avenida Circunvalar a 100 mts de la Via 40**

**Barrio Las Flores, Barranquilla**

**Colombia**

(Address of Principal Executive Offices) (Zip Code)

**(57)(5)3734000**

(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Ordinary Shares, par value \$0.0001 per share	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

Yes [ ] No [X]

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirement for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark if disclosure of delinquent filers in response to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.:

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of June 30, 2016 (the last business day of the registrant's most recently completed second fiscal quarter), the aggregate market value of the ordinary shares held by non-affiliates of the registrant was approximately \$66,151,398 based on its last reported sales price of \$11.31 on the NASDAQ Capital Market.

As of December 31, 2016, there were **33,172,144** ordinary shares, \$0.0001 par value per share, outstanding.

Documents Incorporated by Reference: None.

**TECNOGLASS INC.**

**FORM 10-K**

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## FORWARD LOOKING STATEMENTS AND INTRODUCTION

All statements other than statements of historical fact included in this Annual Report on Form 10-K (this “Form 10-K”) including, without limitation, statements under “Management’s Discussion and Analysis of Financial Condition and Results of Operations” regarding our financial position, business strategy and the plans and objectives of management for future operations, are forward looking statements. When used in this Form 10-K, words such as “anticipate,” “believe,” “estimate,” “expect,” “intend” and similar expressions, as they relate to us or our management, identify forward looking statements. Such forward looking statements are based on the beliefs of management, as well as assumptions made by, and information currently available to, our management. Actual results could differ materially from those contemplated by the forward looking statements as a result of certain factors detailed in our filings with the Securities and Exchange Commission. All subsequent written or oral forward looking statements attributable to us or persons acting on our behalf are qualified in their entirety by this paragraph.

Unless the context otherwise requires:

references to the “Company” , “TGI” and to “we, “ “us” or “our” are to Tecnoglass Inc., a Cayman Islands exempted company, and its subsidiaries;

references to “Tecnoglass Holding” are to Tecno Corporation;

references to “Tecnoglass” and “TG” are to Tecnoglass S.A.;

references to “ES” are to C.I. Energía Solar S.A. E.S. Windows;

references to “ESW” are to ES Windows LLC, our indirect wholly-owned subsidiary, based in Florida. We recently acquired ESW, which was formerly a related party of ours.

References to “VS” are to Ventana Solar S.A., a Panama-based company with which we have a strategic commercial relationship

references to “Tecno LLC” are to Tecnoglass LLC;

references to “Tecno RE” are to Tecno RE LLC; and

references to “GM&P” are to Giovanni Monti and Partners Consulting and Glazing Contractors.

## PART I

### Item 1. Business.

#### Overview

We were originally formed under the name “Andina Acquisition Corporation” for the purpose of effecting a merger, share exchange, asset acquisition, share purchase, recapitalization, reorganization or other similar business combination with one or more businesses or entities. On March 22, 2012, we consummated our initial public offering (the “IPO”), and on December 20, 2013, we consummated our initial business combination (the “Merger”), whereby our wholly-owned subsidiary merged with and into Tecnoglass Holding. As a result of the Merger, Tecnoglass Holding and its indirect, wholly-owned subsidiaries, Tecnoglass and ES, became our direct and indirect subsidiaries. Accordingly, the business of Tecnoglass Holding and its subsidiaries became our business. We are now a holding company operating through our direct and indirect subsidiaries.

The Merger was accounted for as a reverse acquisition with Tecnoglass Holding being considered the accounting acquirer in the Merger. For accounting and financial purposes, we were treated as the acquired company, and Tecnoglass Holding was treated as the acquiring company. Accordingly, historical information, including historical financial information and the historical description of our business, for periods and dates prior to December 20, 2013, include information for Tecnoglass Holding and its subsidiaries.

In December 2016, as part of our strategy to vertically integrate our operations, we acquired 100% of the stock of ESW LLC, 85.06% of which was acquired directly by the Company and 14.94% by our subsidiary ES, for a total purchase price of \$13.5 million, which consisted of (i) 734,400 ordinary shares issued in connection with the transaction for approximately \$9.2 million based on a stock price of \$12.50, (ii) approximately \$2.3 million in cash, and (iii) approximately \$2.0 million related to the assignment of certain accounts receivable.

As the Acquisition of ESW LLC was deemed to be a transaction between entities under common control, the assets and liabilities were transferred at the historical cost of ESW LLC, with prior periods retroactively adjusted to include the historical financial results of the acquired company for the period they were controlled by the previous owners of ESW LLC in the Company’s financial statements. The following information includes the financial information as originally reported and as adjusted.

December 31, 2015

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	Prior to acquisition	Effect of Acquisition	After acquisition
Total Assets	\$316,199	\$ 5,212	\$321,411
Total Sales	\$238,833	\$ 3,406	\$242,239
Net income (loss)	\$(12,765 )	\$ 1,745	\$(11,020 )
Basic income per share	\$(0.50 )	\$ 0.09	\$(0.42 )
Diluted income per share	\$(0.50 )	\$ 0.09	\$(0.42 )
Basic weighted average common shares outstanding	25,720,469	734,400	26,454,469
Diluted weighted average common shares outstanding	25,720,469	734,400	26,454,469

The number of basic and diluted weighted average common shares outstanding prior to the acquisition of ESW LLC includes 272,905 shares issued after the financial statements for the year ended December 31, 2015 were issued related to a stock dividend in November 2016.

The following table includes a reconciliation of the financial information for the year ended December 31, 2016 as being reported, the net effect of the ESW acquisition after elimination of intercompany transactions, and the financial information that would have been, had the Company not acquired ESW LLC:

	December 31, 2016		
	Without acquisition	Net effect of acquisition	Considering acquisition
Total Assets	\$392,527	\$ 2,203	\$394,730
Total Sales	\$299,972	\$ 5,044	\$305,016
Net income (loss)	\$23,277	\$ (97 )	\$23,180
Basic income per share	\$0.82	\$ (0.03 )	\$0.79
Diluted income per share	\$0.79	\$ (0.02 )	\$0.77
Basic weighted average common shares outstanding	28,497,054	734,400	29,231,054
Diluted weighted average common shares outstanding	29,519,068	734,400	30,253,068

## Our Business

### General

We are a leading manufacturer of hi-spec architectural glass and windows for the western hemisphere residential and commercial construction industries, operating through our direct and indirect subsidiaries. Headquartered in Barranquilla, Colombia, we operate out of a 2.7 million square foot vertically-integrated, state-of-the-art



manufacturing complex that provides easy access to the Americas, the Caribbean, and the Pacific.

We sell our products to more than 900 customers in North, Central and South America. The United States accounted for approximately 62% and 59% of our combined revenues in 2016 and 2015, respectively, while Colombia accounted for approximately 32% and 34%, and Panama for approximately 3% and 3% of our combined revenues in those years, respectively. Our tailored, high-end products are found on some of the world's most distinctive properties, including the 50 UN Plaza (New York), UB Law (Baltimore) Fordham University Law School (New York), Soho Mall (Panama), Brickell City Centre (Miami), Wesleyan (Houston) and the El Dorado Airport (Bogota).

The Company is a leading manufacturer of a variety of glass products installed primarily in commercial and residential buildings, including tempered safety, double thermo-acoustic and laminated glass. Tecnoglass products are installed in hotels, residential buildings, commercial and corporate centers, universities, airports and hospitals in a variety of applications such as floating facades, curtain walls, windows, doors, handrails, interior and bathroom spatial dividers. In 2015 Tecnoglass established its Solartec plant, to produce low emissivity glass with high thermal insulation specifications using soft coat technology.

Tecnoglass also produces aluminum products such as profiles, rods, bars, plates and other hardware used in the manufacture of windows. In 2007, Tecnoglass established its Alutions plant in Barranquilla, Colombia for extrusion, smelting, painting and anodizing processes, and for exporting, importing and marketing aluminum products. The Alutions plant contributes all of the raw materials needed for production of Tecnoglass aluminum products.

Glass Magazine ranked Tecnoglass as the second largest glass fabricator serving the U.S. market in 2016. We believe that it is the leading glass transformation company in Colombia, capturing 40% of the market share in the country by sales and volume.

The Company is also a leader in the production of high-end windows, with more than 33 years of experience in the glass and aluminum structure assembly market in Colombia. The Company designs, manufactures, markets and installs architectural systems for high, medium and low rise construction, glass and aluminum windows and doors, office dividers and interiors, floating facades and commercial display windows.

The Company has an important and dominant presence in the Florida market, which has historically represented (and continues to represent) a substantial portion of our total sales and backlog. The Company grew in the Florida market not only through sustained organic growth, but also through the asset acquisitions of Glasswall LLC and RC Aluminum, both in 2014, and the recent acquisition of ESW (formerly a related party), which would reinforce our vertical integration strategy and expansion strategy into U.S. markets. ES has expanded its U.S. sales outside of the Florida market for windows, and into the high-tech market for curtain walls, a product that is in high demand and we believe represents a new trend in architecture, and floating façades. For example, it has been used in El Dorado Airport (Bogotá), University of Baltimore Law School (Baltimore) and Via 57 West (New York). Due to the sophistication of these new products, we believe that we can generate higher margins through the sale of curtain walls as compared to traditional window frames or floor-to-ceiling windows. Curtain walls produced by the Company are composed of high performance materials produced by Alutions, our aluminum smelting plant, and our glass treatment plant.

In 2014, we established two entities in South Florida, Tecno LLC and Tecno RE, to acquire manufacturing and warehousing facilities, customer lists and exclusive design permits in order to support sales growth in the United States. We will continue to manufacture our products at our facilities in Barranquilla, Colombia while performing select manufacturing and light assembly in the U.S. to enhance client service and create certain cost efficiencies.

In Panama, ES sells products primarily to companies participating in large construction projects in the exclusive areas of Panama City. For example, ES products were supplied in the construction of the tallest building in Central and South America, The Point, as well as in the construction of other modern hotels in the region, such as Megapolis, and in the development of the Soho Plaza, a complex consisting of a shopping mall and two skyscrapers.

As part of our strategy to vertically integrate our operations, on December 2, 2016 we acquired 100% of the stock of ESW LLC, for a total purchase price of \$13.5 million. Since 2004, we have a strategic commercial relationship with ESW LLC, a Florida-based company partially owned by Christian T. Daes and José M. Daes, who are also our executive officers and directors, up onto recent acquisition. ESW LLC acts as one of ES's importers and distributors in the U.S. and is a member of the American Architectural Manufacturers Association, a technical information center for the architecture industry with highest standards. ESW LLC sends project specifications and orders from its clients to ES, and in turn, receives pricing quotes from ES which are conveyed to the client.

As a subsequent event, on March 1, 2017, the Company entered into and consummated a purchase agreement with Giovanni Monti, the owner of 100% of the outstanding shares of GM&P. GM&P is a consulting and glazing contracting company located in Miami, Florida with over 15 years of experience in the design and installation of various building enclosure systems such as curtain window walls and a long-standing commercial relationship with the Company, working alongside it in different projects within the U.S, by providing engineering and installation services to those projects. The Company acquired all of the shares of GM&P for a purchase price of \$35 million, of which the Company will pay \$6 million of the purchase price in cash within the 60 days following the closing date and the remaining \$29 million of the purchase price to be payable on or before September 1, 2017 in cash, our ordinary shares or a combination of both, at our sole option.

### ***Competitive Strengths***

#### *Vertical Integration*

We believe we are unique in vertically integrating the purchase of raw materials, the manufacture of glass and aluminum products and the subsequent production and distribution of customized glass and windows for architectural and industrial settings. By vertically integrating these functions, we are able to price our products competitively while maintaining strict quality control measures to guarantee the high quality of our products. Additionally, we benefit from significant advantages in efficiency and time-to-market for new or customized products. This vertically integrated model provides attractive margins with significant operating leverage.

*Ideally situated, with easy access to cost-efficient transport hubs*

Our principal manufacturing facilities are located in Barranquilla, Colombia, which is strategically located near three of the country's major ports: Barranquilla, Cartagena and Santa Marta. These ports, which are no more than two hours' drive from each other, provide us with maritime access to all major markets globally. The Barranquilla port is just 16 kilometers away from our production facilities, and shipping to Miami's main port is a three-day journey, six days to New York and 11 days to Los Angeles (through the Panama Canal). Our location provides a significant competitive advantage in light of the relatively low cost of shipping our products from Barranquilla to the U.S. (particularly Florida) as compared to our main competitors located elsewhere, even including our competitors located in Midwest U.S. In addition to very positive impact on cost structure, our strategic location allows us to be more responsive to our customers' requirements.

*High Barriers to Entry*

Entry into many of the markets that we serve is limited due to the technical certifications required on high specification building projects such as IGCC, IqNet Icontec 14001 and ISO9001. Our success in those markets is due in large part to our ability to produce sophisticated products, the breadth of our product offering and our reputation for delivering high quality, made-to-order architectural glass on time. These factors are required to compete successfully for multimillion dollar projects typical of our business. Given the vertically-integrated nature of our operations, including the aluminum extrusion products provided by TG, there is a more limited set of competitors and entry into these markets. In addition, the equipment needed to operate in the glass and window industry is expensive, requiring a significant upfront capital investment. In addition, our ES Windows University provides training to our employees ensuring a dedicated and loyal work force, giving us an advantage that potential competitors lack, as they may not be able to bear the cost of providing similar training or retaining similarly trained employees.

*Innovation*

We have made significant investments in machinery and equipment in order to deploy the latest technology in our production lines. We have state-of-the-art glass making equipment, glass laminating lines and high-volume insulating equipment, which allow for a more precise and high quality manufacturing less raw material waste and the chance of developing new products. Being able to employ state-of-the-art technology is a competitive differentiator that (i) allows us to produce higher-quality products creating a competitive pricing advantage that can translate into higher margins, (ii) allows for less material waste and a more energy efficient process, and (iii) enables the manufacturing of a broader array of products.

During the last two years, we acquired three aluminum extrusion presses that together added more than 1,000 tons of production capacity per month, along with related aluminum paint line and a new foundry, which investments totaled \$80.2 million in 2015 and \$42.5 million in the year ended December 31, 2016.

In August 2014, we entered into a contract to purchase equipment to produce soft coated low emissivity glass as part of our improvement plan, which started production in the last quarter of 2015 and was in production throughout 2016.

We purchased two glass-laminating and tempering furnaces that use state-of-the-art technologies to produce tempered glass with no distortion using air cushion technology (TecnoAir) and to produce curved glass in a broad range of easily modifiable curvatures (TecnoBend). TecnoAir technology glass sheets “float” on air pressing systems rather than running on metallic rolls. TecnoBend has a flexible mold that permits different curved shapes to be employed in architectural structures.

For certain of our products, we offer DuPont Sentryglass®, laminated glass interlayers recognized as industry-leading laminated glass solutions with five times the resistance strength of competing materials.

We also use a laminator and jumbo tempering oven capable of producing extra-large slabs of laminated glass, which are sought after in the high-end window market. For example, our extra-large glass slabs have been recently used in El Dorado Airport (Bogotá).

These investments in machinery and equipment, together with our highly trained labor force, allow us to offer state-of-the-art custom designed products that are tailored to meet customer demands.

#### *Competitive cost structure*

We provide high quality products to our customers at competitive prices primarily as a result of the efficiencies we achieve through vertical integration and comparatively low labor costs. Our ES Windows University provides training to our employees ensuring a dedicated and loyal work force that works efficiently and also is less susceptible to workplace injuries. These competitive advantages give us greater flexibility in pricing without adversely affecting our profit margins and allow our products to be competitive in a variety of markets.

#### *Superior Customer Service*

In addition to manufacturing high quality products, our value proposition to our customers is based on industry-leading lead times, on-time delivery and superior after-sale support. Through the coordinated efforts of our sales teams, product specialists, and field service teams, we deliver high quality service to our customers, from the time the initial order is placed through the delivery and installation of our products. By providing an efficient flow of product from order through delivery, our manufacturing processes allow us to deliver made-to-order products consistently on time, which we believe is an important competitive strength.



### *Management Experience*

José Daes, our chief executive officer, and Christian Daes, our chief operating officer, have more than 30 years of industry experience, respectively. In addition, our executive management teams have worked together for many years at our operating subsidiaries. This long tenure in the industry, and as a team, has enabled our management to build significant relationships with both clients and field level management. We believe that these relationships, coupled with management's strong technical expertise, create a significant competitive advantage.

### *Strong relationship with local communities*

For several decades, we have had committed resources to improving the quality of life of our employees and the local communities surrounding our plants. As a result of these initiatives, we have developed close and cooperative relationships with local communities in Colombia, which are supported by several social responsibility initiatives we have undertaken. We view our employees as key to our historical and future success and therefore have focused initiatives of our non-for-profit, *Fundación Tecnoglass*, on offering our employees and their families the resources to purchase or improve their homes through the *Programa de Mejora de Vivienda*. Additionally, our foundation offers educational stipends for higher education pursuits. During 2016, 60 families were benefited from our *Programa de Mejora de Vivienda*, and currently we are sponsoring 128 employees and their children through our scholarship program, *Programa de Becas*. *Fundación Tecnoglass* also supports a school for primary and secondary education in the La Paz neighborhood in Barranquilla, Colombia, and, in collaboration with *Fundación Pacific Rubiales*, *Fundación Colombia Somos Todos* and soccer star James Rodriguez, we support children in vulnerable neighborhoods to thrive through sports, with around 400 children participating to date, among several other social welfare programs designed to lend support to the most vulnerable citizens in Barranquilla and its surrounding communities. All of these initiatives have allowed us to maintain an excellent relationship with our employees, in which we have been able to maintain a labor union free environment since our incorporation.

### *Strategy*

We have identified the following items that we believe are important in advancing our business:

*Development of additional high-value products supported by continued investments in equipment and state-of-the-art technology.*

We have a track record of developing new products and will continue to focus on capitalizing on new product opportunities in the future. We constantly identify shifting global trends and growing marketplace needs, and design proposals to meet those needs. For instance, with the installation of our new soft coating facility, we are now able to manufacture low emissivity glass that is energy efficient and will allow us to service a growing market that demands “green” initiatives. We will seek to leverage our existing platform of cutting-edge production facilities to adapt our products to evolving demands for structural architectural glass in our current markets and evaluate opportunities to enter new markets. We expect our reputation and proven track-record of innovation will position us well to take advantage of these opportunities.

We made investments of an aggregate of \$136.8 million from 2014 to 2015, and \$42.5 million during the year ended December 31, 2016, including:

state-of-the-art glass-making equipment;

the installation of new laminating lines;

high-volume insulating equipment;

a new aluminum extrusion press with the capacity for an additional one thousand tons per month;

a new paint line with the capacity to treat one million pounds of aluminum per month; and

a new aluminum foundry.

Additionally, we are in the process of implementing new technologies to produce tempered glass that offers notably more transparency with significantly less distortion than industry standard using air cushion technology, as well as new technology used to produce curved glass in a broad range of easily modifiable curvatures. Additionally, in 2014 we started producing architectural systems that integrate LED lighting allowing the façade of the building to display different colors and patterns. We further intend to explore expanding our operation to provide value-added glass products such as our soft-coated low-emissivity window panes that minimize the effect of solar heat.

We believe these innovative products will provide us with a competitive edge. The continued development of new products with the corresponding investments in technology, allows us to support our track-record of innovation and allow for continued customer demand by fulfilling ever-changing needs.



*Manufacture the highest quality products in the market through a rigorous quality assurance program*

Our plants are organized internally by processes, each of which is independently and continually supervised by the Quality Assurance department. The Quality Assurance department maintains rigorous oversight over energy, water, recyclable waste and process optimization indicators, in order to produce high quality sustainable products. Our quality assurance control system has established the measures and indicators necessary for the inspections implemented over the reception of materials, production process and final products. Additionally, between 5% and 10% of our production, randomly chosen, is sent to our laboratories to verify compliance with a variety of quality standards, such as water leaks, functionality, manufacturing and accessories, through tests undertaken according to ASTM and AAMA rules. We have implemented these measures in order to reach an effective control in detecting potential issues and to take the specific actions to mitigate their occurrence. By providing the highest quality products and ensuring they meet the highest standards of quality, we seek to ensure customer satisfaction and loyalty.

*Continued vertical integration provides margin enhancement*

We benefit from having our key operating companies and processes operating together at a combined facility, providing advantages in meeting customer and market needs, controlling supply chain issues and managing operating costs. By continuing to operate as a vertically integrated company, we seek to further enhance productivity, create cost efficiencies and increase operating margins. In recent developments, we strive to further vertically integrate the operations of the Company through the acquisition of ESW LLC, an importer and distributor of Company products in the U.S in December 2016. Furthermore, on March 1, 2017, the Company acquired GM&P, a South Florida glazing contracting company to incorporate the design and installation of various building enclosure systems such as curtain window walls and a long-standing commercial relationship with the Company, working alongside it in different projects within the U.S, by providing engineering and installation services to those projects.

*Leverage strength in Florida market to further penetrate U.S.*

We believe we have an established and leading presence in the Florida construction market as providers of high value, impact-resistant glass products. ES's hurricane-proof products are certified in compliance with the stringent requirements of hurricane-proof windows in accordance with applicable U.S. regulations. With a quality of product proven by our success and compliance in the impact-resistant market, we have successfully entered the U.S. remodeling and replacement parts market. In addition, we have grown geographically in the U.S., particularly into other coastal markets on the East Coast which are affected by hurricanes, significant temperature fluctuations and other extreme weather. As we continue to explore opportunities in other markets in the U.S., we intend to leverage the strong reputation we have developed in markets such as Florida to take advantage of a resurgent commercial and residential real estate sector.

*Continue to leverage strength in Colombia market to further penetrate Latin America*

With a strong base in Colombia, we have already successfully expanded into nearby geographies. Our glass products are featured in major construction projects in Argentina, Aruba, Costa Rica, Panama and Puerto Rico. As the construction market throughout Latin America grows, we are positioned to capture new growth in the markets we have currently penetrated, as well as in new high growth countries. We will also take advantage of our geographical location to deliver products to South American markets at relatively low shipping and operating cost.

*Maintain fast and reliable delivery to customers due to strategic location*

From the Port of Barranquilla, products can be transported to Panama by air in one hour and to Houston and Miami within two hours, within two days by sea to Panama and within four days by sea to Houston and Miami. Our ability to deliver our products on a timely basis complements the relatively low cost of shipping our products from Barranquilla to Florida and supports the value of our strategic location. As a result of this strategic location, we are able to meet the requirements of architectures and developers who seek to obtain building products on a schedule that does not interfere with their construction progress. As we target different projects and markets, we will seek to take advantage of our unique delivery capabilities to satisfy demands of the construction industry.

### ***Products***

The Company manufactures and sells the following products:

*Soft Coat Glass* - manufactured by depositing metal particles on the surface of the glass inside a vacuum chamber. This product offers excellent thermal insulation designed to improve energy efficiency of buildings.

*Laminated/Thermo-Laminated Glass* - produced by bonding two glass sheets with an intermediate film in-between. As a safety feature, this product fractures into small pieces if it breaks.

*Thermo-Acoustic Glass* - manufactured with two or more glass sheets separated by an aluminum or micro-perforated steel profile. This product has a double-seal system that ensures the unit's tightness, buffering noise and improving thermal control. This product serves as an excellent noise barrier, which is used especially in zones close to airports, traffic or wherever there are unpleasant sounds.

*Tempered Glass* - glass subject to a tempering process through elevated temperatures resulting in greater superficial elasticity and resistance than conventional glass.

*Silk-Screened Glass* - special paint is applied to glass using automatic machinery and numerical control which ensures paint homogeneity and an excellent finish.

*Curved Glass* - produced by bending a flat glass sheet over a mold, using an automated heat process, which maintains the glass' physical properties.

*Digital Print Glass* - digital printing allows any kind of appearance required by the client, offering versatility to projects.

The Company's aluminum products sold through its Alutions brand include bars, plates, profiles, rods and tubes used primarily in the manufacture of architectural glass settings including windows, doors, spatial separators and similar products.

*Floating facades* - act as a window screen hanging outside a building and are available in many technical specifications and profiles to define colors, thickness, glass types and finishes, and types of ventilation and design complements.

*Windows and Doors* - line of window and door products defined by the different types of glass finish, such as normal, impact resistant, hurricane-proof, safety, soundproof and thermal. Additionally, they are available in numerous structures, including fixed body, sliding windows, projecting windows, guillotine windows, sliding doors and swinging doors.

*Commercial display windows* - commercial and interior display windows with a broad range of profiles, colors and crystal finishes. Products combine functionality, aesthetics and elegance and are available in a broad range of

structures and materials.

*Hurricane-proof windows* - combine heavy-duty aluminum or vinyl frames with special laminated glass to provide protection from hurricane-force winds up to 180 mph and wind-borne debris by maintaining their structural integrity and preventing penetration by impacting objects.

*Automatic doors* - exclusive representative in Colombia of Horton Automatics, a manufacturer of automatic doors including glass window systems.

*Bathroom dividers* - bathroom cubicle division systems, formed by combining glass panels, frames and doors.

*Other* - polyvinyl structures and other components of architectural systems.

### ***Brands and Trademarks***

Our brands include Tecnoglass, ES Windows and Alutions. Our registered trademarks include “Alutions by Tecnoglass” with the accompanying logo and “Alutions”.

### ***Sales, Marketing and Customer Service***

#### ***Sales and marketing***

Our sales strategy primarily focuses on attracting and retaining customers by consistently providing exceptional customer service, leading product quality, and competitive pricing. Our customers also value our shorter lead times, knowledge of building code requirements and technical expertise, which collectively generate significant customer loyalty. Our products are marketed using a combination of internal sales representatives, independent sales representatives and directly to distributors. Our internal sales representatives receive a portion of their performance-based compensation based on sales and profitability metrics. We primarily market our products based on product quality, outstanding service, shorter lead times and on-time delivery.

We employ a highly efficient number of in-house sales employees. Most of our sales and marketing efforts are handled by area sales representatives who work on a commission basis.

We do not rely on significant traditional advertising expenditures to drive net sales. We have established and maintain credibility primarily through the strength of our products, our customer service and quality assurance, the speed at which we deliver finished products and the attractiveness of our pricing. Our advertising expenditures consist primarily of maintaining our subsidiaries' websites.

### *Customer Service*

We believe that our ability to provide customers outstanding service quality serves as a strong competitive differentiator. Our customer relationships are established and maintained through the coordinated efforts of our sales and production teams. We employ a highly responsive and efficient team of professionals devoted to addressing customer support with the goal of resolving any issue in a timely manner. In order to promote customer loyalty and employee development, we developed ES Windows University with the primary objectives of training employees to be aware of client and supplier needs and familiarizing them with our strategic goals in order to improve the competitiveness, productivity and quality of all products offered.

### **Working Capital Requirements**

Our principal use of cash is related to trade accounts receivable which amounted to \$26.0 million and \$29.4 million during the years ended December 31, 2016 and 2015, respectively. Such use is directly correlated with the company's ongoing growth and an industry related longer cash cycle. These receivables are often associated to sophisticated, long-lead projects that typically have longer collection periods as distributors also have to collect from end-users, and for that, certain performance conditions must always be met. Additionally, the Company's strategy continues to include further geographical diversification into more distant markets within the United States, which also may contribute to longer collection cycles. Albeit these factors, the Company doesn't foresee a deterioration in its ability to collect from its direct or indirect clients (as evidenced by its relatively stable days sales outstanding relation without accounting for foreign currency translation) and by its very low receivables write-off. The Company continues to focus on ways to improve collection times with some of its most representative clients.

Our inventory requirements are not as significant since our products are made-to-order rather than build-to-stock and as such, inventory levels follow customer orders. During 2016, the Company spent a fair amount of time and resources undertaking "lean manufacturing" best practices with an external consultant and as a result, it was able to better manage inventory levels and improve turnover during the year.

### **Customers**

Our customers include architects, building owners, general contractors and glazing subcontractors in the commercial construction market. We have over 900 customers. Of our 100 most representative customers, which represent over 88% of our sales, about 52% are located in North America, 4% in Central America and the Caribbean, and 44% in South America. Only one customer, GM&P Consulting and Glazing, accounted for more than 10% or more of our net sales during 2016 and 2015 with 26% and 14% of sales during the year ended December 31, 2016 and 2015, respectively. On March 1, 2017 the Company entered into and consummated a purchase agreement with Giovanni

Monti, the owner of 100% of the outstanding shares of GM&P. With the acquisition of GM&P, the Company has reduced its customer risk concentration and dependence on a single client.

## **Backlog**

We had combined outstanding orders of \$396 million as of December 31, 2016 as compared to \$375 million as of December 31, 2015. We do not believe that backlog is indicative of our future results of operations or prospects. Although we seek commitments from customers well in advance of shipment dates, actual confirmed orders are typically not received until close to the required shipment dates.

## **Materials and Suppliers**

Our primary manufacturing materials include glass, ionoplast, polyvinyl butyral, and aluminum and vinyl extrusions. Although in some instances we have agreements with our suppliers, these agreements are generally terminable by us or the supplier counterparties on limited notice. Typically, all of our materials are readily available from a number of sources, and no supplier delays or shortages are anticipated.

We source raw materials and glass necessary to manufacture our products from a variety of domestic and foreign suppliers. For the year ended December 31, 2016, three suppliers individually accounted for more than 10% of total raw material purchases, which in aggregate represent 38% of raw material purchases. For the year ended December 31, 2015, no single supplier accounted for more than 10% of raw material purchases.

## **Warranties**

We offer product warranties which we believe are competitive for the markets in which our products are sold. The nature and extent of these warranties depend upon the product. Our standard warranties are generally from five to ten years for architectural glass, curtain wall, laminated and tempered glass, window and door products. Warranties are not priced or sold separately and do not provide the customer with services or coverages in addition to the assurance that the product complies with original agreed-upon specifications. In the event of a claim against a product for which we have received a warranty from the supplier, we transfer the claim back to the supplier. The Company evaluated historical information regarding claims for replacements under warranties and concluded that the costs that the Company has incurred in relation to these warranties have not been material.

## Certifications

Among our many designations and certifications, Tecnoglass has earned the Miami-Dade County Notice of Acceptance (“NOA”), one of the most demanding certificates in the industry and a requirement to market hurricane-resistant glass in Florida. Tecnoglass’ products comply with Miami-Dade county’s safety code standards as its laminated anti-hurricane glass resists impact, pressure, water and wind. Tecnoglass is also the only company in Latin America authorized by PPG Industries and Guardian Industries to manufacture floating glass facades.

Our subsidiaries have received a number of other certifications from other national and international standard-setting bodies.

TG Certifications include:

NTC-1578

ASTM E774 1997

ISO 9001: 2008 Certificate of Quality Assurance

ISO 14001: 2004 Certificate of Environmental Management

Safety Glazing Certification Council (SGCC) for tempered and laminated glass: ANZI Z97 1-2004

International Glass Certification Council (IGCC) for insulated glass: ASTM E774 - 97

Pittsburgh Plate Glass (PPG) certified supplier

Member of ACOLVISE (Colombia Association of Safety Glass Transformers)

ES Certifications include:

NTC-ISO 9001: 2008 Certificate of Quality Assurance

NTC-ISO 14001: 2004 Certificate of Environmental Management

Member of the American Architectural Manufacturers Association (AAMA)

Complies with Miami-Dade County’s stringent safety code regulations for hurricane-proof windows

## Competitors

We have local competitors in Colombia as well as competitors in the international markets in each of the glass, aluminum and finished products sectors. Glass Tecnología en Vidrios y Ventanas S.A., Arquicentro S.A., Aluminum



Estructural S.A. and Ventanar Ltda, compete with us in the finished products market in Colombia. Apogee Enterprises, Inc., PGT, Inc. and WinDoor Inc. compete with us in the U.S. finished products market. Golden Glass Security, Vid-plex Universal S.A., Aluace Ltda and Laminados y Blindados compete with us locally in the glass and aluminum markets. Oldcastle, Inc., Trulite Inc., and PRL Glass Systems are among others that compete with us in the U.S. glass and aluminum products markets.

The key factors on which we and our competitors compete for business include: quality, price and reputation, breadth of products and service offerings, and production speed. We face intense competition from both smaller and larger market players who compete against us in our various markets including glass, window and aluminum manufacturing.

The principal methods of competition in the window and door industry are the development of long-term relationships with window and door distributors and dealers, and the retention of customers by delivering a full range of high-quality customized products on demand with short turnaround times while offering competitive pricing. The vertical integration of our operations, our geographic scope, low labor costs and economies of scale have helped our subsidiaries consolidate their leading position in Colombia and bolstered their expansion in the U.S. and other foreign markets.

## **Government Regulations**

We are subject to extensive and varied federal, state and local government regulation in the jurisdictions in which we operate, including laws and regulations relating to our relationships with our employees, public health and safety and fire codes. Additionally, certain of the jurisdictions in which we operate require that installation of doors and windows be approved by competent authorities that grant distribution licenses. Although our business and facilities are subject to federal, state and local environmental regulation, environmental regulation does not have a material impact on our operations.

Also, we are subject to a potential revision of the United States-Colombia Free Trade Agreement (“USCOFTA”), which allows Colombian entities to export to USA without any tariffs. Mr. Donald Trump, US President, has made public announcements about the intention to re-negotiate certain terms of free trade agreements, which could potentially implement a tariff. However, the Company can mitigate this risk by transferring the price to its consumers and diversifying its business operations.

## **Research and Development**

During the years ended December 31, 2016 and December 31, 2015, we spent approximately \$2.2 million and \$2.0 million, respectively, in research and development. The Company incurs in costs related to the development of new products and pays for external tests that need to be performed on our products in order to comply with strict building codes. The Company is fully permitted to commercialize hurricane windows in the Miami-Dade County, Florida, which has one of the most demanding certifications in the world of window frames.

## **Employees**

As of December 31, 2016, we had a total of 5,853 employees, with 3,373 employed by ES, 2,459 employed by Tecnoglass and 21 employed by ESW LLC, none of whom is represented by a union. As of December 31, 2015, we had a total of 5,399 employees, with 3,250 employed by ES, 2,149 employed by Tecnoglass and 20 employed by ESW LLC. Most of our employees are hired through seven temporary staffing companies and are employed under one-year fixed-term employment contracts. Management believes it has good relations with our employees. We provide ongoing training programs to our employees through the self-established E.S. Windows University.

## **Company History**

We were formed under the name “Andina Acquisition Corporation” as an exempted company incorporated in the Cayman Islands on September 21, 2011 in order to effect a merger, share exchange, asset acquisition, share purchase, recapitalization, reorganization or other similar business combination with one or more businesses or entities.

In March, 2012, we closed our IPO of 4,200,000 units, with each unit consisting of one ordinary share and one warrant to purchase one ordinary share at an exercise price of \$8.00 per share, at an offering price of \$10.00 per unit, generating total gross proceeds of \$42,000,000. Simultaneously with the consummation of the IPO, we consummated a private placement of 4,800,000 warrants (“private warrants”) at a price of \$0.50 per warrant and, to the underwriters, options to purchase an aggregate of 900,000 units at a price of \$500,100, generating total proceeds of \$2,900,100. After deducting the underwriting discounts and commissions and the offering expenses, the total net proceeds to us were \$43,163,000 of which \$42,740,000 was deposited into a trust account. The remaining proceeds of \$423,000 became available to be used as working capital to provide for business, legal and accounting due diligence on prospective business combinations and continuing general and administrative expenses. The IPO was conducted pursuant to a registration statement on Form S-1 (Reg. No. 333-178061), that became effective on March 16, 2012.

From the consummation of our IPO until August 17, 2013, we were searching for a suitable target business to acquire. On August 17, 2013, we entered into an agreement and plan of reorganization, pursuant to which agreement, as amended, we acquired Tecnoglass Holding, Tecnoglass and ES as direct and indirect subsidiaries. On December 20, 2013, we held an extraordinary general meeting of our shareholders, at which our shareholders approved the Merger and other related proposals. On the same date, we closed the Merger and Tecnoglass Holding and its indirect, wholly-owned subsidiaries, Tecnoglass and ES, became our direct and indirect subsidiaries.

Tecnoglass Holding is a corporation formed under the laws of the Cayman Islands that was founded in 2014 in connection with the Merger. Tecnoglass is a corporation formed under the laws of Colombia that was founded in 1994 by Jose M. Daes, our Chief Executive Officer, and Christian T. Daes, our Chief Operating Officer. ES is a corporation formed under the laws of Colombia that was founded in 1984 by Jose M. Daes and Christian T. Daes.

At the closing of the Business Combination, 2,251,853 of the 4,200,000 public shares sold in our IPO were converted to cash at a conversion price of approximately \$10.18 per share, or an aggregate of approximately \$22.9 million of the approximately \$42.7 million held in the trust account. As consideration for the Business Combination, we issued Energy Holding Corp., a holding company and sole shareholder of Tecnoglass Holding, of which former shareholders of TG and ES were the sole shareholders, an aggregate of 20,567,141 ordinary shares, or approximately 87% of the outstanding ordinary shares. Pursuant to the agreement and plan of reorganization, we also issued to Energy Holding Corp. an additional 500,000 ordinary shares upon the achievement of the specified EBITDA targets in the fiscal year ended December 31, 2014, 1,000,000 ordinary shares upon achievement of the specified EBITDA target in the fiscal year ended December 31, 2015 and 1,500,000 ordinary shares upon the achievement of the specified EBITDA target in the fiscal year ended December 31, 2016.

In connection with the Business Combination, we changed our name to “Tecnoglass Inc.” We also changed our fiscal year end from February 28 to December 31 in order to coincide with the fiscal year end of Tecnoglass Holding and its subsidiaries.

In 2014, we established two entities in South Florida, Tecno LLC and Tecno RE, to acquire manufacturing and sales-related assets to support sales and customer service in the United States.

In September 2016, we completed a warrant exchange whereby each warrant holder was given the opportunity to exchange 2.5 outstanding warrants for one ordinary share. As a result of the warrant exchange, 5,479,049 warrants, or 82% of the outstanding warrants were validly tendered. As of September 30, 2016, 1,275,823 warrants remained outstanding following completion of the warrant exchange referenced above. Of these, 1,265,842 warrants were exercised prior to the December 20, 2016 expiration, resulting in the issuance of 478,218 Tecnoglass common shares. The remaining unexercised warrants expired by their own terms on December 20, 2016.

As part of our strategy to vertically integrate our operations, on December 2, 2016 we acquired 100% of the equity of ESW LLC, for a total purchase price of \$13.5 million. The acquisition was recorded retroactively starting from the first date of common control. Instead of using fair value, the Company consolidates the financial statements of the entity acquired using the existing carrying values.

As a subsequent event, on March 1, 2017 the Company entered into and consummated a purchase agreement with Giovanni Monti, the owner of 100% of the outstanding shares of GM&P. The Company acquired all of the shares of GM&P for a purchase price of \$35 million, of which the Company will pay \$6 million of the purchase price in cash within the 60 days following the closing date and the remaining \$29 million of the purchase price to be payable on or before September 1, 2017 in cash, our ordinary shares or a combination of both, at our sole option.

### **Additional Information About the Company**

We maintain websites for our subsidiaries, TG and ES, which can be found at [www.tecnoglass.com](http://www.tecnoglass.com) and [www.energiasolarsa.com](http://www.energiasolarsa.com), respectively. Although we do not have a website dedicated to Tecnoglass Inc., the corporate filings of Tecnoglass Inc., including our Annual Reports on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K, our proxy statements and reports filed by our executive officers and directors under Section 16(a) of the Securities Exchange Act, and any amendments to those filings, are available free of charge on the Investor Relations page of each of the subsidiary websites, which are updated as soon as reasonably practicable after we electronically file (or furnish in certain cases) such material with the Securities and Exchange Commission, and can also be found at the SEC’s website at <http://sec.gov>. We do not intend for information contained in either subsidiary website, including the Investor Relations pages, to be a part of this Form 10-K. Also, the public may read

and copy any materials the Company files with the SEC at the SEC' public reference room at 100 F St NE, Washington D.C, 20549 or by calling 1-800-SEC-0330.

We are an "emerging growth company," as defined in the Jumpstart Our Business Startups Act (or JOBS Act), and are eligible to take advantage of certain exemptions from various reporting requirements that are applicable to other public companies that are not emerging growth companies. However, we have irrevocably opted not to take advantage of one such exemption which would have allowed us an extended transition period for complying with new or revised accounting standards. We are, and will continue to be, subject to the same new or revised accounting standards as other public companies that are not emerging growth companies.

We could remain an emerging growth company until the last day of our fiscal year following March 22, 2017 (the fifth anniversary of the consummation of our initial public offering). However, if our non-convertible debt issued within a three-year period or our total revenues exceed \$1 billion or the market value of our ordinary shares that are held by non-affiliates exceeds \$700 million on the last day of the second fiscal quarter of any given fiscal year, we would cease to be an emerging growth company as of the following fiscal year.

**Item 1A. Risk Factors.**

Not Applicable.

**Item 1B. Unresolved Staff Comments.**

Not Applicable.

## **Item 2. Properties.**

We own and operate a 2.7 million square foot manufacturing complex located in Barranquilla, Colombia. This manufacturing campus houses a glass production plant, aluminum plant and window and facade assembly plant. The glass plant has four lamination machines with independent assembly rooms, six specialized tempering furnaces and glass molding furnaces, a computer numerical-controlled profile bending machine, as well as five silk-screening machines. The Alutions plant has an effective installed capacity of 1,000 tons per month and can create a variety of shapes and forms for windows, doors and related products. We also own three natural gas power generation plants with a capacity of 1,750 kilowatts each which supply the electricity requirements of the entire manufacturing complex and are supported by three emergency generators.

In December 2014, we acquired a 123,399 square foot manufacturing and warehousing facility in a 215,908 square foot lot size in Miami-Dade County, Florida, United States. The facility houses manufacturing and assembly equipment, warehouse space, and administrative and sales offices.

During the first week of July 2016, TG paid \$10.5 million to acquire a lot adjacent to the Company's facilities to expand the manufacturing facilities.

We believe that our existing properties are adequate for the current operating requirements of our business and that additional space will be available as needed.

## **Item 3. Legal Proceedings.**

On March 2, 2016 ES filed a lawsuit against Bagatelos Architectural Glass Systems, Inc. ("Bagatelos") in Colombia. In addition, we also filed a lawsuit against Bagatelos in the State of California for breach of contract. To lift the lien declared by the Court in California, Bagatelos submitted a bond for \$2.0 million in favor of ES and its release is subject to the court's ruling. This bond is a "mechanics lien surety bond" which guarantees ES payment of the amounts due with interest and costs should the Company win the case. Mediation scheduled for February 17, 2017 was unsuccessful and parties continue discovery. Bagatelos as defendant presented a cross complaint on September 23, 2016 seeking damages of approximately \$3 million. Although we already received a payment order from the Colombian judge, the Company continues to pursue its rights, remedies and defenses in the U.S. We received on January 31, 2017 a case update from our U.S. counsel stating that due to ES' favorable terms and conditions and the fact that Bagatelos has overstated their claim and ignored their contractual duties, it is probable that the Company will be able to recover the outstanding amount of \$2.0 million.

## **Item 4. Mine Safety Disclosures.**

Not Applicable.

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## PART II

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.**

**Market Information**

Our ordinary shares are listed on the NASDAQ Capital Market under the symbol TGLS. Effective January 6, 2016, the Company's shares also commenced trading on the Bolsa de Valores de Colombia ("BVC"), the principal stock exchange of Colombia, under the symbol TGLSC. The listing of the Company's shares on the BVC is secondary to the primary listing on the NASDAQ Market. No new shares were issued in connection with the admission to trading on the BVC.

The following table sets forth the high and low sales prices for our ordinary shares for the periods indicated below and starting from the first quarter of 2015.

Period	Ordinary Shares	
	High	Low
Fiscal 2017:		
First Quarter*	\$12.34	\$11.40
Fiscal 2016:		
Fourth Quarter	\$12.70	\$10.87
Third Quarter	\$12.93	\$10.20
Second Quarter	\$12.49	\$10.25
First Quarter	\$14.30	\$9.82
Fiscal 2015:		
Fourth Quarter	\$15.59	\$13.05
Third Quarter	\$15.95	\$12.39
Second Quarter	\$13.74	\$8.50
First Quarter	\$10.73	\$9.16

\* Through March 1, 2017.



**Holders**

As of December 31, 2016, there were 339 holders of record of our ordinary shares.

**Dividends****Private Finance****September 30, 2008 Portfolio Company**

(unaudited) (in thousands, except number of shares) Investment<sup>(1)(2)</sup> Principal Cost Value

## ForeSite Towers, LLC

Equity Interest \$ 980

(Tower Leasing)

**Total Investment 980**

## Global Communications, LLC

Senior Loan (10.0%, Due 9/02)<sup>(6)</sup> \$ 1,335 1,335 1,335

(Business Services)

**Total Investment 1,335 1,335**

## Hot Light Brands, Inc.

Senior Loan (9.0%, Due 2/11)<sup>(6)</sup> 29,662 29,662 13,256

(Retail)

Common Stock (93,500 shares) 5,151

**Total Investment 34,813**

**13,256**

Standby Letter of Credit (\$105)

## Hot Stuff Foods, LLC

Senior Loan (7.2%, Due 2/11-2/12) 53,707 53,554 52,659

(Consumer Products)

Subordinated Debt (13.3%, Due 8/12-2/13)<sup>(6)</sup> 83,692 83,393 Common Stock (1,147,453 shares)

56,187

**Total Investment 193,134 52,659**

## Huddle House, Inc.

Subordinated Debt (15.0%, Due 12/12) 56,778 56,590 56,590

(Retail)

Common Stock (358,428 shares) 35,828 32,996

**Total Investment 92,418**

**89,586**

## IAT Equity, LLC and Affiliates

Subordinated Debt (9.0%, Due 6/14) 6,000 6,000 6,000

d/b/a Industrial Air Tool

Equity Interests 7,500 8,633

(Industrial Products)

**Total Investment 13,500 14,633**

## Impact Innovations Group, LLC

Equity Interests in Affiliate 321

(Business Services)

**Total Investment 321**

## Insight Pharmaceuticals Corporation

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Subordinated Debt (15.0%, Due 9/12)	45,595	45,498	45,498	
(Consumer Products)				
Subordinated Debt (19.0%, Due 9/12) <sup>(6)</sup>	16,177	16,126	15,698	Preferred Stock (25,000 shares)
25,000 Common Stock (620,000 shares)		6,325		<b>Total Investment</b>
<b>92,949</b>	<b>61,196</b>			
Jakel, Inc.				
Subordinated Debt (15.5%, Due 3/08) <sup>(6)</sup>	748	748	748	
(Industrial Products)				
<b>Total Investment</b>	<b>748</b>	<b>748</b>		
Knightsbridge CLO 2007-1 Ltd. <sup>(4)</sup>				
Class E Notes (11.8%, Due 1/22)	18,700	18,700	16,431	
(CLO)				
Income Notes (15.0%) <sup>(11)</sup>	40,656	35,705		<b>Total Investment</b>
<b>52,136</b>				<b>59,356</b>

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (11) Represents the effective interest yield earned on the cost basis of these preferred equity investments and income notes. The yield is included in interest income in the consolidated statement of operations.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	September 30, 2008 (unaudited)		Value
			Cost		
Knightsbridge CLO 2008-1 Ltd. <sup>(4)</sup> (CLO)	Class C Notes (10.5%, Due 6/18)	\$ 12,800	\$ 12,800		\$ 12,800
	Class D Notes (11.5%, Due 6/18)	8,000	8,000		8,000
	Class E Notes (8.0%, Due 6/18)	13,200	10,534		10,534
	Income Notes (16.6%) <sup>(11)</sup>		20,453		20,453
	<b>Total Investment</b>		<b>51,787</b>		<b>51,787</b>
Legacy Partners Group, Inc. (Financial Services)	Senior Loan (14.0%, Due 5/09) <sup>(6)</sup>	843	843		843
	Equity Interests		4,273		1,268
	<b>Total Investment</b>		<b>5,116</b>		<b>2,111</b>
MHF Logistical Solutions, Inc. (Business Services)	Subordinated Debt (13.0%, Due 6/12 6/13) <sup>(9)</sup>	49,841	49,633		
	Preferred Stock (10,000 shares)				
	Common Stock (20,934 shares)		20,942		
	<b>Total Investment</b>		<b>70,575</b>		
MVL Group, Inc. (Business Services)	Senior Loan (12.0%, Due 6/09 7/09)	30,674	30,657		30,657
	Subordinated Debt (14.5%, Due 6/09 7/09)	40,958	40,831		40,831
	Common Stock (560,716 shares)		555		21
	<b>Total Investment</b>		<b>72,043</b>		<b>71,509</b>
Old Orchard Brands, LLC (Consumer Products)	Subordinated Debt (18.0%, Due 7/14)	18,760	18,688		18,688
	Equity Interests		15,857		35,081

	<b>Total Investment</b>		<b>34,545</b>	<b>53,769</b>
Penn Detroit Diesel Allison, LLC	Subordinated Debt (15.5%, Due 8/13)	37,701	37,580	37,580
(Business Services)	Equity Interests		18,862	33,223
	<b>Total Investment</b>		<b>56,442</b>	<b>70,803</b>
Service Champ, Inc.	Subordinated Debt (15.5%, Due 4/12)	26,878	26,808	26,808
(Business Services)	Common Stock (55,112 shares)		11,785	24,726
	<b>Total Investment</b>		<b>38,593</b>	<b>51,534</b>
Startec Equity, LLC	Equity Interests		206	214
(Telecommunications)	<b>Total Investment</b>		<b>206</b>	<b>214</b>
Unitranche Fund LLC	Subordinated Certificates (10.3%)		114,339	114,339
(Private Debt Fund)	Equity Interests		1	1
	<b>Total Investment</b>		<b>114,340</b>	<b>114,340</b>
Worldwide Express Operations, LLC	Subordinated Debt (14.0%, Due 2/14)	2,812	2,670	2,670
(Business Services)	Equity Interests		11,384	16,262
	Warrants		144	205
	<b>Total Investment</b>		<b>14,198</b>	<b>19,137</b>
<b>Total companies more than 25% owned</b>			<b>\$ 2,242,291</b>	<b>\$ 1,433,700</b>

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (11) Represents the effective interest yield earned on the cost basis of these preferred equity investments and income notes. The yield is included in interest income in the consolidated statement of operations.

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

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

<b>Private Finance Portfolio Company (in thousands, except number of shares) Companies 5% to 25% Owned</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>September 30, 2008 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
10 <sup>th</sup> Street, LLC  (Business Services)	Subordinated Debt (13.0%, Due 11/14) Equity Interests Option	\$ 21,223	\$ 21,109 421 25	\$ 21,223 1,075 25
	<b>Total Investment</b>		<b>21,555</b>	<b>22,323</b>
Advantage Sales & Marketing, Inc.  (Business Services)	Subordinated Debt (12.0%, Due 3/14) Equity Interests	157,811	157,302	157,302 13,000
	<b>Total Investment</b>		<b>157,302</b>	<b>170,302</b>
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan (5.6%, Due 3/11) Equity Interests	4,635	4,597 2,993	4,332 10,700
	<b>Total Investment</b>		<b>7,590</b>	<b>15,032</b>
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock (536 shares) Common Stock (11,657 shares)		531 13	
	<b>Total Investment</b>		<b>544</b>	
Amerex Group, LLC  (Consumer Products)	Subordinated Debt (12.3%, Due 1/13) Equity Interests	8,789	8,784 3,508	8,784 13,662
	<b>Total Investment</b>		<b>12,292</b>	<b>22,446</b>
BB&T Capital Partners/Windsor Mezzanine Fund, LLC <sup>(5)</sup>  (Private Equity Fund)	Equity Interests		11,787	10,346
	<b>Total Investment</b>		<b>11,787</b>	<b>10,346</b>

Becker Underwood, Inc.	Subordinated Debt (14.5%, Due 8/12)	25,341	25,284	25,341
(Industrial Products)	Common Stock (4,376 shares)		5,014	4,300
	<b>Total Investment</b>		<b>30,298</b>	<b>29,641</b>
Drew Foam Companies, Inc.	Preferred Stock (622,555 shares)		623	335
(Business Services)	Common Stock (6,286 shares)		6	
	<b>Total Investment</b>		<b>629</b>	<b>335</b>
Hilden America, Inc.	Common Stock (19 shares)		454	70
(Consumer Products)	<b>Total Investment</b>		<b>454</b>	<b>70</b>
Lydall Transport, Ltd.	Equity Interests		432	423
(Business Services)	<b>Total Investment</b>		<b>432</b>	<b>423</b>

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- (5) Non-registered investment company.

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

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>September 30, 2008 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
MedBridge Healthcare, LLC	Senior Loan (8.0%, Due 8/09) <sup>(6)</sup>	\$ 6,587	\$ 6,587	\$ 6,587
(Healthcare Services)	Subordinated Debt (10.0%, Due 8/14) <sup>(6)</sup>	5,153	5,153	753
	Convertible Subordinated Debt (2.0%, Due 8/14) <sup>(6)</sup>	2,970	984	
	Equity Interests		1,425	
	<b>Total Investment</b>		<b>14,149</b>	<b>7,340</b>
Multi-Ad Services, Inc.	Unitranche Debt (11.3%, Due 11/11)	3,026	3,007	2,947
(Business Services)	Equity Interests		1,731	1,422
	<b>Total Investment</b>		<b>4,738</b>	<b>4,369</b>
Progressive International Corporation	Preferred Stock (500 shares)		500	1,103
(Consumer Products)	Common Stock (197 shares)		13	4,600
	Warrants			
	<b>Total Investment</b>		<b>513</b>	<b>5,703</b>
Regency Healthcare Group, LLC	Unitranche Debt (11.1%, Due 6/12)	10,901	10,851	11,107
(Healthcare Services)	Equity Interests		1,298	1,568
	<b>Total Investment</b>		<b>12,149</b>	<b>12,675</b>
SGT India Private Limited <sup>(4)</sup>	Common Stock (150,596 shares)		4,122	1,206
(Business Services)	<b>Total Investment</b>		<b>4,122</b>	<b>1,206</b>
Soteria Imaging Services, LLC	Subordinated Debt (11.3%, Due 11/10)	4,250	4,155	4,107



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(Healthcare Services)	Equity Interests		1,881	2,157
	<b>Total Investment</b>		<b>6,036</b>	<b>6,264</b>
Triax Holdings, LLC	Subordinated Debt (21.0%, Due 2/12)	10,551	10,514	10,316
(Consumer Products)	Equity Interests		16,528	42,114
	<b>Total Investment</b>		<b>27,042</b>	<b>52,430</b>
Universal Environmental Services, LLC	Equity Interests		1,580	
(Business Services)	<b>Total Investment</b>		<b>1,580</b>	
<b>Total companies 5% to 25% owned</b>			<b>\$ 313,212</b>	<b>\$ 360,905</b>
<b>Companies Less Than 5% Owned</b>				
3SI Security Systems, Inc.	Subordinated Debt (14.6%, Due 8/13)	\$ 28,865	\$ 28,779	\$ 28,115
(Consumer Products)	<b>Total Investment</b>		<b>28,779</b>	<b>28,115</b>
Abraxas Corporation	Subordinated Debt (14.6%, Due 4/13)	37,000	36,831	36,274
(Business Services)	<b>Total Investment</b>		<b>36,831</b>	<b>36,274</b>
AgData, L.P.	Senior Loan (12.0%, Due 7/12)	1,843	1,837	1,834
(Consumer Services)	Unitranche Debt (12.0%, Due 7/12)	13,925	13,876	13,854
	<b>Total Investment</b>		<b>15,713</b>	<b>15,688</b>

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

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>September 30, 2008 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Augusta Sportswear Group, Inc.	Subordinated Debt (13.0%, Due 1/15)	\$ 53,000	\$ 52,818	\$ 53,032
(Consumer Products)	Common Stock (2,500 shares)		2,500	2,000
	<b>Total Investment</b>		<b>55,318</b>	<b>55,032</b>
Axium Healthcare Pharmacy, Inc.	Senior Loan (14.0%, Due 12/12)	3,750	3,722	3,667
(Healthcare Services)	Unitranche Debt (14.0%, Due 12/12)	8,500	8,469	7,897
	Common Stock (22,860 shares)		2,286	99
	<b>Total Investment</b>		<b>14,477</b>	<b>11,663</b>
Baird Capital Partners IV Limited <sup>(5)</sup>	Limited Partnership Interest		3,114	2,994
(Private Equity Fund)	<b>Total Investment</b>		<b>3,114</b>	<b>2,994</b>
BenefitMall Holdings Inc.	Subordinated Debt (18.0%, Due 6/14)	40,326	40,234	40,234
(Business Services)	Common Stock (39,274,290 shares) <sup>(12)</sup>		39,274	90,653
	Warrants <sup>(12)</sup>			
	<b>Total Investment</b>		<b>79,508</b>	<b>130,887</b>
Broadcast Electronics, Inc.	Senior Loan (9.8%, Due 7/12) <sup>(6)</sup>	4,913	4,885	1,358
(Business Services)	<b>Total Investment</b>		<b>4,885</b>	<b>1,358</b>
Bushnell, Inc.	Subordinated Debt (10.3%, Due 2/14)	41,325	39,955	36,572

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(Consumer Products)	<b>Total Investment</b>		<b>39,955</b>	<b>36,572</b>
Callidus Debt Partners CDO Fund I, Ltd. <sup>(4)(10)</sup>	Class C Notes (12.9%, Due 12/13)	18,800	18,913	17,094
(CDO)	Class D Notes (17.0%, Due 12/13)	9,400	9,456	8,674
	<b>Total Investment</b>		<b>28,369</b>	<b>25,768</b>
Callidus Debt Partners CLO Fund III, Ltd. <sup>(4)(10)</sup>	Preferred Shares (23,600,000 shares, 14.2%) <sup>(11)</sup>		20,100	18,129
(CLO)	<b>Total Investment</b>		<b>20,100</b>	<b>18,129</b>
Callidus Debt Partners CLO Fund IV, Ltd. <sup>(4)(10)</sup>	Class D Notes (7.3%, Due 4/20)	3,000	1,997	2,165
(CLO)	Income Notes (20.6%) <sup>(11)</sup>		14,509	13,749
	<b>Total Investment</b>		<b>16,506</b>	<b>15,914</b>

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

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

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>September 30, 2008 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Callidus Debt Partners CLO Fund V, Ltd. <sup>(4)(10)</sup>	Income Notes (22.0%) <sup>(11)</sup>		\$ 13,251	\$ 12,694
(CLO)	<b>Total Investment</b>		<b>13,251</b>	<b>12,694</b>
Callidus Debt Partners CLO Fund VI, Ltd. <sup>(4)(10)</sup>	Class D Notes (8.8%, Due 10/21)	\$ 9,000	7,104	5,783
(CLO)	Income Notes (23.2%) <sup>(11)</sup>		27,907	28,111
	<b>Total Investment</b>		<b>35,011</b>	<b>33,894</b>
Callidus Debt Partners CLO Fund VII, Ltd. <sup>(4)(10)</sup>	Income Notes (15.3%) <sup>(11)</sup>		23,825	19,699
(CLO)	<b>Total Investment</b>		<b>23,825</b>	<b>19,699</b>
Callidus MAPS CLO Fund I LLC <sup>(10)</sup>	Class E Notes (8.7%, Due 12/17)	17,000	17,000	13,955
(CLO)	Income Notes (4.4%) <sup>(11)</sup>		45,792	33,767
	<b>Total Investment</b>		<b>62,792</b>	<b>47,722</b>
Callidus MAPS CLO Fund II, Ltd. <sup>(4)(10)</sup>	Subordinated Debt (7.0%, Due 7/22)		3,494	3,494
(CLO)	Income Notes (17.4%) <sup>(11)</sup>	7,700	18,230	15,224
	<b>Total Investment</b>		<b>21,724</b>	<b>18,718</b>
Carlisle Wide Plank Floors, Inc. (Consumer Products)	Senior Loan (7.5%, Due 6/11)	500	497	481
	Unitranche Debt (14.5%, Due 6/11)	3,161	3,136	3,031
	Preferred Stock (345,056 Shares)		345	150
	<b>Total Investment</b>		<b>3,978</b>	<b>3,662</b>
Catterton Partners VI, L.P. <sup>(5)</sup>	Limited Partnership Interest		2,776	2,771

(Private Equity Fund)	<b>Total Investment</b>	<b>2,776</b>	<b>2,771</b>
Centre Capital Investors V, L.P. <sup>(5)</sup>	Limited Partnership Interest	1,741	1,526
(Private Equity Fund)	<b>Total Investment</b>	<b>1,741</b>	<b>1,526</b>

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

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>September 30, 2008 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
CK Franchising, Inc. (Consumer Services)	Senior Loan (7.0%, Due 7/12)	\$ 6,075	\$ 6,000	\$ 6,000
	Subordinated Debt (12.3%, Due 7/12 7/17)	21,000	20,923	20,923
	Preferred Stock (1,281,887 shares)		1,282	1,549
	Common Stock (7,585,549 shares)		7,586	10,700
	<b>Total Investment</b>		<b>35,791</b>	<b>39,172</b>
Commercial Credit Group, Inc. (Financial Services)	Subordinated Debt (15.0%, Due 6/15)	16,000	15,971	15,971
	Preferred Stock (64,679 shares)		15,543	9,073
	Warrants			
	<b>Total Investment</b>		<b>31,514</b>	<b>25,044</b>
Community Education Centers, Inc. (Education Services)	Subordinated Debt (13.5%, Due 11/13)	35,413	35,347	33,701
	<b>Total Investment</b>		<b>35,347</b>	<b>33,701</b>
Component Hardware Group, Inc. (Industrial Products)	Subordinated Debt (13.5%, Due 1/13)	18,640	18,581	18,444
	<b>Total Investment</b>		<b>18,581</b>	<b>18,444</b>
Cook Inlet Alternative Risk, LLC (Business Services)	Unitranche Debt (10.8%, Due 4/13)	90,000	89,597	87,765
	Equity Interests		552	300
	<b>Total Investment</b>		<b>90,149</b>	<b>88,065</b>
Cortec Group Fund IV, L.P. <sup>(5)</sup>	Limited Partnership Interest		4,647	4,084

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(Private Equity)	<b>Total Investment</b>		<b>4,647</b>	<b>4,084</b>
Diversified Mercury Communications, LLC	Senior Loan (6.2%, Due 3/13)	2,983	2,969	2,717
(Business Services)	<b>Total Investment</b>		<b>2,969</b>	<b>2,717</b>
Digital VideoStream, LLC	Unitranche Debt (11.0%, Due 2/12)	14,568	14,498	14,609
(Business Services)	Convertible Subordinated Debt (10.0%, Due 2/16)	4,434	4,421	5,412
	<b>Total Investment</b>		<b>18,919</b>	<b>20,021</b>
DirectBuy Holdings, Inc.	Subordinated Debt (14.5%, Due 5/13)	75,428	75,110	72,282
(Consumer Products)	Equity Interests		8,000	6,000
	<b>Total Investment</b>		<b>83,110</b>	<b>78,282</b>
Distant Lands Trading Co.	Senior Loan (10.0%, Due 11/11)	4,050	4,022	3,892
(Consumer Products)	Unitranche Debt (13.0%, Due 11/11)	42,890	42,770	42,684
	Common Stock (3,451 shares)		3,451	678
	<b>Total Investment</b>		<b>50,243</b>	<b>47,254</b>
Driven Brands, Inc.	Subordinated Debt (11.7%, Due 1/15 7/15)	88,300	88,082	88,082
d/b/a Meineke and Econo Lube	Common Stock (10,463,473 shares) <sup>(12)</sup>		26,398	13,469
(Consumer Services)	Warrants <sup>(12)</sup>			
	<b>Total Investment</b>		<b>114,480</b>	<b>101,551</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	September 30, 2008 (unaudited)		
		Principal	Cost	Value
Dryden XVIII Leveraged Loan 2007 Limited <sup>(4)</sup> (CLO)	Class B Notes (7.3%, Due 10/19) Income Notes (17.1%) <sup>(11)</sup>	\$ 9,000	\$ 7,580 22,462	\$ 7,383 20,760
	<b>Total Investment</b>		<b>30,042</b>	<b>28,143</b>
Dynamic India Fund IV <sup>(4)(5)</sup> (Private Equity Fund)	Equity Interests		9,350	11,524
	<b>Total Investment</b>		<b>9,350</b>	<b>11,524</b>
EarthColor, Inc. (Business Services)	Subordinated Debt (15.0%, Due 11/13) Common Stock (63,438 shares) <sup>(12)</sup> Warrants <sup>(12)</sup>	119,248	118,813 63,438	118,813 9,751
	<b>Total Investment</b>		<b>182,251</b>	<b>128,564</b>
eCentury Capital Partners, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		7,274	1,822
	<b>Total Investment</b>		<b>7,274</b>	<b>1,822</b>
eInstruction Corporation (Education Services)	Subordinated Debt (13.6%, Due 7/14-1/15) Common Stock (2,406 shares)	33,266	33,124 2,500	31,384 2,300
	<b>Total Investment</b>		<b>35,624</b>	<b>33,684</b>
Farley s & Sathers Candy Company, Inc. (Consumer Products)	Subordinated Debt (11.0%, Due 3/11)	2,500	2,493	2,375
	<b>Total Investment</b>		<b>2,493</b>	<b>2,375</b>
FCP-BHI Holdings, LLC		26,485	26,387	25,390

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d/b/a Bojangles	Subordinated Debt (12.0%, Due 9/13) Equity Interests		968	1,700
(Retail)	<b>Total Investment</b>		<b>27,355</b>	<b>27,090</b>
Fidus Mezzanine Capital, L.P. <sup>(5)</sup>	Limited Partnership Interest		9,597	9,077
(Private Equity Fund)	<b>Total Investment</b>		<b>9,597</b>	<b>9,077</b>
Freedom Financial Network, LLC (Financial Services)	Senior Loan (6.5%, Due 2/13) Subordinated Debt (13.5%, Due 2/14)	7,000 13,000	6,903 12,942	6,570 12,625
	<b>Total Investment</b>		<b>19,845</b>	<b>19,195</b>
Frozen Specialties, Inc.	Warrants		375	
(Consumer Products)	<b>Total Investment</b>		<b>375</b>	
Garden Ridge Corporation	Subordinated Debt (8.0%, Due 5/12) <sup>(6)</sup>	20,500	20,500	20,500
(Retail)	<b>Total Investment</b>		<b>20,500</b>	<b>20,500</b>
Geotrace Technologies, Inc.	Warrants		2,027	2,800
(Energy Services)	<b>Total Investment</b>		<b>2,027</b>	<b>2,800</b>

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

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>September 30, 2008 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Gilchrist & Soames, Inc.	Subordinated Debt (13.4%, Due 10/13)	\$ 25,800	\$ 25,652	\$ 24,949
(Consumer Products)	<b>Total Investment</b>		<b>25,652</b>	<b>24,949</b>
Havco Wood Products LLC	Equity Interests		910	2,100
(Industrial Products)	<b>Total Investment</b>		<b>910</b>	<b>2,100</b>
Higginbotham Insurance Agency, Inc.	Subordinated Debt (13.7%, Due 8/13 8/14)	52,205	51,983	51,983
(Business Services)	Common Stock (23,695 shares) <sup>(12)</sup>		23,695	24,828
	Warrant <sup>(12)</sup>			
	<b>Total Investment</b>		<b>75,678</b>	<b>76,811</b>
The Hillman Companies, Inc. <sup>(3)</sup>	Subordinated Debt (10.0%, Due 9/11)	44,580	44,483	44,480
(Consumer Products)	<b>Total Investment</b>		<b>44,483</b>	<b>44,480</b>
The Homax Group, Inc. (Consumer Products)	Senior Loan (6.4%, Due 10/12)	11,921	11,877	10,897
	Subordinated Debt (12.0%, Due 4/14)	14,000	13,342	12,880
	Preferred Stock (76 shares)		76	10
	Common Stock (24 shares)		5	
	Warrants		954	149
	<b>Total Investment</b>		<b>26,254</b>	<b>23,936</b>
Ideal Snacks Corporation	Senior Loan (6.8%, Due 6/10)	1,113	1,113	1,072
(Consumer Products)	<b>Total Investment</b>		<b>1,113</b>	<b>1,072</b>

Integrity Interactive Corporation	Unitranche Debt (10.5%, Due 2/12)	10,789	10,709	10,923
(Business Services)	<b>Total Investment</b>		<b>10,709</b>	<b>10,923</b>
International Fiber Corporation	Preferred Stock (21,566 shares)		2,157	2,000
(Industrial Products)	<b>Total Investment</b>		<b>2,157</b>	<b>2,000</b>
Kodiak Fund LP <sup>(5)</sup>	Equity Interests		9,440	900
(Private Equity Fund)	<b>Total Investment</b>		<b>9,440</b>	<b>900</b>
Line-X, Inc.	Senior Loan (15.0%, Due 8/11) <sup>(6)</sup>	900	888	888
(Consumer Products)	Unitranche Debt (15.0% Due 8/11) <sup>(6)</sup>	48,445	48,319	36,112
	<b>Total Investment</b>		<b>49,207</b>	<b>37,000</b>
	Standby Letter of Credit (\$1,500)			

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

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>September 30, 2008 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Market Track Holdings, LLC (Business Services)	Senior Loan (8.5%, Due 6/14)	\$ 500	\$ 450	\$ 479
	Subordinated Debt (15.9%, Due 6/14)	24,600	24,483	24,171
	<b>Total Investment</b>		<b>24,933</b>	<b>24,650</b>
NetShape Technologies, Inc.  (Industrial Products)	Senior Loan (7.0%, Due 2/13)	266	266	245
	<b>Total Investment</b>		<b>266</b>	<b>245</b>
Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (10.0%, Due 12/11)	19,052	19,135	19,052
	Convertible Subordinated Debt (9.8%, Due 12/15)	14,533	14,587	14,587
	<b>Total Investment</b>		<b>33,722</b>	<b>33,639</b>
Novak Biddle Venture Partners III, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,018	1,596
	<b>Total Investment</b>		<b>2,018</b>	<b>1,596</b>
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		206	950
	<b>Total Investment</b>		<b>206</b>	<b>950</b>
Pangaea CLO 2007-1 Ltd. <sup>(4)</sup> (CLO)	Class D Notes (7.5%, Due 10/21)	15,000	11,667	9,497
	<b>Total Investment</b>		<b>11,667</b>	<b>9,497</b>
PC Helps Support, LLC (Business Services)	Senior Loan (6.5%, Due 12/13)	8,846	8,756	8,799
	Subordinated Debt (13.3%, Due 12/13)	28,909	28,775	30,023
	<b>Total Investment</b>		<b>37,531</b>	<b>38,822</b>

Performant Financial Corporation	Common Stock (478,816 shares)		734	
(Business Services)	<b>Total Investment</b>		<b>734</b>	
Peter Brasseler Holdings, LLC	Equity Interests		3,451	3,600
(Business Services)	<b>Total Investment</b>		<b>3,451</b>	<b>3,600</b>
PharMEDium Healthcare Corporation	Senior Loan (6.4%, Due 10/13)	1,910	1,910	1,769
(Healthcare Services)	<b>Total Investment</b>		<b>1,910</b>	<b>1,769</b>
Postle Aluminum Company, LLC	Unitranche Debt (11.0%, Due 10/12)			
(Industrial Products)	Equity Interests	60,750	60,541	31,489
	<b>Total Investment</b>		<b>62,706</b>	<b>31,489</b>

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.

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



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

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>September 30, 2008 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Pro Mach, Inc. (Industrial Products)	Subordinated Debt (12.5%, Due 6/12) Equity Interests	\$ 14,616	\$ 14,570 1,294	\$ 14,173 1,900
	<b>Total Investment</b>		<b>15,864</b>	<b>16,073</b>
Promo Works, LLC (Business Services)	Unitranche Debt (10.3%, Due 12/11)	24,932	24,762	23,988
	<b>Total Investment</b>		<b>24,762</b>	<b>23,988</b>
Reed Group, Ltd. (Healthcare Services)	Senior Loan (6.5%, Due 12/13) Subordinated Debt (13.8%, Due 12/13) Equity Interests	10,920 18,367	10,784 18,289 1,800	9,897 17,060 500
	<b>Total Investment</b>		<b>30,873</b>	<b>27,457</b>
S.B. Restaurant Company (Retail)	Unitranche Debt (9.8%, Due 4/11) Preferred Stock (46,690 shares) Warrants	39,501	39,272 117 534	38,138 117 180
	<b>Total Investment</b>		<b>39,923</b>	<b>38,435</b>
	Standby Letters of Credit (\$2,465)			
Snow Phipps Group, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		4,113	4,457
	<b>Total Investment</b>		<b>4,113</b>	<b>4,457</b>
SPP Mezzanine Funding II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		9,503	9,400
	<b>Total Investment</b>		<b>9,503</b>	<b>9,400</b>

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Stag-Parkway, Inc.	Unitranche Debt (14.0%, Due 7/12)	49,285	49,126	37,450
(Business Services)	<b>Total Investment</b>		<b>49,126</b>	<b>37,450</b>
STS Operating, Inc.	Subordinated Debt (11.0%, Due 1/13)	30,386	30,290	30,114
(Industrial Products)	<b>Total Investment</b>		<b>30,290</b>	<b>30,114</b>
Summit Energy Services, Inc.	Senior Loan (6.0%, Due 8/13)	9,075	9,031	8,514
(Business Services)	Subordinated Debt (11.6%, Due 8/13)	35,730	35,584	36,440
	Common Stock (415,982 shares)		1,861	1,800
	<b>Total Investment</b>		<b>46,476</b>	<b>46,754</b>
Tank Intermediate Holding Corp.	Senior Debt (8.5%, Due 9/14)	538	384	384
(Industrial Products)	Senior Debt (8.3%, Due 9/14)	30,900	30,079	30,079
	<b>Total Investment</b>		<b>30,463</b>	<b>30,463</b>

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- (5) Non-registered investment company.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>September 30, 2008 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Tappan Wire & Cable Inc.  (Business Services)	Unitranche Debt (15.0%, Due 8/14)  Common Stock (12,940 shares) <sup>(12)</sup> Warrant <sup>(12)</sup>	\$ 22,346	\$ 22,243	\$ 22,243
	<b>Total Investment</b>		<b>24,184</b>	<b>22,727</b>
The Step2 Company, LLC  (Consumer Products)	Unitranche Debt (11.0%, Due 4/12) Equity Interests	95,563	95,275	92,570
	<b>Total Investment</b>		<b>97,424</b>	<b>94,070</b>
Tradesmen International, Inc.  (Business Services)	Subordinated Debt (12.0%, Due 12/12)	40,000	39,516	37,793
	<b>Total Investment</b>		<b>39,516</b>	<b>37,793</b>
TransAmerican Auto Parts, LLC  (Consumer Products)	Subordinated Debt (16.3%, Due 11/12) <sup>(6)</sup> Equity Interests	24,561	24,418	1,034
	<b>Total Investment</b>		<b>25,452</b>	
Trover Solutions, Inc.  (Business Services)	Subordinated Debt (12.0%, Due 11/12)	60,054	59,834	57,350
	<b>Total Investment</b>		<b>59,834</b>	<b>57,350</b>
United Road Towing, Inc.  (Consumer Services)	Subordinated Debt (10.0%, Due 1/14)	29,000	28,871	28,710
	<b>Total Investment</b>		<b>28,871</b>	<b>28,710</b>

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Venturehouse-Cibernet Investors, LLC	Equity Interest			
(Business Services)	<b>Total Investment</b>			
VICORP Restaurants, Inc.	Warrants			33
(Retail)	<b>Total Investment</b>			<b>33</b>
WMA Equity Corporation and Affiliates	Subordinated Debt (16.8%, Due 4/13-4/14) <sup>(6)</sup>	139,455	138,559	77,687
d/b/a Wear Me Apparel	Common Stock (86 shares)		39,721	
(Consumer Products)	<b>Total Investment</b>		<b>178,280</b>	<b>77,687</b>

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

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>September 30, 2008 (unaudited)</b>	
			<b>Cost</b>	<b>Value</b>
Webster Capital II, L.P. <sup>(5)</sup>	Limited Partnership Interest		\$ 1,700	\$ 1,431
(Private Equity Fund)	<b>Total Investment</b>		<b>1,700</b>	<b>1,431</b>
Woodstream Corporation	Subordinated Debt (12.0%, Due 2/15)	\$ 90,000	89,618	84,975
(Consumer Products)	Common Stock (6,960 shares)		6,961	3,600
	<b>Total Investment</b>		<b>96,579</b>	<b>88,575</b>
York Insurance Services Group, Inc.	Common Stock (12,939 shares)		1,294	1,700
(Business Services)	<b>Total Investment</b>		<b>1,294</b>	<b>1,700</b>
Other companies	Other debt investments	159	88	81
	Other equity investments		25	
	<b>Total Investment</b>		<b>113</b>	<b>81</b>
<b>Total companies less than 5% owned</b>			<b>\$ 2,600,556</b>	<b>\$ 2,307,332</b>
<b>Total private finance (146 portfolio investments)</b>			<b>\$ 5,156,059</b>	<b>\$ 4,101,937</b>

(1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.

(2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.

(5) Non-registered investment company.

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

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

			September 30, 2008 (unaudited)	
	Stated Interest Rate Ranges	Number of Loans	Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	3	\$ 24,688	\$ 24,688
	7.00% 8.99%	2	4,359	4,294
	9.00% 10.99%	1	6,462	6,462
	11.00% 12.99%	1	10,466	9,588
	15.00% and above	2	3,970	6,397
<b>Total commercial mortgage loans<sup>(13)</sup></b>			<b>\$ 49,945</b>	<b>\$ 51,429</b>
<b>Real Estate Owned</b>			<b>\$ 20,855</b>	<b>\$ 24,010</b>
<b>Equity Interests<sup>(2)</sup> Companies more than 25% owned</b>			<b>\$ 14,429</b>	<b>\$ 31,193</b>
Guarantees (\$6,871)				
Standby Letter of Credit (\$650)				
<b>Total commercial real estate finance</b>			<b>\$ 85,229</b>	<b>\$ 106,632</b>
<b>Total portfolio</b>			<b>\$ 5,241,288</b>	<b>\$ 4,208,569</b>

	Yield	Cost	Value
<b>Investments in U.S. Treasury Bills, Money Market and Other Securities</b>			
Blackrock Liquidity Funds	2.9%	\$ 1,226	\$ 1,226
SEI Daily Income Tr Prime Obligation Money Market Fund	2.3%	5	5
Columbia Money Market Reserves Fund	2.6%	12,153	12,153
<b>Total</b>		<b>\$ 13,384</b>	<b>\$ 13,384</b>

(2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.

(13) Commercial mortgage loans totaling \$7.6 million at value were on non-accrual status and therefore were considered non-income producing.

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) Companies More Than 25% Owned	Investment <sup>(1)(2)</sup>	December 31, 2007		
		Principal	Cost	Value
Alaris Consulting, LLC (Business Services)	Senior Loan (16.5%, Due 12/05 12/07) <sup>(9)</sup> Equity Interests	\$ 27,055	\$ 26,987	\$
	<b>Total Investment</b>		<b>5,189</b>	
	Guaranty (\$1,100)			
AllBridg Financial, LLC (Asset Management)	Equity Interests		7,800	7,800
	<b>Total Investment</b>		<b>7,800</b>	<b>7,800</b>
	Standby Letter of Credit (\$30,000)			
Allied Capital Senior Debt Fund, L.P. <sup>(5)</sup> (Private Debt Fund)	Equity Interests (See Note 3)		31,800	32,811
	<b>Total Investment</b>		<b>31,800</b>	<b>32,811</b>
Avborne, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (12,500 shares) Common Stock (27,500 shares)		611	1,633
	<b>Total Investment</b>		<b>611</b>	<b>1,633</b>
Avborne Heavy Maintenance, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (1,568 shares) Common Stock (2,750 shares)		2,401	2,557 370
	<b>Total Investment</b>		<b>2,401</b>	<b>2,927</b>
	Guaranty (\$2,401)			
Aviation Properties Corporation (Business Services)	Common Stock (100 shares)		65	
	<b>Total Investment</b>		<b>65</b>	
	Standby Letters of Credit (\$1,000)			

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Border Foods, Inc.	Preferred Stock (100,000 shares)		12,721	4,648
(Consumer Products)	Common Stock (148,838 shares)		3,847	
	<b>Total Investment</b>		<b>16,568</b>	<b>4,648</b>
Calder Capital Partners, LLC <sup>(5)</sup>	Senior Loan (9.4%, Due 5/09) <sup>(6)</sup>	2,907	2,907	3,035
(Asset Management)	Equity Interests		2,396	3,559
	<b>Total Investment</b>		<b>5,303</b>	<b>6,594</b>
Callidus Capital Corporation	Subordinated Debt (18.0%, Due 10/08)	6,871	6,871	6,871
(Asset Management)	Common Stock (100 shares)		2,067	44,587
	<b>Total Investment</b>		<b>8,938</b>	<b>51,458</b>
Ciena Capital LLC	Class A Equity Interests(25.0% See Note 3) <sup>(6)</sup>	99,044	99,044	68,609
(Financial Services)	Class B Equity Interests		119,436	
	Class C Equity Interests		109,301	
	<b>Total Investment</b>		<b>327,781</b>	<b>68,609</b>
	Guaranty (\$258,707 See Note 3)			
	Standby Letters of Credit (\$18,000 See Note 3)			

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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

**Private Finance**

**Portfolio Company**

(in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	<b>December 31, 2007</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
CitiPostal Inc. (Business Services)	Senior Loan (8.4%, Due 12/13)	\$ 692	\$ 679	\$ 679
	Unitranche Debt (12.0%, Due 12/13)	50,852	50,597	50,597
	Subordinated Debt (16.0%, Due 12/15)	8,049	8,049	8,049
	Common Stock (37,024 shares)		12,726	12,726
	<b>Total Investment</b>		<b>72,051</b>	<b>72,051</b>
Coverall North America, Inc. (Business Services)	Unitranche Debt (12.0%, Due 7/11)	35,054	34,923	34,923
	Subordinated Debt (15.0%, Due 7/11)	6,000	5,979	5,979
	Common Stock (884,880 shares)		16,648	27,597
	<b>Total Investment</b>		<b>57,550</b>	<b>68,499</b>
CR Holding, Inc. (Consumer Products)	Subordinated Debt (16.6%, Due 2/13)	40,956	40,812	40,812
	Common Stock (37,200,551 shares)		33,321	40,934
	<b>Total Investment</b>		<b>74,133</b>	<b>81,746</b>
Direct Capital Corporation (Financial Services)	Subordinated Debt (16.0%, Due 3/13)	39,184	39,030	39,030
	Common Stock (2,097,234 shares)		19,250	6,906
	<b>Total Investment</b>		<b>58,280</b>	<b>45,936</b>
Financial Pacific Company (Financial Services)	Subordinated Debt (17.4%, Due 2/12 8/12)	73,031	72,850	72,850
	Preferred Stock (10,964 shares)		10,276	19,330

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	Common Stock (14,735 shares)		14,819	38,544
	<b>Total Investment</b>		<b>97,945</b>	<b>130,724</b>
ForeSite Towers, LLC (Tower Leasing)	Equity Interest			878
	<b>Total Investment</b>			<b>878</b>
Global Communications, LLC  (Business Services)	Senior Loan (10.0%, Due 9/02) <sup>(6)</sup>	1,822	1,822	1,822
	<b>Total Investment</b>		<b>1,822</b>	<b>1,822</b>
Hot Stuff Foods, LLC  (Consumer Products)	Senior Loan (8.4%, Due 2/11-2/12)	50,940	50,752	50,752
	Subordinated Debt (12.1%, Due 8/12)	30,000	29,907	29,907
	Subordinated Debt (15.4%, Due 2/13) <sup>(6)</sup>	52,373	52,150	1,337
	Common Stock (1,147,453 shares)		56,187	
	<b>Total Investment</b>		<b>188,996</b>	<b>81,996</b>
Huddle House, Inc.  (Retail)	Subordinated Debt (15.0%, Due 12/12)	59,857	59,618	59,618
	Common Stock (415,328 shares)		41,533	44,154
	<b>Total Investment</b>		<b>101,151</b>	<b>103,772</b>
Impact Innovations Group, LLC  (Business Services)	Equity Interests in Affiliate			320
	<b>Total Investment</b>			<b>320</b>

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

**Private Finance**

**Portfolio Company**

(in thousands, except number of shares)

	<b>Investment<sup>(1)(2)</sup></b>	<b>December 31, 2007</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Insight Pharmaceuticals Corporation	Subordinated Debt (15.0%, Due 9/12)	\$ 44,257	\$ 44,136	\$ 45,041
(Consumer Products)	Subordinated Debt (19.0%, Due 9/12) <sup>(6)</sup>	16,181	16,130	16,796
	Preferred Stock (25,000 shares)		25,000	1,462
	Common Stock (620,000 shares)		6,325	
	<b>Total Investment</b>		<b>91,591</b>	<b>63,299</b>
Jakel, Inc.	Subordinated Debt (15.5%, Due 3/08) <sup>(6)</sup>	1,563	1,563	1,563
(Industrial Products)	<b>Total Investment</b>		<b>1,563</b>	<b>1,563</b>
Legacy Partners Group, Inc.	Senior Loan (14.0%, Due 5/09) <sup>(6)</sup>	3,843	3,843	3,843
(Business Services)	Equity Interests		4,261	1,332
	<b>Total Investment</b>		<b>8,104</b>	<b>5,175</b>
Litterer Beteiligungs-GmbH <sup>(4)</sup>	Subordinated Debt (8.0%, Due 12/08)	772	772	772
(Business Services)	Equity Interest		1,809	700
	<b>Total Investment</b>		<b>2,581</b>	<b>1,472</b>
MVL Group, Inc.	Senior Loan (12.0%, Due 6/09 7/09)	30,674	30,639	30,639
(Business Services)	Subordinated Debt (14.5%, Due 6/09 7/09)	40,191	39,943	39,943
	Common Stock (648,661 shares)		643	4,949
	<b>Total Investment</b>		<b>71,225</b>	<b>75,531</b>
Old Orchard Brands, LLC	Subordinated Debt (18.0%, Due 7/14)	19,632	19,544	19,544
(Consumer Products)	Equity Interests		18,767	25,419

	<b>Total Investment</b>		<b>38,311</b>	<b>44,963</b>
Penn Detroit Diesel Allison, LLC	Subordinated Debt (15.5%, Due 8/13)	39,331	39,180	39,180
(Business Services)	Equity Interests		21,128	37,965
	<b>Total Investment</b>		<b>60,308</b>	<b>77,145</b>
Powell Plant Farms, Inc.	Senior Loan (15.0%, Due 12/07) <sup>(6)</sup>	1,350	1,350	1,534
(Consumer Products)	<b>Total Investment</b>		<b>1,350</b>	<b>1,534</b>
Service Champ, Inc.	Subordinated Debt (15.5%, Due 4/12)	28,443	28,351	28,351
(Business Services)	Common Stock (63,888 shares)		13,662	26,292
	<b>Total Investment</b>		<b>42,013</b>	<b>54,643</b>
Staffing Partners Holding Company, Inc.	Subordinated Debt (13.5%, Due 1/07) <sup>(6)</sup>	509	509	223
(Business Services)	<b>Total Investment</b>		<b>509</b>	<b>223</b>
Startec Equity, LLC	Equity Interests		190	430
(Telecommunications)	<b>Total Investment</b>		<b>190</b>	<b>430</b>
Sweet Traditions, Inc.	Senior Loan (13.0%, Due 9/08 8/11) <sup>(6)</sup>	39,692	36,052	35,229
(Retail)	Preferred Stock (961 shares)		950	
	Common Stock (10,000 shares)		50	
	<b>Total Investment</b>		<b>37,052</b>	<b>35,229</b>

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(4) Non-U.S. company or principal place of business outside the U.S.

- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

**Private Finance**

**Portfolio Company**

(in thousands, except number of shares)

		<b>December 31, 2007</b>		
	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Triview Investments, Inc. <sup>(8)</sup>	Senior Loan (10.0%, Due 12/07)	\$ 433	\$ 433	\$ 433
(Broadcasting & Cable/Business Services/Consumer Products)	Subordinated Debt (12.9%, Due 1/10 6/17)	43,157	42,977	42,977
	Subordinated Debt (12.5%, Due 11/07 3/08) <sup>(6)</sup>	1,400	1,400	1,583
	Common Stock (202 shares)		120,638	83,453
	<b>Total Investment</b>		<b>165,448</b>	<b>128,446</b>
	Guaranty (\$900)			
	Standby Letter of Credit (\$200)			
Unitranche Fund LLC (Private Debt Fund)	Subordinated Certificates		744	744
	Equity Interests		1	1
	<b>Total Investment</b>		<b>745</b>	<b>745</b>
Worldwide Express Operations, LLC (Business Services)	Subordinated Debt (14.0%, Due 2/14)	2,845	2,670	2,670
	Equity Interests		12,900	21,516
	Warrants		163	272
	<b>Total Investment</b>		<b>15,733</b>	<b>24,458</b>
	<b>Total companies more than 25% owned</b>		<b>\$ 1,622,094</b>	<b>\$ 1,279,080</b>
<b>Companies 5% to 25% Owned</b>				
10 <sup>th</sup> Street, LLC (Business Services)	Subordinated Debt (13.0%, Due 12/14)	\$ 20,774	\$ 20,645	\$ 20,645
	Equity Interests		446	1,100
	<b>Total Investment</b>		<b>21,091</b>	<b>21,745</b>

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Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt (12.0%, Due 3/14) Equity Interests	155,432	154,854	154,854 10,973
	<b>Total Investment</b>		<b>154,854</b>	<b>165,827</b>
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan (7.8%, Due 3/11) Equity Interests	3,030	2,980 3,470	2,980 10,800
	<b>Total Investment</b>		<b>6,450</b>	<b>13,780</b>
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock (622 shares) Common Stock (13,513 shares)		622 14	749 262
	<b>Total Investment</b>		<b>636</b>	<b>1,011</b>
Amerex Group, LLC (Consumer Products)	Subordinated Debt (12.0%, Due 1/13) Equity Interests	8,400	8,400 3,509	8,400 13,713
	<b>Total Investment</b>		<b>11,909</b>	<b>22,113</b>
BB&T Capital Partners/Windsor Mezzanine Fund, LLC <sup>(5)</sup> (Private Equity Fund)	Equity Interests		11,739	11,467
	<b>Total Investment</b>		<b>11,739</b>	<b>11,467</b>

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (8) Triview Investments, Inc. had a cost basis of \$165.4 million and holds investments in Longview Cable & Data, LLC (Broadcasting & Cable) with a value of \$7.0 million, Triax Holdings, LLC (Consumer Products) with a value of \$62.0 million, and Crescent Hotels & Resorts, LLC and affiliates (Business Services) with a value of \$59.4 million, for a total value of \$128.4 million.

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



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

<b>Private Finance</b>		<b>December 31, 2007</b>		
<b>Portfolio Company</b>		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
<b>(in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>			
Becker Underwood, Inc.	Subordinated Debt (14.5%, Due 8/12)	\$ 24,865	\$ 24,798	\$ 24,798
(Industrial Products)	Common Stock (5,073 shares)		5,813	4,190
	<b>Total Investment</b>		<b>30,611</b>	<b>28,988</b>
BI Incorporated	Subordinated Debt (13.5%, Due 2/14)	30,615	30,499	30,499
(Business Services)	Common Stock (40,000 shares)		4,000	7,382
	<b>Total Investment</b>		<b>34,499</b>	<b>37,881</b>
Creative Group, Inc.	Subordinated Debt (14.0%, Due 9/13) <sup>(6)</sup>	15,000	13,686	6,197
(Business Services)	Common Stock (20,000 shares)			
	Warrant		1,387	
	<b>Total Investment</b>		<b>15,073</b>	<b>6,197</b>
Drew Foam Companies, Inc.	Preferred Stock (722 shares)		722	396
(Business Services)	Common Stock (7,287 shares)		7	
	<b>Total Investment</b>		<b>729</b>	<b>396</b>
MedBridge Healthcare, LLC	Senior Loan (8.0%, Due 8/09) <sup>(6)</sup>	7,164	7,164	7,164
(Healthcare Services)	Subordinated Debt (10.0%, Due 8/14) <sup>(6)</sup>	5,184	5,184	2,406
	Convertible Subordinated Debt (2.0%, Due 8/14) <sup>(6)</sup>	2,970	984	
	Equity Interests		1,416	
	<b>Total Investment</b>		<b>14,748</b>	<b>9,570</b>
MHF Logistical Solutions, Inc.		33,600	33,448	9,280

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	Subordinated Debt (11.5%, Due 6/12) <sup>(6)</sup>			
(Business Services)	Subordinated Debt (18.0%, Due 6/13) <sup>(6)</sup>	11,211	11,154	
	Common Stock (20,934 shares) <sup>(12)</sup>		20,942	
	Warrants <sup>(12)</sup>			
	<b>Total Investment</b>		<b>65,544</b>	<b>9,280</b>
Multi-Ad Services, Inc.	Unitranche Debt (11.3%, Due 11/11)	19,800	19,704	19,704
(Business Services)	Equity Interests		2,000	940
	<b>Total Investment</b>		<b>21,704</b>	<b>20,644</b>
Progressive International Corporation	Subordinated Debt (16.0%, Due 12/09)	1,557	1,545	1,545
(Consumer Products)	Preferred Stock (500 shares)		500	1,038
	Common Stock (197 shares)		13	4,900
	Warrants			
	<b>Total Investment</b>		<b>2,058</b>	<b>7,483</b>
Regency Healthcare Group, LLC	Unitranche Debt (11.1%, Due 6/12)	12,000	11,941	11,941
(Healthcare Services)	Equity Interests		1,500	1,681
	<b>Total Investment</b>		<b>13,441</b>	<b>13,622</b>

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(2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.

(6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

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

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

<b>Private Finance Portfolio Company</b>		<b>December 31, 2007</b>		
<b>(in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
SGT India Private Limited <sup>(4)</sup>	Common Stock (150,596 shares)		\$ 4,098	\$ 3,075
(Business Services)	<b>Total Investment</b>		<b>4,098</b>	<b>3,075</b>
Soteria Imaging Services, LLC	Subordinated Debt (12.0%, Due 11/10)	\$ 14,500	13,744	13,744
(Healthcare Services)	Equity Interests		2,170	2,686
	<b>Total Investment</b>		<b>15,914</b>	<b>16,430</b>
Universal Environmental Services, LLC	Equity Interests		1,810	
(Business Services)	<b>Total Investment</b>		<b>1,810</b>	
<b>Total companies 5% to 25% owned</b>			<b>\$ 426,908</b>	<b>\$ 389,509</b>
<b>Companies Less Than 5% Owned</b>				
3SI Security Systems, Inc.	Subordinated Debt (14.5%, Due 8/13)	\$ 27,937	\$ 27,837	\$ 27,837
(Consumer Products)	<b>Total Investment</b>		<b>27,837</b>	<b>27,837</b>
AgData, L.P.	Senior Loan (10.3%, Due 7/12)	843	815	815
(Consumer Services)	<b>Total Investment</b>		<b>815</b>	<b>815</b>
Axium Healthcare Pharmacy, Inc.	Senior Loan (12.5%, Due 12/12)	2,600	2,567	2,567
(Healthcare Services)	Unitranche Debt (12.5%, Due 12/12)	8,500	8,463	8,463
	Common Stock (26,500 shares)		2,650	1,097

	<b>Total Investment</b>		<b>13,680</b>	<b>12,127</b>
Baird Capital Partners IV Limited Partnership <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,234	2,114
	<b>Total Investment</b>		<b>2,234</b>	<b>2,114</b>
BenefitMall, Inc. (Business Services)	Subordinated Debt (14.9%, Due 10/13-10/14) Common Stock (45,528,000 shares) <sup>(12)</sup> Warrants <sup>(12)</sup> Standby Letters of Credit (\$3,961)	82,167	81,930	81,930
	<b>Total Investment</b>		<b>127,458</b>	<b>164,334</b>
Broadcast Electronics, Inc. (Business Services)	Senior Loan (9.0%, Due 7/12) <sup>(6)</sup>	4,913	4,884	3,273
	<b>Total Investment</b>		<b>4,884</b>	<b>3,273</b>
Bushnell, Inc. (Consumer Products)	Subordinated Debt (11.3%, Due 2/14)	41,325	39,821	39,821
	<b>Total Investment</b>		<b>39,821</b>	<b>39,821</b>

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

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	December 31, 2007		
		Principal	Cost	Value
Callidus Debt Partners CDO Fund I, Ltd. <sup>(4)(10)</sup>	Class C Notes (12.9%, Due 12/13)	\$ 18,800	\$ 18,929	\$ 18,988
(CDO)	Class D Notes (17.0%, Due 12/13)	9,400	9,465	9,494
	<b>Total Investment</b>		<b>28,394</b>	<b>28,482</b>
Callidus Debt Partners CLO Fund III, Ltd. <sup>(4)(10)</sup>	Preferred Shares (23,600,000 shares, 12.9%) <sup>(11)</sup>		21,783	19,999
(CLO)	<b>Total Investment</b>		<b>21,783</b>	<b>19,999</b>
Callidus Debt Partners CLO Fund IV, Ltd. <sup>(4)(10)</sup>	Income Notes (14.8%) <sup>(11)</sup>		12,298	11,290
(CLO)	<b>Total Investment</b>		<b>12,298</b>	<b>11,290</b>
Callidus Debt Partners CLO Fund V, Ltd. <sup>(4)(10)</sup>	Income Notes (20.3%) <sup>(11)</sup>		13,977	14,658
(CLO)	<b>Total Investment</b>		<b>13,977</b>	<b>14,658</b>
Callidus Debt Partners CLO Fund VI, Ltd. <sup>(4)(10)</sup>	Class D Notes (11.3%, Due 10/21)	5,000	4,329	4,329
(CLO)	Income Notes (19.3%) <sup>(11)</sup>		26,985	26,985
	<b>Total Investment</b>		<b>31,314</b>	<b>31,314</b>
Callidus Debt Partners <sup>(4)(10)</sup> CLO Fund VII, Ltd.	Income Notes (16.6%) <sup>(11)</sup>		22,113	22,113
(CLO)	<b>Total Investment</b>		<b>22,113</b>	<b>22,113</b>



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Callidus MAPS CLO Fund I LLC <sup>(10)</sup>	Class E Notes (10.4%, Due 12/17)	17,000	17,000	16,119
(CLO)	Income Notes (5.6%) <sup>(11)</sup>		49,252	36,085
	<b>Total Investment</b>		<b>66,252</b>	<b>52,204</b>
Callidus MAPS CLO Fund II, Ltd. <sup>(4)(10)</sup>	Income Notes (14.7%) <sup>(11)</sup>		18,753	18,753
(CLO)	<b>Total Investment</b>		<b>18,753</b>	<b>18,753</b>
Camden Partners Strategic Fund II, L.P. <sup>(5)</sup>	Limited Partnership Interest		997	1,350
(Private Equity Fund)	<b>Total Investment</b>		<b>997</b>	<b>1,350</b>
Carlisle Wide Plank Floors, Inc.	Senior Loan (9.8%, Due 6/11)	500	497	497
(Consumer Products)	Unitranche Debt (10.0%, Due 6/11)	3,161	3,129	3,129
	Preferred Stock (400,000 Shares)		400	507
	<b>Total Investment</b>		<b>4,026</b>	<b>4,133</b>
Catterton Partners V, L.P. <sup>(5)</sup>	Limited Partnership Interest		3,624	2,952
(Private Equity Fund)	<b>Total Investment</b>		<b>3,624</b>	<b>2,952</b>

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- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (10) The fund is managed by Callidus Capital, a portfolio company of Allied Capital.
- (11) Represents the effective interest yield earned on the cost basis of these preferred equity investments and income notes. The yield is included in interest income from companies less than 5% owned in the consolidated statement of operations.

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

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

<b>Private Finance</b>		<b>December 31, 2007</b>		
<b>Portfolio Company</b>		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
<b>(in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>			
Catterton Partners VI, L.P. <sup>(5)</sup>	Limited Partnership Interest		\$ 2,259	\$ 2,103
(Private Equity Fund)	<b>Total Investment</b>		<b>2,259</b>	<b>2,103</b>
Centre Capital Investors IV, L.P. <sup>(5)</sup>	Limited Partnership Interest		2,215	2,276
(Private Equity Fund)	<b>Total Investment</b>		<b>2,215</b>	<b>2,276</b>
Centre Capital Investors V, L.P. <sup>(5)</sup>	Limited Partnership Interest		628	628
(Private Equity Fund)	<b>Total Investment</b>		<b>628</b>	<b>628</b>
CK Franchising, Inc. (Consumer Services)	Senior Loan (8.7%, Due 7/12)	\$ 9,000	8,911	8,911
	Subordinated Debt (12.3%, Due 7/12 7/17)	21,000	20,908	20,908
	Preferred Stock (1,486,004 shares)		1,486	1,586
	Common Stock (8,793,408 shares)		8,793	8,654
	<b>Total Investment</b>		<b>40,098</b>	<b>40,059</b>
Commercial Credit Group, Inc. (Financial Services)	Subordinated Debt (14.8%, Due 2/11)	12,000	12,023	12,023
	Preferred Stock (74,978 shares)		18,018	19,421
	Warrants			
	<b>Total Investment</b>		<b>30,041</b>	<b>31,444</b>
Community Education Centers, Inc. (Education Services)	Subordinated Debt (13.5%, Due 11/13)	35,011	34,936	34,936
	<b>Total Investment</b>		<b>34,936</b>	<b>34,936</b>

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Component Hardware Group, Inc.	Subordinated Debt (13.5%, Due 1/13)	18,432	18,363	18,363
(Industrial Products)	<b>Total Investment</b>		<b>18,363</b>	<b>18,363</b>
Cook Inlet Alternative Risk, LLC	Unitranche Debt (10.8%, Due 4/13)	95,000	94,530	94,530
(Business Services)	Equity Interests		640	1,696
	<b>Total Investment</b>		<b>95,170</b>	<b>96,226</b>
Cortec Group Fund IV, L.P. <sup>(5)</sup>	Limited Partnership Interest		3,383	2,922
(Private Equity)	<b>Total Investment</b>		<b>3,383</b>	<b>2,922</b>
Diversified Mercury Communications, LLC	Senior Loan (8.5%, Due 3/13)	233	217	217
(Business Services)	<b>Total Investment</b>		<b>217</b>	<b>217</b>
Digital VideoStream, LLC	Unitranche Debt (11.0%, Due 2/12)	17,213	17,128	17,128
(Business Services)	Convertible Subordinated Debt (10.0%, Due 2/16)	4,118	4,103	5,397
	<b>Total Investment</b>		<b>21,231</b>	<b>22,525</b>
DirectBuy Holdings, Inc.	Subordinated Debt (14.5%, Due 5/13)	75,000	74,631	74,631
(Consumer Products)	Equity Interests		8,000	8,000
	<b>Total Investment</b>		<b>82,631</b>	<b>82,631</b>

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(5) Non-registered investment company.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

	Investment <sup>(1)(2)</sup>	December 31, 2007		
		Principal	Cost	Value
Distant Lands Trading Co.	Senior Loan (10.3%, Due 11/11)	\$ 10,000	\$ 9,966	\$ 9,966
(Consumer Products)	Unitranche Debt (11.0%, Due 11/11)	42,375	42,226	42,226
	Common Stock (4,000 shares)		4,000	2,645
	<b>Total Investment</b>		<b>56,192</b>	<b>54,837</b>
Driven Brands, Inc.	Senior Loan (8.7%, Due 6/11)	37,070	36,951	36,951
d/b/a Meineke and Econo Lube	Subordinated Debt (12.1%, Due 6/12 6/13)	83,000	82,754	82,754
(Consumer Services)	Common Stock (11,675,331 shares) <sup>(12)</sup>		29,455	15,977
	Warrants <sup>(12)</sup>			
	<b>Total Investment</b>		<b>149,160</b>	<b>135,682</b>
Dryden XVIII Leveraged Loan 2007 Limited <sup>(4)</sup>	Subordinated Debt (9.7%, Due 10/19)	9,000	7,406	7,406
(CLO)	Income Notes (14.2%) <sup>(11)</sup>		21,940	21,940
	<b>Total Investment</b>		<b>29,346</b>	<b>29,346</b>
Dynamic India Fund IV <sup>(4)(5)</sup>	Equity Interests		6,050	6,215
(Private Equity Fund)	<b>Total Investment</b>		<b>6,050</b>	<b>6,215</b>
EarthColor, Inc.	Subordinated Debt (15.0%, Due 11/13)	127,000	126,463	126,463
(Business Services)	Common Stock (73,540 shares) <sup>(12)</sup>		73,540	62,675
	Warrants <sup>(12)</sup>			
	<b>Total Investment</b>		<b>200,003</b>	<b>189,138</b>

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eCentury Capital Partners, L.P. <sup>(5)</sup>	Limited Partnership Interest		6,899	2,176
(Private Equity Fund)	<b>Total Investment</b>		<b>6,899</b>	<b>2,176</b>
eInstruction Corporation	Subordinated Debt (13.5%, Due 7/14-1/15)	47,000	46,765	46,765
(Education Services)	Common Stock (2,406 shares)		2,500	2,500
	<b>Total Investment</b>		<b>49,265</b>	<b>49,265</b>
Farley s & Sathers Candy Company, Inc.	Subordinated Debt (13.7%, Due 3/11)	18,000	17,932	17,932
(Consumer Products)	<b>Total Investment</b>		<b>17,932</b>	<b>17,932</b>
FCP-BHI Holdings, LLC	Subordinated Debt (12.8%, Due 9/13)	24,000	23,887	23,887
d/b/a Bojangles	Equity Interests		1,000	998
(Retail)	<b>Total Investment</b>		<b>24,887</b>	<b>24,885</b>
Fidus Mezzanine Capital, L.P. <sup>(5)</sup>	Limited Partnership Interest		6,357	6,357
(Private Equity Fund)	<b>Total Investment</b>		<b>6,357</b>	<b>6,357</b>
Frozen Specialties, Inc.	Warrants		435	229
(Consumer Products)	<b>Total Investment</b>		<b>435</b>	<b>229</b>
Garden Ridge Corporation	Subordinated Debt (7.0%, Due 5/12) <sup>(6)</sup>	20,500	20,500	20,500
(Retail)	<b>Total Investment</b>		<b>20,500</b>	<b>20,500</b>

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

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

	Investment <sup>(1)(2)</sup>	December 31, 2007		
		Principal	Cost	Value
Geotrace Technologies, Inc.	Subordinated Debt (10.0%, Due 6/09)	\$ 6,772	\$ 6,616	\$ 6,616
(Energy Services)	Warrants		2,350	2,993
	<b>Total Investment</b>		<b>8,966</b>	<b>9,609</b>
Gilchrist & Soames, Inc.	Senior Loan (9.0%, Due 10/13)	20,000	19,954	19,954
(Consumer Products)	Subordinated Debt (13.4%, Due 10/13)	25,800	25,676	25,676
	<b>Total Investment</b>		<b>45,630</b>	<b>45,630</b>
Grotech Partners, VI, L.P. <sup>(5)</sup>	Limited Partnership Interest		8,808	8,252
(Private Equity Fund)	<b>Total Investment</b>		<b>8,808</b>	<b>8,252</b>
Havco Wood Products LLC	Senior Loan (9.7%, Due 8/11)	600	585	585
(Industrial Products)	Unitranche Debt (11.5%, Due 8/11)	5,100	4,248	4,248
	Equity Interests		1,055	3,192
	<b>Total Investment</b>		<b>5,888</b>	<b>8,025</b>
Haven Eldercare of New England, LLC	Subordinated Debt (12.0%, Due 8/09) <sup>(6)</sup>	1,927	1,927	
(Healthcare Services)	<b>Total Investment</b>		<b>1,927</b>	
Higginbotham Insurance Agency, Inc.	Senior Loan (7.7%, Due 8/12)	15,033	14,942	14,942
(Business Services)	Subordinated Debt (13.5%, Due 8/13 8/14)	46,356	46,136	46,136
	Common Stock (23,926 shares) <sup>(12)</sup>		23,926	23,868
	Warrant <sup>(12)</sup>			
	<b>Total Investment</b>		<b>85,004</b>	<b>84,946</b>

The Hillman Companies, Inc. <sup>(3)</sup>	Subordinated Debt (10.0%, Due 9/11)	44,580	44,458	44,458
(Consumer Products)	<b>Total Investment</b>		<b>44,458</b>	<b>44,458</b>
The Homax Group, Inc.	Senior Loan (8.7%, Due 10/12)	10,969	10,969	10,969
(Consumer Products)	Subordinated Debt (12.0%, Due 4/14)	14,000	13,244	13,244
	Preferred Stock (89 shares)		89	13
	Common Stock (28 shares)		6	
	Warrants		1,106	194
	<b>Total Investment</b>		<b>25,414</b>	<b>24,420</b>
Ideal Snacks Corporation	Senior Loan (9.0%, Due 6/10)	288	288	288
(Consumer Products)	<b>Total Investment</b>		<b>288</b>	<b>288</b>
Integrity Interactive Corporation	Unitranche Debt (10.5%, Due 2/12)	12,193	12,095	12,095
(Business Services)	<b>Total Investment</b>		<b>12,095</b>	<b>12,095</b>
International Fiber Corporation	Subordinated Debt (14.0%, Due 6/12)	24,572	24,476	24,476
(Industrial Products)	Preferred Stock (25,000 shares)		2,500	2,194
	<b>Total Investment</b>		<b>26,976</b>	<b>26,670</b>

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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





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

<b>Private Finance</b>		<b>December 31, 2007</b>		
<b>Portfolio Company</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
<b>(in thousands, except number of shares)</b>				
Jones Stephens Corporation	Senior Loan (8.8%, Due 9/12)	\$ 5,537	\$ 5,525	\$ 5,525
(Consumer Products)	<b>Total Investment</b>		<b>5,525</b>	<b>5,525</b>
Knightsbridge CLO 2007-1 Ltd. <sup>(4)</sup>	Subordinated Debt (14.1%, Due 1/22)	22,000	22,000	22,000
(CLO)	Income Notes (15.2%) <sup>(11)</sup>		31,211	31,211
	<b>Total Investment</b>		<b>53,211</b>	<b>53,211</b>
Kodiak Fund LP <sup>(5)</sup>	Equity Interests		9,423	2,853
(Private Equity Fund)	<b>Total Investment</b>		<b>9,423</b>	<b>2,853</b>
Line-X, Inc.	Senior Loan (12.0%, Due 8/11)	900	885	885
(Consumer Products)	Unitranche Debt (12.0% Due 8/11)	48,198	48,039	42,784
	<b>Total Investment</b>		<b>48,924</b>	<b>43,669</b>
	Standby Letter of Credit (\$1,500)			
MedAssets, Inc. <sup>(3)</sup>	Common Stock (224,817 shares)		2,049	6,652
(Business Services)	<b>Total Investment</b>		<b>2,049</b>	<b>6,652</b>
Mid-Atlantic Venture Fund IV, L.P. <sup>(5)</sup>	Limited Partnership Interest		6,975	1,791
(Private Equity Fund)	<b>Total Investment</b>		<b>6,975</b>	<b>1,791</b>
Milestone AV Technologies, Inc.	Subordinated Debt (11.3%, Due 6/13)	37,500	37,500	36,750

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(Business Services)	<b>Total Investment</b>		<b>37,500</b>	<b>36,750</b>
NetShape Technologies, Inc.	Senior Loan (8.6%, Due 2/13)	5,802	5,773	5,773
(Industrial Products)	<b>Total Investment</b>		<b>5,773</b>	<b>5,773</b>
Network Hardware Resale, Inc.	Unitranche Debt (10.5%, Due 12/11)	20,512	20,614	20,614
(Business Services)	Convertible Subordinated Debt (9.8%, Due 12/15)	13,242	13,302	15,586
	<b>Total Investment</b>		<b>33,916</b>	<b>36,200</b>
Norwesco, Inc.	Subordinated Debt (12.7%, Due 1/12 7/12)	82,924	82,674	82,674
(Industrial Products)	Common Stock (559,603 shares) <sup>(12)</sup>		38,313	117,831
	Warrants <sup>(12)</sup>			
	<b>Total Investment</b>		<b>120,987</b>	<b>200,505</b>
Novak Biddle Venture Partners III, L.P. <sup>(5)</sup>	Limited Partnership Interest		1,910	1,256
(Private Equity Fund)	<b>Total Investment</b>		<b>1,910</b>	<b>1,256</b>
Oahu Waste Services, Inc.	Stock Appreciation Rights		239	998
(Business Services)	<b>Total Investment</b>		<b>239</b>	<b>998</b>

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- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (11) Represents the effective interest yield earned on the cost basis of these preferred equity investments and income notes. The yield is included in interest income from companies less than 5% owned in the consolidated statement of operations.
- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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



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

**Private Finance****Portfolio Company**

(in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	<b>December 31, 2007</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Odyssey Investment Partners Fund III, LP <sup>(5)</sup>	Limited Partnership Interest		\$ 2,276	\$ 2,567
(Private Equity Fund)	<b>Total Investment</b>		<b>2,276</b>	<b>2,567</b>
Pangaea CLO 2007-1 Ltd. <sup>(4)</sup>	Subordinated Debt (10.2%, Due 10/21)	\$ 15,000	11,570	11,570
(CLO)	<b>Total Investment</b>		<b>11,570</b>	<b>11,570</b>
Passport Health Communications, Inc. (Healthcare Services)	Preferred Stock (651,381 shares) Common Stock (19,680 shares)		2,000 48	2,433 7
	<b>Total Investment</b>		<b>2,048</b>	<b>2,440</b>
PC Helps Support, LLC (Business Services)	Senior Loan (8.9%, Due 12/13) Subordinated Debt (13.3%, Due 12/13)	20,000 30,895	20,000 30,743	20,000 30,743
	<b>Total Investment</b>		<b>50,743</b>	<b>50,743</b>
Pendum, Inc. (Business Services)	Subordinated Debt (17.0%, Due 1/11) <sup>(6)</sup> Preferred Stock (82,715 shares) Warrants	34,028	34,028	
	<b>Total Investment</b>		<b>34,028</b>	
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	
	<b>Total Investment</b>		<b>734</b>	
PharMEDium Healthcare Corporation (Healthcare Services)	Senior Loan (8.6%, Due 10/13)	19,577	19,577	19,577
	<b>Total Investment</b>		<b>19,577</b>	<b>19,577</b>

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Postle Aluminum Company, LLC (Industrial Products)	Unitranche Debt (11.0%, Due 10/12) Equity Interests	61,500	61,252 2,500	61,252 3,092
	<b>Total Investment</b>		<b>63,752</b>	<b>64,344</b>
Pro Mach, Inc. (Industrial Products)	Subordinated Debt (13.0%, Due 6/12) Equity Interests	14,562	14,506 1,500	14,506 1,596
	<b>Total Investment</b>		<b>16,006</b>	<b>16,102</b>
Promo Works, LLC (Business Services)	Unitranche Debt (10.3%, Due 12/11) Guaranty (\$600)	26,215	26,006	26,006
	<b>Total Investment</b>		<b>26,006</b>	<b>26,006</b>
Reed Group, Ltd. (Healthcare Services)	Senior Loan (8.7%, Due 12/13) Subordinated Debt (13.8%, Due 12/13) Equity Interests	21,000 18,000	20,970 17,910 1,800	20,970 17,910 1,800
	<b>Total Investment</b>		<b>40,680</b>	<b>40,680</b>
S.B. Restaurant Company (Retail)	Unitranche Debt (9.8%, Due 4/11) Preferred Stock (54,125 shares) Warrants Standby Letters of Credit (\$2,540)	34,001	33,733 135 619	33,733 135 2,095
	<b>Total Investment</b>		<b>34,487</b>	<b>35,963</b>

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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>		<b>December 31, 2007</b>		
	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
			\$	\$
SBBUT, LLC	Equity Interests			
(Consumer Products)	<b>Total Investment</b>			
Service Center Metals, LLC	Subordinated Debt (15.5%, Due 9/11)	\$ 5,000	4,981	4,981
(Industrial Products)	Equity Interests		313	343
	<b>Total Investment</b>		<b>5,294</b>	<b>5,324</b>
Snow Phipps Group, L.P. <sup>(5)</sup>	Limited Partnership Interest		2,288	2,288
(Private Equity Fund)	<b>Total Investment</b>		<b>2,288</b>	<b>2,288</b>
SPP Mezzanine Funding, L.P. <sup>(5)</sup>	Limited Partnership Interest		2,268	1,942
(Private Equity Fund)	<b>Total Investment</b>		<b>2,268</b>	<b>1,942</b>
SPP Mezzanine Funding II, L.P. <sup>(5)</sup>	Limited Partnership Interest		4,077	3,731
(Private Equity Fund)	<b>Total Investment</b>		<b>4,077</b>	<b>3,731</b>
Stag-Parkway, Inc.	Unitranche Debt (10.8%, Due 7/12)	51,000	50,810	50,810
(Business Services)	<b>Total Investment</b>		<b>50,810</b>	<b>50,810</b>
STS Operating, Inc.	Subordinated Debt (11.0%, Due 1/13)	30,386	30,273	30,273
(Industrial Products)	<b>Total Investment</b>		<b>30,273</b>	<b>30,273</b>
Summit Energy Services, Inc.	Senior Loan (8.5%, Due 8/13)	24,239	24,239	23,512
(Business Services)		35,765	35,596	35,596



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	Subordinated Debt (11.6%, Due 8/13)			
	Common Stock (89,406 shares)		2,000	1,995
	<b>Total Investment</b>		<b>61,835</b>	<b>61,103</b>
Tappan Wire & Cable Inc. (Business Services)	Unitranche Debt (15.0%, Due 8/14)	24,100	23,975	23,975
	Common Stock (15,000 shares) <sup>(12)</sup>		2,250	5,810
	Warrant <sup>(12)</sup>			
	<b>Total Investment</b>		<b>26,225</b>	<b>29,785</b>
The Step2 Company, LLC (Consumer Products)	Unitranche Debt (11.0%, Due 4/12)	96,041	95,693	95,693
	Equity Interests		2,483	2,987
	<b>Total Investment</b>		<b>98,176</b>	<b>98,680</b>
Tradesmen International, Inc. (Business Services)	Subordinated Debt (12.0%, Due 12/12)	49,124	48,431	48,431
	<b>Total Investment</b>		<b>48,431</b>	<b>48,431</b>
TransAmerican Auto Parts, LLC (Consumer Products)	Subordinated Debt (14.0%, Due 11/12)	24,076	23,907	23,907
	Equity Interests		1,198	1,014
	<b>Total Investment</b>		<b>25,105</b>	<b>24,921</b>
Trover Solutions, Inc. (Business Services)	Subordinated Debt (12.0%, Due 11/12)	60,000	59,740	59,740
	<b>Total Investment</b>		<b>59,740</b>	<b>59,740</b>
Universal Air Filter Company (Industrial Products)	Subordinated Debt (12.0%, Due 11/12)	14,750	14,688	14,688
	<b>Total Investment</b>		<b>14,688</b>	<b>14,688</b>

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maturity dates.

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

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

**Private Finance**

**Portfolio Company**

(in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	December 31, 2007	
			Cost	Value
Udata Venture Partners II, L.P. <sup>(5)</sup>	Limited Partnership Interest		\$ 4,465	\$ 4,306
(Private Equity Fund)	<b>Total Investment</b>		<b>4,465</b>	<b>4,306</b>
Venturehouse-Cibernet Investors, LLC	Equity Interest			54
(Business Services)	<b>Total Investment</b>			<b>54</b>
Venturehouse Group, LLC <sup>(5)</sup>	Equity Interest			613
(Private Equity Fund)	<b>Total Investment</b>			<b>613</b>
VICORP Restaurants, Inc.	Warrants		33	
(Retail)	<b>Total Investment</b>		<b>33</b>	
Walker Investment Fund II, LLLP <sup>(5)</sup>	Limited Partnership Interest		1,330	
(Private Equity Fund)	<b>Total Investment</b>		<b>1,330</b>	
WMA Equity Corporation and Affiliates	Subordinated Debt (13.6%, Due 4/13)	\$ 125,000	124,010	124,010
d/b/a Wear Me Apparel	Subordinated Debt (9.0%, Due 4/14) <sup>(6)</sup>	13,033	13,033	13,302
(Consumer Products)	Common Stock (100 shares)		46,046	13,726
	<b>Total Investment</b>		<b>183,089</b>	<b>151,038</b>
Webster Capital II, L.P. <sup>(5)</sup>	Limited Partnership Interest		897	897
(Private Equity Fund)	<b>Total Investment</b>		<b>897</b>	<b>897</b>

Woodstream Corporation (Consumer Products)	Subordinated Debt (12.0%, Due 2/15) Common Stock (7,500 shares)	90,000	89,574 7,500	89,574 7,482
	<b>Total Investment</b>		<b>97,074</b>	<b>97,056</b>
York Insurance Services Group, Inc. (Business Services)	Subordinated Debt (14.5%, Due 1/14) Common Stock (15,000 shares)	45,141	44,966 1,500	44,966 1,995
	<b>Total Investment</b>		<b>46,466</b>	<b>46,961</b>
Other companies	Other debt investments Other equity investments	159	57 8	62
	<b>Total Investment</b>		<b>65</b>	<b>62</b>
<b>Total companies less than 5% owned</b>			<b>\$ 2,994,880</b>	<b>\$ 2,990,732</b>
<b>Total private finance (156 portfolio investments)</b>			<b>\$ 5,043,882</b>	<b>\$ 4,659,321</b>

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

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

	Stated Interest Rate Ranges	Number of Loans	December 31, 2007	
			Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	3	\$ 20,361	\$ 19,842
	7.00% 8.99%	8	22,768	22,768
	9.00% 10.99%	3	8,372	8,372
	11.00% 12.99%	1	10,456	10,456
	15.00% and above	2	3,970	3,970
<b>Total commercial mortgage loans<sup>(13)</sup></b>		<b>17</b>	<b>\$ 65,927</b>	<b>\$ 65,408</b>
<b>Real Estate Owned</b>			<b>\$ 15,272</b>	<b>\$ 21,253</b>
<b>Equity Interests<sup>(2)</sup> Companies more than 25% owned</b>			<b>\$ 15,743</b>	<b>\$ 34,539</b>
Guarantees (\$6,871)				
Standby Letter of Credit (\$1,295)				
<b>Total commercial real estate finance</b>			<b>\$ 96,942</b>	<b>\$ 121,200</b>
<b>Total portfolio</b>			<b>\$ 5,140,824</b>	<b>\$ 4,780,521</b>

	Yield	Cost	Value
<b>Investments in U.S. Treasury Bills, Money Market and Other Securities</b>			
American Beacon Money Market Select FD Fund	4.5%	\$ 126,910	\$ 126,910
American Beacon Money Market Fund	4.8%	40,163	40,163
SEI Daily Income Tr Prime Obligation Money Market Fund	4.9%	34,143	34,143
Columbia Money Market Reserves Fund	4.6%	6	6
<b>Total</b>		<b>\$ 201,222</b>	<b>\$ 201,222</b>

(2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.

(13) Commercial mortgage loans totaling \$14.3 million at value were on non-accrual status and therefore were considered non-income producing.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Information at and for the three and nine months ended September 30, 2008 and 2007, is unaudited)**

**Note 1. Organization**

Allied Capital Corporation, a Maryland corporation, is a closed-end, non-diversified management investment company that has elected to be regulated as a business development company ( BDC ) under the Investment Company Act of 1940 ( 1940 Act ). Allied Capital Corporation ( ACC ) has a real estate investment trust subsidiary, Allied Capital REIT, Inc. ( Allied REIT ), and several subsidiaries that are single member limited liability companies established for specific purposes including holding real estate properties. ACC also has a subsidiary, A.C. Corporation ( AC Corp ), that generally provides diligence and structuring services, as well as transaction, management, consulting, and other services, including underwriting and arranging loans, to the Company, its portfolio companies and its managed funds.

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

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

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

**Note 2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The consolidated financial statements include the accounts of ACC and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2007 balances to conform with the 2008 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of September 30, 2008, the results of operations for the three and nine months ended September 30, 2008 and 2007, and changes in net assets and cash flows for the nine months ended September 30, 2008 and 2007. The results of operations for the three and nine months ended September 30, 2008, are not necessarily indicative of the operating results to be expected for the full year.

The private finance portfolio and the interest and related portfolio income and net realized gains (losses) on the private finance portfolio are presented in three categories: 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, where the Company controls the portfolio company's board of directors, or where the Company acts as manager to a fund, 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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

outstanding voting securities of such portfolio company or where the Company holds one or more seats on the portfolio company's board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where the Company directly or indirectly owns less than 5% of the outstanding voting securities of such portfolio company and where the Company has no other affiliations with such portfolio company. The interest and related portfolio income and net realized gains (losses) from the commercial real estate finance portfolio and other sources, including investments in U.S. treasury bills, money market and other securities, are included in the companies less than 5% owned category on the consolidated statement of operations.

In the ordinary course of business, the Company enters into transactions with portfolio companies that may be considered related party transactions.

***Valuation Of Portfolio Investments***

The Company, as a BDC, has invested in illiquid securities including debt and equity securities of portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. The Company's investments may be subject to certain restrictions on resale and generally have no established trading market. The Company values substantially all of its investments at fair value as determined in good faith by the Board of Directors in accordance with the Company's valuation policy and the provisions of the Investment Company Act of 1940 and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement). The Company determines fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. The Company's valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests and that fair value for its investments must typically be determined using unobservable inputs. The Company's valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio.

The Company adopted SFAS 157 on a prospective basis in the first quarter of 2008. SFAS 157 requires the Company to assume that the portfolio investment is to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. In accordance with the Statement, the Company has considered its principal market, or the market in which the Company exits its portfolio investments with the greatest volume and level of activity.

The Company has determined that for its buyout investments, where the Company has control or could gain control through an option or warrant security, both the debt and equity securities of the portfolio investment would exit in the merger and acquisition (M&A) market as the principal market generally through a sale or recapitalization of the portfolio company. The Company believes that the in-use premise of value (as defined in SFAS 157), which assumes the debt and equity securities are sold together, is appropriate as this would provide maximum proceeds to the seller. As a result, the Company will continue to use the enterprise value methodology to determine the fair value of these investments under SFAS 157. Enterprise value means the entire value of the company to a market participant, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. Enterprise value is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to

purchase a portfolio company, recent transactions involving the purchase or sale

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

of the portfolio company's equity securities, liquidation events, or other events. The Company allocates the enterprise value to these securities in order of the legal priority of the securities.

While the Company typically exits its securities upon the sale or recapitalization of the portfolio company in the M&A market, for investments in portfolio companies where the Company does not have control or the ability to gain control through an option or warrant security, the Company cannot typically control the exit of its investment into its principal market (the M&A market). As a result, in accordance with SFAS 157, the Company is required to determine the fair value of these investments assuming a sale of the individual investment (the in-exchange premise of value) in a hypothetical market to a hypothetical market participant. The Company continues to perform an enterprise value analysis for the investments in this category to assess the credit risk of the loan or debt security and to determine the fair value of its equity investment in these portfolio companies. The determined equity values are generally discounted when the Company has a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors, which the Company believes would lead a market participant to discount such securities. For loan and debt securities, the Company performs a yield analysis assuming a hypothetical current sale of the investment. The yield analysis requires the Company to estimate the expected repayment date of the instrument and a market participant's required yield. The Company's estimate of the expected repayment date of a loan or debt security is generally shorter than the legal maturity of the instruments as the Company's loans have historically been repaid prior to the maturity date. The yield analysis considers changes in interest rates and changes in leverage levels of the loan or debt security as compared to the Company's estimates of market interest rates and leverage levels at the balance sheet date. Assuming the credit quality of the loan or debt security remains stable, the Company will use the value determined by the yield analysis as the fair value for that security. A change in the assumptions that the Company uses to estimate the fair value of its loans and debt securities using the yield analysis could have a material impact on the determination of fair value. If there is deterioration in credit quality or a loan or debt security is in workout status, the Company may consider other factors in determining the fair value of a loan or debt security, including the value attributable to the loan or debt security from the enterprise value of the portfolio company or the proceeds that would be received in a liquidation analysis.

The Company's equity investments in private debt and equity funds are generally valued at such fund's net asset value, unless other factors lead to a determination of fair value at a different amount. The value of the Company's equity securities in public companies for which quoted prices in an active market are readily available is based on the closing public market price on the measurement date.

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

The Company will record unrealized depreciation on investments when it determines that the fair value of a security is less than its cost basis, and will record unrealized appreciation when it determines



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

that the fair value is greater than its cost basis. Because of the inherent uncertainty of valuation, the values determined at the measurement date 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. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the values determined at the measurement date.

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

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

***Interest and Dividend Income***

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. In general, interest is not accrued on loans and debt securities if the Company has doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status generally do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by the Company depending on such company's capital requirements.

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. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

The Company recognizes interest income on the CLO preferred shares/income notes using the effective interest method, based on the anticipated yield that is determined using the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred shares/income notes from the date the estimated yield was changed. CLO and CDO bonds have stated interest rates. The weighted average yield on the CLO/CDO Assets is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective yield on the preferred shares/income notes, divided by (b) CLO/CDO Assets at value. The weighted average yields are computed as of the balance sheet date.

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

***Fee Income***

Fee income includes fees for loan prepayment premiums, guarantees, commitments, and services rendered by the Company to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Loan prepayment premiums are recognized at the time of prepayment. Guaranty and commitment fees are generally recognized as income over the related period of the guaranty or commitment, respectively. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management, consulting and other services fees, including fund management fees, are generally recognized as income as the services are rendered. Fees are not accrued if the Company has doubt about collection of those fees.

***Guarantees***

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

***Financing Costs***

Debt financing costs are based on actual costs incurred in obtaining debt financing and are deferred and amortized as part of interest expense over the term of the related debt instrument using a method that approximates the effective interest method. Costs associated with the issuance of common stock are recorded as a reduction to the proceeds from the sale of common stock. Financing costs generally include underwriting, accounting and legal fees, and printing costs.

***Dividends to Shareholders***

Dividends to shareholders are recorded on the ex-dividend date.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 2. Summary of Significant Accounting Policies, continued

*Stock Compensation Plans*

The Company has a stock-based employee compensation plan. See Note 9. Effective January 1, 2006, the Company adopted the provisions of FASB Statement No. 123 (Revised 2004), *Share-Based Payment* (SFAS 123R). SFAS 123R was adopted using the modified prospective method of application, which required the Company to recognize compensation costs on a prospective basis beginning January 1, 2006. Accordingly, the Company did not restate prior year financial statements. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations using the fair value amounts determined for pro forma disclosure under SFAS 123R. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized over the related service period in the statement of operations. The stock option expense for the three and nine months ended September 30, 2008 and 2007, was as follows:

(\$ in millions, except per share amounts)	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Employee Stock Option Expense:				
Options granted:				
Previously awarded, unvested options as of January 1, 2006	\$	\$1.7	\$3.9	\$8.2
Options granted on or after January 1, 2006	1.5	2.2	5.6	8.9
Total options granted	1.5	3.9	9.5	17.1
Options cancelled in connection with tender offer (see Note 9)		14.4		14.4
Total employee stock option expense	\$1.5	\$18.3	\$9.5	\$31.5
Per basic share	\$0.01	\$0.12	\$0.06	\$0.21
Per diluted share	\$0.01	\$0.12	\$0.06	\$0.20

In addition to employee stock option expense for options granted for the nine months ended September 30, 2008 and 2007, administrative expense included \$0.1 million and \$0.2 million, respectively, of expense related to options granted to non-officer directors. Options were granted to non-officer directors in both the second quarters of 2008 and 2007. No options were granted to non-officer directors in the first or third quarters of 2008 or 2007. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

The stock option expense for options granted was based on the underlying value of the options granted by the Company. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following weighted average assumptions were used to calculate the fair value of options granted during the three and nine months ended September 30, 2008 and 2007:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Expected term (in years)	5.0	5.0	5.0	5.0
Risk-free interest rate	3.4%	4.6%	2.8%	4.6%
Expected volatility	32.8%	24.4%	27.8%	26.4%
Dividend yield	8.5%	8.9%	8.5%	8.9%
Weighted average fair value per option	\$1.81	\$2.51	\$2.18	\$2.96

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

To determine the stock options expense for the options granted, the calculated fair value of the options granted is applied to the options granted, net of assumed future option forfeitures. The Company estimates that the employee-related stock option expense will be \$11.8 million, \$4.8 million, and \$3.1 million for the years ended December 31, 2008, 2009, and 2010, respectively. This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to stock option grants after September 30, 2008, as the fair value of those stock options will be determined at the time of grant. The aggregate total stock option expense remaining as of September 30, 2008, is expected to be recognized over an estimated weighted-average period of 1.6 years.

**Options Cancelled in Connection with Tender Offer.** As discussed in Note 9, the Company completed a tender offer in July 2007, whereby the Company accepted for cancellation 10.3 million vested options held by employees and non-officer directors of the Company in exchange for an option cancellation payment ( OCP ). The OCP was equal to the in-the-money value of the stock options cancelled, determined using the Weighted Average Market Price of \$31.75, and was paid one-half in cash and one-half in unregistered shares of the Company's common stock. In accordance with the terms of the tender offer, the Weighted Average Market Price represented the volume weighted average price of the Company's common stock over the fifteen trading days preceding the first day of the offer period, or June 20, 2007. Because the Weighted Average Market Price at the commencement of the tender offer on June 20, 2007, was higher than the market price of the Company's common stock at the close of the offer on July 18, 2007,

SFAS 123R required the Company to record a non-cash employee-related stock option expense of \$14.4 million and administrative expense related to stock options cancelled that were held by non-officer directors of \$0.4 million. The same amounts were recorded as an increase to

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

additional paid-in capital and, therefore, had no effect on the Company's net asset value. The portion of the OCP paid in cash of \$52.8 million reduced the Company's additional paid-in capital and therefore reduced the Company's net asset value. For income tax purposes, the Company's tax deduction resulting from the OCP will be similar to the tax deduction that would have resulted from an exercise of stock options in the market. Any tax deduction for the Company resulting from the OCP or an exercise of stock options in the market is limited by Section 162(m) of the Code for persons subject to Section 162(m).

***Federal and State Income Taxes and Excise Tax***

The Company intends to comply with the requirements of the Code that are applicable to regulated investment companies ( RIC ) and real estate investment trusts ( REIT ). ACC and any subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of their current year taxable income to shareholders; therefore, the Company has made no provision for income taxes exclusive of excise taxes for these entities.

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

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

***Per Share Information***

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

***Use of Estimates in the Preparation of Financial Statements***

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

The consolidated financial statements include portfolio investments at value of \$4.2 billion and \$4.8 billion at September 30, 2008, and December 31, 2007, respectively. At September 30, 2008, and December 31, 2007, 91% and 92%, respectively, of the Company's total assets represented portfolio investments whose fair values have been determined by the Board of Directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the Board of Directors' determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

***Recent Accounting Pronouncements***

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company has adopted this statement on a prospective basis beginning in the quarter ended March 31, 2008. Adoption of this statement did not have a material effect on the Company's consolidated financial statements. However, the impact on its consolidated financial statements for future periods cannot be determined at this time as it will be influenced by the estimates of fair value for those periods, the number and amount of investments the Company originates, acquires or exits, and the effect of any additional guidance or any changes in the interpretation of this statement.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115*. This statement permits an entity to choose to measure many financial instruments and certain other items at fair value. This statement applies to all reporting entities, and contains financial statement presentation and disclosure requirements for assets and liabilities reported at fair value as a consequence of the election. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company did not elect fair value measurement for assets or liabilities other than portfolio investments, which were already required to be measured at fair value, therefore, the adoption of this statement did not impact the Company's consolidated financial position or its results of operations.

In October 2008, the FASB issued FASB Staff Position No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. This FSP applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurements in accordance with Statement 157. This FSP clarifies the application of Statement 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value. The Company has applied the provisions of this FSP in determining the fair value of its portfolio investments at September 30, 2008. The application of the FSP did not have a material impact on the Company's consolidated financial position or its results of operations.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio**

***Private Finance***

At September 30, 2008, and December 31, 2007, the private finance portfolio consisted of the following:

(\$ in millions)	Cost	2008 Value	Yield <sup>(1)</sup>	Cost	2007 Value	Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 622.4	\$ 434.9	4.2%	\$ 374.1	\$ 344.3	7.7%
Unitranche debt <sup>(2)</sup>	639.0	579.3	12.0%	659.2	653.9	11.5%
Subordinated debt <sup>(3)</sup>	2,420.2	2,062.6	13.1%	2,576.4	2,416.4	12.8%
Total loans and debt securities <sup>(4)</sup>	3,681.6	3,076.8	11.7%	3,609.7	3,414.6	12.1%
Equity securities:						
Preferred shares/income notes of CLOs <sup>(5)</sup>	247.2	218.3	17.1%	218.3	203.0	14.6%
Subordinated certificates in Unitranche Fund LLC <sup>(5)</sup>	114.3	114.3	10.3%	0.7	0.7	12.4%
Other equity securities	1,113.0	692.5		1,215.2	1,041.0	
Total equity securities	1,474.5	1,025.1		1,434.2	1,244.7	
Total	\$ 5,156.1	\$ 4,101.9		\$ 5,043.9	\$ 4,659.3	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At September 30, 2008, and December 31, 2007, the cost and value of subordinated debt included the Class A equity interests in Ciena Capital LLC, which were placed on non-accrual status during the fourth quarter of 2006. At September 30, 2008, senior loans included the senior secured loan to Ciena totaling \$319.0 million at cost and \$180.2 million at value, which was placed on non-accrual on the purchase date.

The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) total preferred shares/income notes of CLOs at value. The weighted average yields are computed as of the balance sheet date. The effective interest yield on the CLO assets represents the yield used for recording interest income. The market yield used in the valuation of the CLO assets may be different than the interest yields.

The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest (LIBOR plus 7.5%) divided by (b) total investment at value.

(2) Unitranche debt is an investment that combines both senior and subordinated financing, generally in a first lien position.

- (3) Subordinated debt includes bonds in CLOs and in a CDO.
- (4) The total principal balance outstanding on loans and debt securities was \$3,718.7 million and \$3,639.6 million at September 30, 2008, and December 31, 2007, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$37.1 million and \$29.9 million at September 30, 2008, and December 31, 2007, respectively.
- (5) Investments in the preferred shares/income notes of CLOs and the subordinated certificates in Unitranche Fund LLC earn a current return that is included in interest income in the accompanying consolidated statement of operations.

The Company's private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. The Company's private finance debt and equity investments are generally issued by private companies and are generally illiquid and may be subject to certain restrictions on resale.

The Company's private finance debt investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

pre-determined strike price, which is generally a nominal price for warrants or options in a private company. The annual stated interest rate is only one factor in pricing the investment relative to the Company's rights and priority in the portfolio company's capital structure, and will vary depending on many factors, including if the Company has received nominal cost equity or other components of investment return, such as loan origination fees or market discount. The stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity.

At September 30, 2008, 83% of the private finance loans and debt securities had a fixed rate of interest and 17% had a floating rate of interest. At December 31, 2007, 86% of the private finance loans and debt securities had a fixed rate of interest and 14% had a floating rate of interest. Senior loans may carry a fixed rate of interest or a floating rate of interest, usually set as a spread over LIBOR, and may require payments of both principal and interest throughout the life of the loan. Senior loans generally have contractual maturities of three to six years and interest is generally paid to the Company monthly or quarterly. Unitranche debt generally carries a fixed rate of interest and generally requires payments of both principal and interest throughout the life of the loan. Unitranche debt generally has contractual maturities of five to six years and interest is generally paid to the Company quarterly. Subordinated debt generally carries a fixed rate of interest generally with contractual maturities of five to ten years and generally has interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest on subordinated debt is generally paid to the Company quarterly.

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

**Ciena Capital LLC.** Ciena Capital LLC (Ciena) has provided loans to commercial real estate owners and operators. Ciena has been a participant in the Small Business Administration's 7(a) Guaranteed Loan Program and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). Ciena remains subject to SBA rules and regulations. Ciena is headquartered in New York, NY.

At both September 30, 2008, and December 31, 2007, the Company held all of the Class A equity interests, all of the Class B equity interests, and 94.9% of the Class C equity interests. At September 30, 2008, the Company also held \$319 million of the \$324 million of senior secured loans to Ciena.

At September 30, 2008, the Company's investment in Ciena totaled \$646.7 million at cost and \$180.2 million at value, after the effect of unrealized depreciation of \$466.5 million. Other assets





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

includes amounts receivable from or related to Ciena totaling \$15.4 million, which have a value of \$2.2 million at September 30, 2008. At December 31, 2007, the Company's investment in Ciena totaled \$327.8 million at cost and \$68.6 million at value, after the effect of unrealized depreciation of \$259.2 million.

Net change in unrealized appreciation or depreciation included depreciation related to the Company's investment in Ciena of \$151.9 million and \$220.5 million for the three and nine months ended September 30, 2008, respectively. Net change in unrealized appreciation or depreciation included depreciation related to the Company's investment in Ciena of \$84.1 million and \$103.2 million for the three and nine months ended September 30, 2007, respectively.

Ciena has continued to experience significant deterioration in the value of its assets as a result of a continued increase in the uncertainty in the financial markets, decreasing bid prices and a further reduction in the number of loan buyers. Ciena, therefore, believes that the value of its assets is insufficient to cover all of its liabilities and it is insolvent. On September 30, 2008, Ciena voluntarily filed for bankruptcy protection under Chapter 11 of Title 11 of the United States Code (the Bankruptcy Code) in the United States Bankruptcy Court for the Southern District of New York (the Court).

Ciena intends to continue to operate its servicing business and manage its assets as a debtor-in-possession under the jurisdiction of the Court and in accordance with the applicable provisions of the Bankruptcy Code and the orders of the Court. Ciena believes that by filing for bankruptcy protection it will be able to proceed with an orderly sale of its assets over time in more favorable market conditions in the future and thereby maximize the value of its assets and reduce costs in order to repay its debts.

As a result of Ciena's decision to file for bankruptcy protection, the Company's unconditional guaranty of the obligations outstanding under Ciena's revolving credit facility became due, and the Company, in lieu of paying under its guaranty, purchased the positions of the senior lenders under Ciena's revolving credit facility except for a \$5 million position held by Citibank, N.A. The Company paid \$325.4 million to fund the purchase, which included \$319.0 million of principal, \$1.4 million of interest, and \$5.0 million of other payments related to the revolving credit facility and the bankruptcy. On October 6, 2008, \$6.4 million of the purchase was funded. As of September 30, 2008, the senior secured loan had a cost basis of \$319.0 million and a value of \$180.2 million. The Company continues to guarantee the remaining principal balance of \$5 million, plus related interest, fees and expenses payable to Citibank. In connection with the Company's continuing guaranty of the amounts held by Citibank, the Company has agreed with Citibank that the amounts owing to Citibank under the Ciena revolving credit facility will be paid before any of the secured obligations of Ciena now owed to the Company.

Total interest and related portfolio income earned from the Company's investment in Ciena for the three and nine months ended September 30, 2008 and 2007, was as follows:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007

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Interest income on Class A equity interests	\$	\$	\$	\$
Fees and other income		1.3		4.1
Total interest and related portfolio income	\$	\$1.3	\$	\$4.1

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

In the fourth quarter of 2006, the Company placed its investment in Ciena's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from the Company's investment in Ciena for the three and nine months ended September 30, 2008 and 2007. In consideration for providing a guaranty on Ciena's revolving credit facility and standby letters of credit, the Company earned fees of \$1.3 million and \$4.1 million for the three and nine months ended September 30, 2007, respectively, which were included in fees and other income. These fees were \$5.4 million for the year ended December 31, 2007. Ciena has not yet paid the \$5.4 million in such fees earned by the Company during 2007, and at September 30, 2008, and December 31, 2007, such fees were included as a receivable in other assets with a carrying amount, net of depreciation, of zero and \$5.4 million, respectively. The Company considered this outstanding receivable in its valuation of Ciena at September 30, 2008, and December 31, 2007. The Company did not accrue the fees earned from Ciena for providing the guaranty and standby letters of credit for the three and nine months ended September 30, 2008. Subsequent to September 30, 2008, the Company will not earn any fees from Ciena for continuing to provide the guaranty or letters of credit.

At September 30, 2008, the Company had standby letters of credit issued under its line of credit of \$102.6 million in connection with term securitization transactions completed by Ciena. The Company considered these standby letters of credit in its valuation of Ciena at September 30, 2008.

Ciena maintains two non-recourse securitization warehouse facilities, both of which have matured. In order to pay down debt under the conventional loan warehouse facility, Ciena is in the process of selling loans on behalf of the conventional loan warehouse facility providers. Ciena is also working with the providers of the SBA loan warehouse facility with regard to the repayment of that facility. The Company has issued performance guaranties whereby the Company agreed to indemnify the warehouse providers for any damages, losses, liabilities and related costs and expenses that they may incur as a result of Ciena's failure to perform any of its obligations as loan originator, loan seller or loan servicer under the warehouse securitizations.

The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA-guaranteed loans issued by Ciena. Specifically, on or about January 9, 2007, Ciena became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleged that a former Ciena employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. The Company understands that Ciena is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. On October 1, 2007, the former Ciena employee pled guilty to one count of conspiracy to fraudulently originate SBA-guaranteed loans and one count of making a false statement before a grand jury.

On March 6, 2007, Ciena entered into an agreement with the SBA. According to the agreement, Ciena would remain a preferred lender in the SBA 7(a) Guaranteed Loan Program and would retain the ability to sell loans into the secondary market. As part of this agreement, Ciena immediately paid approximately \$10 million to the SBA to cover amounts paid by the SBA with respect to some of the SBA-guaranteed loans that have been the subject of the charges by the U.S. Attorney's Office for the Eastern District of Michigan against Mr. Harrington. Ciena also entered into an escrow agreement with the SBA pursuant to which Ciena deposited \$10 million with the escrow agent for any additional payments Ciena may be obligated to pay to the SBA in the future under the agreement. The agreement provided that, during its



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

term, an independent third party selected by the SBA would review loans originated by Ciena before they could be sold into the secondary market and would review defaulted loans repurchased from the secondary market by Ciena before the SBA would reimburse Ciena. Ciena and the SBA have disagreed regarding the operation of the agreement, particularly the SBA's repurchase obligations for defaulted loans subject to third party review. Further, Ciena's position is that the agreement terminated on September 6, 2008.

Ciena is also subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of Ciena's lending practices under the Business and Industry Loan (B&I) program. The OIG and the U.S. Department of Justice are also conducting a civil investigation of Ciena's lending practices in various jurisdictions. The Company is unable to predict the outcome of these inquiries, and it is possible that third parties could try to seek to impose liability against the Company in connection with certain defaulted loans in Ciena's portfolio. These investigations, audits and reviews are ongoing.

On or about January 16, 2007, Ciena (f/k/a Business Loan Express, LLC) and its subsidiary Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC). The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans. On December 18, 2007, the United States District Court for the Northern District of Georgia dismissed all claims in this matter. The plaintiffs appealed the dismissal. Ciena's bankruptcy filing automatically stayed the appeal; however, pursuant to Ciena's request, the Court lifted the automatic stay to permit the appeal to proceed. Ciena and BLC's request to have oral argument on the appeal placed back on the appellate calendar is currently pending before the U.S. Court of Appeals for the 11th Circuit.

These investigations, audits, reviews, and litigation have had and may continue to have a material adverse impact on Ciena and, as a result, could continue to negatively affect the Company's financial results. The Company has considered Ciena's voluntary filing for bankruptcy protection, current regulatory issues, ongoing investigations, and litigation in performing the valuation of Ciena at September 30, 2008.

**Mercury Air Centers, Inc.** In April 2004, the Company completed the purchase of a majority ownership in Mercury Air Centers, Inc. (Mercury). At June 30, 2007, the Company's investment in Mercury totaled \$85.3 million at cost and \$320.1 million at value, which included unrealized appreciation of \$234.8 million. In August 2007, the Company completed the sale of its majority equity interest in Mercury. For the year ended December 31, 2007, the Company realized a gain of \$262.4 million, subject to post-closing adjustments. For the nine months ended September 30, 2008, the Company realized an additional gain of \$3.3 million resulting from these post-closing adjustments. In addition, the Company was repaid approximately \$51 million of subordinated debt outstanding to Mercury at closing.

Mercury owned and operated fixed base operations generally under long-term leases from local airport authorities, which consisted of terminal and hangar complexes that serviced the needs of the general aviation community. Mercury was headquartered in Richmond Heights, OH.

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

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

(\$ in millions)	<b>For the Three Months Ended September 30, 2007</b>	<b>For the Nine Months Ended September 30, 2007</b>
Interest income	\$ 1.0	\$ 5.1
Fees and other income		0.2
Total interest and related portfolio income	\$ 1.0	\$ 5.3

Net change in unrealized appreciation or depreciation for the three months ended September 30, 2007, included the reversal of \$234.8 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of the Company's majority equity interest in Mercury. Net change in unrealized appreciation or depreciation for the nine months ended September 30, 2007, included an increase in unrealized appreciation totaling \$74.9 million for the first half of 2007 and the reversal of \$234.8 million associated with the sale of the Company's majority equity interest in the third quarter of 2007.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

*Collateralized Loan Obligations ( CLOs ) and Collateralized Debt Obligations ( CDOs )*. At September 30, 2008, and December 31, 2007, the Company owned bonds and preferred shares/income notes in CLOs and bonds in a CDO as follows:

(\$ in millions)	Cost	2008 Value	Yield <sup>(1)</sup>	Cost	2007 Value	Yield <sup>(1)</sup>
<i>Bonds<sup>(2)</sup>:</i>						
Callidus Debt Partners CDO Fund I, Ltd.	\$ 28.4	\$ 25.8	15.5%	\$ 28.4	\$ 28.5	14.0%
Callidus Debt Partners CLO Fund IV, Ltd.	2.0	2.2	20.0%			
Callidus Debt Partners CLO Fund VI, Ltd.	7.1	5.8	16.7%	4.3	4.3	13.4%
Callidus MAPS CLO Fund I LLC	17.0	13.9	10.6%	17.0	16.1	11.0%
Callidus MAPS CLO Fund II LLC	3.5	3.5	23.8%			
Dryden XVIII Leveraged Loan 2007 Limited	7.6	7.4	17.4%	7.4	7.4	12.7%
Knightsbridge CLO 2007-1 Ltd. <sup>(3)</sup>	18.7	16.4	13.4%	22.0	22.0	14.1%
Knightsbridge CLO 2008-1 Ltd. <sup>(3)</sup>	31.3	31.3	11.1%			
Pangaea CLO 2007-1 Ltd.	11.6	9.5	16.2%	11.6	11.6	13.9%
Total bonds	127.2	115.8	14.0%	90.7	89.9	13.3%
<i>Preferred Shares/Income Notes:</i>						
Callidus Debt Partners CLO Fund III, Ltd.	20.1	18.1	15.7%	21.8	20.0	14.1%
Callidus Debt Partners CLO Fund IV, Ltd.	14.5	13.7	21.7%	12.3	11.3	16.1%
Callidus Debt Partners CLO Fund V, Ltd.	13.2	12.7	23.0%	14.0	14.7	19.3%
Callidus Debt Partners CLO Fund VI, Ltd.	27.9	28.1	23.0%	27.0	27.0	19.3%
Callidus Debt Partners CLO Fund VII, Ltd.	23.8	19.7	18.5%	22.1	22.1	16.6%
Callidus MAPS CLO Fund I LLC	45.8	33.8	6.0%	49.3	36.1	7.6%
Callidus MAPS CLO Fund II, Ltd.	18.2	15.2	20.8%	18.7	18.7	14.7%
Dryden XVIII Leveraged Loan 2007 Limited	22.5	20.8	18.5%	21.9	21.9	14.2%
Knightsbridge CLO 2007-1 Ltd. <sup>(3)</sup>	40.7	35.7	17.0%	31.2	31.2	15.2%
Knightsbridge CLO 2008-1 Ltd. <sup>(3)</sup>	20.5	20.5	16.6%			
Total preferred shares/income notes	247.2	218.3	17.1%	218.3	203.0	14.6%
Total	\$ 374.4	\$ 334.1		\$ 309.0	\$ 292.9	

<sup>(1)</sup> The weighted average yield is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective interest yield on the preferred shares/income notes, divided by (b) CLO and CDO assets at value. The yield on these debt and equity securities is included in interest income in the accompanying consolidated statement of operations.

The market yield used in the valuation of the CLO and CDO assets may be different than the interest yields shown above.

<sup>(2)</sup> These securities are included in private finance subordinated debt.



(3) These funds are managed by the Company through a wholly-owned subsidiary.

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

The bonds, preferred shares and income notes of the CLOs and CDO in which the Company has invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes will bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes. At both September 30, 2008, and December 31, 2007, the face value of the CLO and CDO assets held by the Company was subordinate to as much as 94% of the face value of the securities outstanding in these CLOs and CDO.

At September 30, 2008, and December 31, 2007, the underlying collateral assets of these CLO and CDO issuances, consisting primarily of senior corporate loans, were issued by 658 issuers and 671 issuers, respectively, and had balances as follows:

(\$ in millions)	2008	2007
Bonds	\$ 273.2	\$ 288.5
Syndicated loans	4,435.3	4,122.7
Cash <sup>(1)</sup>	107.8	104.4
Total underlying collateral assets <sup>(2)</sup>	\$ 4,816.3	\$ 4,515.6

<sup>(1)</sup> Includes undrawn liability amounts.

<sup>(2)</sup> At September 30, 2008, and December 31, 2007, the total face value of defaulted obligations was \$28.5 million and \$18.4 million, respectively, or approximately 0.6% and 0.4% respectively, of the total underlying collateral assets.

**Loans and Debt Securities on Non-Accrual Status.** At September 30, 2008, and December 31, 2007, private finance loans and debt securities at value not accruing interest were as follows:

(\$ in millions)	2008	2007
Loans and debt securities in workout status		
Companies more than 25% owned	\$ 197.0	\$ 114.1
Companies 5% to 25% owned	0.8	11.7
Companies less than 5% owned	136.6	23.8
Loans and debt securities not in workout status		
Companies more than 25% owned	34.5	21.4
Companies 5% to 25% owned	6.6	13.4
Companies less than 5% owned		13.3
Total	\$ 375.5	\$ 197.7

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

**Industry and Geographic Compositions.** The industry and geographic compositions of the private finance portfolio at value at September 30, 2008, and December 31, 2007, were as follows:

	<b>2008</b>	<b>2007</b>
<b>Industry</b>		
Business services	34%	37%
Consumer products	24	25
Financial services	8	6
CLO/CDO <sup>(1)</sup>	8	6
Industrial products	5	10
Consumer services	5	4
Retail	5	4
Private debt funds	4	1
Healthcare services	2	3
Other	5	4
<b>Total</b>	<b>100%</b>	<b>100%</b>
<b>Geographic Region<sup>(2)</sup></b>		
Mid-Atlantic	41%	36%
Midwest	26	32
Southeast	17	17
West	14	14
Northeast	2	1
<b>Total</b>	<b>100%</b>	<b>100%</b>

(1) These funds primarily invest in senior corporate loans. Certain of these funds are managed by Callidus Capital, a portfolio company of Allied Capital, and certain of these funds are managed by the Company through a wholly-owned subsidiary.

(2) The geographic region for the private finance portfolio depicts the location of the headquarters for the Company's portfolio companies. The portfolio companies may have a number of other locations in other geographic regions.

**Commercial Real Estate Finance**

At September 30, 2008, and December 31, 2007, the commercial real estate finance portfolio consisted of the following:

	<b>2008</b>		<b>2007</b>		
(\$ in millions)	Cost	Value	Yield <sup>(1)</sup>	Cost	Value
			Yield <sup>(1)</sup>		

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Commercial mortgage loans	\$ 49.9	\$ 51.4	7.4%	\$ 65.9	\$ 65.4	6.8%
Real estate owned	20.9	24.0		15.3	21.3	
Equity interests	14.4	31.2		15.7	34.5	
Total	\$ 85.2	\$ 106.6		\$ 96.9	\$ 121.2	

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

**Commercial Mortgage Loans and Equity Interests.** The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At September 30, 2008, and December 31, 2007, approximately 71% and 85%, respectively, of the Company's commercial mortgage loan portfolio was composed of fixed rate loans and approximately 29% and 15%, respectively, was composed of adjustable interest rate loans. At September 30, 2008, and December 31, 2007, loans with a value of \$7.6 million and \$14.3 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

Equity interests consist primarily of equity securities issued by privately owned companies that invest in single real estate properties. These equity interests may be subject to certain restrictions on their resale and are generally illiquid. Equity interests generally do not produce a current return, but are generally held in anticipation of investment appreciation and ultimate realized gain on sale.

The property types and the geographic composition securing the commercial real estate finance portfolio at value at September 30, 2008, and December 31, 2007, were as follows:

	<b>2008</b>	<b>2007</b>
<b>Property Type</b>		
Hospitality	51%	44%
Office	20	21
Recreation	18	15
Retail	9	18
Other	2	2
Total	100%	100%
<b>Geographic Region</b>		
Southeast	43%	40%
West	26	20
Midwest	22	31
Northeast	8	7
Mid-Atlantic	1	2
Total	100%	100%

**Fair Value Measurements**

The Company, as a BDC, has invested in illiquid securities including debt and equity securities of portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. The Company's investments may be subject to certain restrictions on resale and generally have no established trading market. The Company values substantially all of its investments at fair value as determined in good faith by the Board of Directors

in accordance with the Company's valuation policy and the provisions of the Investment Company Act of 1940 and SFAS 157. The Company determines fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. The Company's valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests and that fair value for its investments must typically be determined using unobservable inputs.

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

SFAS 157 establishes a fair value hierarchy that encourages the use of observable inputs, but allows for unobservable inputs when observable inputs do not exist. Inputs are classified into one of three categories:

Level 1 Quoted prices (unadjusted) in active markets for identical assets

Level 2 Inputs other than quoted prices that are observable to the market participant for the asset or quoted prices in a market that is not active

Level 3 Unobservable inputs

When there are multiple inputs for determining the fair value of an investment, the Company classifies the investment in total based on the lowest level input that is significant to the fair value measurement.

Assets measured at fair value on a recurring basis by level within the fair value hierarchy at September 30, 2008, were as follows:

(\$ in millions)	Fair Value Measurement as of September 30, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at Fair Value:				
Portfolio				
Private finance	\$ 4,101.9	\$	\$	\$ 4,101.9
Commercial real estate finance	106.6			106.6
Total portfolio	\$ 4,208.5	\$	\$	\$ 4,208.5

The table below sets forth a summary of changes in the Company's assets measured at fair value using level 3 inputs.

(\$ in millions)	Private Finance	Commercial Real Estate Finance	Total
Balance at December 31, 2007	\$ 4,652.7	\$ 121.2	\$ 4,773.9
Total gains or losses			
Net realized gains (losses) <sup>(1)</sup>	80.2	(2.2)	78.0

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Net change in unrealized appreciation or depreciation <sup>(2)</sup>	(665.0)	(2.9)	(667.9)
Purchases, issuances, repayments and exits, net <sup>(3)</sup>	34.0	(9.5)	24.5
Transfers in and/or out of level 3			
Balance at September 30, 2008	\$ 4,101.9	\$ 106.6	\$ 4,208.5
Net unrealized appreciation (depreciation) during the period relating to assets still held at the reporting date <sup>(2)</sup>	\$ (611.1)	\$ (5.8)	\$ (616.9)

(1) Includes net realized gains (losses) (recorded as realized gains or losses in the accompanying consolidated statement of operations) and amortization of discounts and closing points (recorded as interest income in the accompanying consolidated statement of operations).

(2) Included in change in net unrealized appreciation or depreciation in the accompanying consolidated statement of operations.

Net change in unrealized appreciation or depreciation includes net unrealized appreciation (depreciation) resulting from changes in portfolio investment values during the reporting period and the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized.

(3) Includes interest and dividend income reinvested through the receipt of a debt or equity security (payment-in-kind income) (recorded as interest and dividend income in the accompanying consolidated statement of operations).



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

The Company manages funds that invest in the debt and equity of primarily private middle market companies in a variety of industries (together, the *Managed Funds*). As of September 30, 2008, the funds that the Company manages had total committed capital of \$4.9 billion and total assets of \$2.0 billion. During 2007, the Company established the Unitranche Fund LLC and the Allied Capital Senior Debt Fund, L.P. In the first quarter of 2008, the Company formed the AGILE Fund I, LLC and assumed the management of Knightsbridge CLO 2007-1 Ltd. In the second quarter of 2008, the Company formed Knightsbridge CLO 2008-1 Ltd. The Company's responsibilities to the *Managed Funds* may include origination, underwriting, and portfolio monitoring and development services consistent with the activities that the Company performs for its portfolio. Each of the *Managed Funds* may separately invest in the debt or equity of a company depending on each fund's investment strategy and other factors. The Company's portfolio may include debt or equity investments issued by the same portfolio company as investments held by one or more *Managed Funds*, and these investments may be senior, pari passu or junior to the debt and equity investments held by the *Managed Funds*.

The Company accounts for the sale of securities to funds with which it has continuing involvement as sales pursuant to SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a replacement of FASB Statement 125, when the securities have been legally isolated from the Company, the Company has no ability to restrict or constrain the ability of the funds to pledge or exchange the transferred securities, and the Company does not have either the entitlement and the obligation to repurchase the securities or the ability to unilaterally cause the fund to put the securities back to the Company.

***Unitranche Fund LLC.*** In December 2007, the Company formed the Unitranche Fund LLC ( *Unitranche Fund* ), which the Company co-manages with an affiliate of General Electric Capital Corporation ( *GE* ). The *Unitranche Fund* is a private fund that generally focuses on making first lien unitranche loans to middle market companies with Earnings before Interest, Taxes, Depreciation, and Amortization of at least \$15 million. GE has committed \$3.075 billion to the *Unitranche Fund* consisting of \$3.0 billion of senior notes and \$0.075 billion of subordinated certificates and the Company has committed \$525.0 million of subordinated certificates. The *Unitranche Fund* is capitalized as transactions are completed. Transactions must be approved by the investment committee of the *Unitranche Fund*, which includes a representative from the Company and GE. The Company earns a management and sourcing fee totaling 0.375% per annum of managed assets. In addition to the management and sourcing fee, the Company earns structuring fees on investments made by the *Unitranche Fund*. At September 30, 2008, the *Unitranche Fund* had total assets of approximately \$702 million, and the Company's investment in the *Unitranche Fund* totaled \$114.3 million at cost and at value.

***Allied Capital Senior Debt Fund, L.P.*** The Company is a special limited partner in the Allied Capital Senior Debt Fund, L.P. ( *ACSDF* ), a private fund that generally invests in senior, unitranche and second lien debt. The Company has committed and funded \$31.8 million to *ACSDF*, which is a portfolio company. The Company's investment in *ACSDF* totaled \$31.8 million at cost and \$32.0 million at value at September 30, 2008, and \$31.8 million at cost and \$32.8 million at value at December 31, 2007. *ACSDF* has closed on \$125 million in equity capital commitments and had total assets of approximately \$424 million at September 30, 2008. As a special limited partner, the Company will earn an incentive allocation to the extent of 20% of *ACSDF*'s annual net income earned in excess of a specified

minimum return, subject to certain performance benchmarks. The value of the Company's investment in ACSDF is based on the net asset value of ACSDF, which reflects the capital invested plus its allocation of the net earnings of ACSDF, including the incentive allocation.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

AC Corp is the investment manager to ACSDF. Callidus Capital Corporation, a portfolio investment controlled by the Company, acts as special manager to ACSDF. A subsidiary of AC Corp is the general partner of ACSDF, and AC Corp serves as collateral manager to a warehouse financing vehicle associated with ACSDF. AC Corp earns a management fee of up to 2% per annum of the net asset value of ACSDF and pays Callidus 25% of that management fee to compensate Callidus for its role as special manager.

The Company may offer to sell loans to ACSDF or the warehouse financing vehicle. ACSDF or the warehouse financing vehicle may purchase loans from the Company. In connection with ACSDF's formation in June 2007 and during the second half of 2007, the Company sold \$224.2 million of seasoned assets with a weighted average yield of 10.0% to a warehouse financing vehicle associated with ACSDF. During the nine months ended September 30, 2008, the Company sold \$72.3 million of seasoned assets with a weighted average yield of 9.2% to the warehouse financing vehicle. ACSDF also purchases loans from other third parties. Due to the lack of liquidity in the securitization markets, ACSDF is not currently purchasing loans and at September 30, 2008, the ACSDF warehouse financing vehicle had completed its reinvestment period and any investment repayments are used to repay outstanding balances under the warehouse facility.

**Knightsbridge CLO 2007-1 Ltd.** On March 31, 2008, the Company, through a wholly-owned subsidiary, assumed the management of Knightsbridge CLO 2007-1 Ltd. ( Knightsbridge 2007 ), which invests primarily in middle market senior loans.

At September 30, 2008, Knightsbridge 2007 had total assets of approximately \$500 million and the Company's investment in this CLO totaled \$59.4 million at cost and \$52.1 million at value. The Company earns a management fee of up to 0.6% per annum of the assets of Knightsbridge 2007, up to 7.5% of which is paid to an unaffiliated third party in its capacity as special equity holder. In addition, Callidus assists the Company in the management of Knightsbridge 2007 and the Company pays Callidus a portion of the management fee earned for this assistance.

The Company may offer to sell loans to Knightsbridge 2007 and Knightsbridge 2007 may purchase loans from the Company or from other third parties. During the three and nine months ended September 30, 2008, the Company sold loans totaling \$17.3 million and \$84.8 million, respectively, with a weighted average yield of 9.0% and 8.5%, respectively, to Knightsbridge 2007.

**Knightsbridge CLO 2008-1 Ltd.** In June 2008, the Company formed Knightsbridge 2008-1 Ltd. ( Knightsbridge 2008 ). Upon its formation, Knightsbridge 2008 completed its initial purchase of assets from a third party. The Company manages Knightsbridge 2008 through a wholly-owned subsidiary. Knightsbridge 2008 invests primarily in middle market senior loans.

At September 30, 2008, Knightsbridge 2008 had total assets of approximately \$241 million and the Company's investment in this CLO totaled \$51.8 million at cost and at value. The Company earns a management fee of up to 0.6% per annum of the assets of Knightsbridge 2008, up to 10% of which is paid to an unaffiliated third party in its capacity as special equity holder. In addition, Callidus assists the Company in the management of Knightsbridge 2008 and the Company pays Callidus a portion of the management fee earned for this assistance.

The Company may offer to sell loans to Knightsbridge 2008 and Knightsbridge 2008 may purchase loans from the Company or from other third parties. During both the three and nine months ended September 30, 2008, the Company sold loans totaling \$29.1 million with a weighted average yield of 9.9% to Knightsbridge 2008.

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

**AGILE Fund I, LLC.** In January 2008, the Company entered into an investment agreement with the Goldman Sachs Private Equity Group, part of Goldman Sachs Asset Management ( Goldman Sachs ).

As part of the investment agreement, the Company agreed to sell a pro-rata strip of private equity and debt investments to AGILE Fund I, LLC ( AGILE ), a private fund in which a fund managed by Goldman Sachs owns substantially all of the interests, for a total transaction value of \$167 million. The sales of the assets closed in the first quarter of 2008. The sale to AGILE included 13.7% of the Company's equity investments in 23 of its buyout portfolio companies and 36 of its minority equity portfolio companies for a total purchase price of \$104 million, which resulted in a net realized gain of \$8.3 million (subsequent to post-closing adjustments) and dividend income of \$5.4 million. In addition, the Company sold approximately \$63 million in debt investments, which represented 7.3% of its unitranche, second lien and subordinated debt investments in the buyout investments included in the equity sale. AGILE generally has the right to co-invest in its proportional share of any future follow-on investment opportunities presented by the companies in its portfolio.

The Company is the managing member of AGILE, and is entitled to an incentive allocation subject to certain performance benchmarks. The Company owns the remaining interests in AGILE not held by Goldman Sachs. At September 30, 2008, AGILE had total assets of approximately \$150 million and the Company's investment in AGILE totaled \$0.8 million at cost and at value.

In addition, pursuant to the investment agreement Goldman Sachs has committed to invest at least \$125 million in future investment vehicles managed by the Company and will have future opportunities to invest in the Company's affiliates, or vehicles managed by them, and to coinvest alongside the Company in the future, subject to various terms and conditions.

As part of this transaction, the Company also sold ten venture capital and private equity limited partnership investments for approximately \$28 million to a fund managed by Goldman Sachs, which assumed the \$5.3 million of unfunded commitments related to these limited partnership investments. The sales of these limited partnership investments closed in the first half of 2008 and resulted in a net realized loss of \$7.0 million (subsequent to post-closing adjustments) for the nine months ended September 30, 2008.

**Note 4. Debt**

At September 30, 2008, and December 31, 2007, the Company had the following debt:

	2008			2007		
	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>
<b>(\$ in millions)</b>						
Notes payable:						
Privately issued unsecured notes payable	\$ 1,081.0	\$ 1,081.0	6.6%	\$1,042.2	\$1,042.2	6.1%

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Publicly issued unsecured notes payable	880.0	880.0	6.7%	880.0	880.0	6.7%
Total notes payable	1,961.0	1,961.0	6.6%	1,922.2	1,922.2	6.4%
Revolving line of credit	632.5	170.0	5.0% <sup>(2)</sup>	922.5	367.3	5.9% <sup>(2)</sup>
Total debt	\$ 2,593.5	\$ 2,131.0	6.8% <sup>(3)</sup>	\$2,844.7	\$2,289.5	6.5% <sup>(3)</sup>

- (1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus the annual amortization of commitment fees, other facility fees and amortization of debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.
- (2) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit in effect at the balance sheet date. In addition to the current interest payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$7.3 million and \$3.7 million at September 30, 2008, and December 31, 2007, respectively.
- (3) The annual interest cost for total debt includes the annual cost of commitment fees, other facility fees and amortization of debt financing costs on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date. The annual interest cost reflects the facilities in place on the balance sheet date.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 4. Debt, continued**

*Notes Payable*

**Privately Issued Unsecured Notes Payable.** The Company has privately issued unsecured long-term notes to institutional investors. The notes have five- or seven-year maturities and have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity. At September 30, 2008, the notes had maturities from March 2009 to June 2015. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreements.

The Company also has issued five-year unsecured long-term notes denominated in Euros and Sterling for a total U.S. dollar equivalent of \$15.2 million. The notes have fixed interest rates and have substantially the same terms as the Company's other unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. These notes mature in March 2009. Simultaneous with issuing the notes, the Company entered into a cross currency swap with a financial institution which fixed the Company's interest and principal payments in U.S. dollars for the life of the debt.

On May 14, 2008, the Company repaid \$153.0 million of unsecured long-term debt that matured. This debt had a fixed interest rate of 5.45%. On June 20, 2008, the Company issued \$140.5 million of five-year, unsecured notes and \$52.5 million of seven-year, unsecured notes with fixed interest rates of 7.82% and 8.14%, respectively. The debt matures in June 2013 and June 2015, respectively.

**Publicly Issued Unsecured Notes Payable.** At September 30, 2008, the Company had outstanding publicly issued unsecured notes as follows:

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

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

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

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 4. Debt, continued**

*Scheduled Maturities.* Scheduled future maturities of notes payable at September 30, 2008, were as follows:

<b>Year</b>	<b>Amount Maturing (\$ in millions)</b>
2008	\$
2009	268.5
2010	408.0
2011	472.5
2012	339.0
Thereafter	473.0
 Total	 \$ 1,961.0

***Revolving Line of Credit***

At December 31, 2007, the Company had an unsecured revolving line of credit with a committed amount of \$922.5 million that was scheduled to expire on September 30, 2008. On April 9, 2008, the Company entered into a three-year unsecured revolving line of credit with total commitments of \$632.5 million, with Bank of America, N.A., as a lender and as administrative agent, and the other lenders thereunder, which replaced the Company's previous revolving line of credit. The Company may obtain additional commitments up to a total committed facility of \$1.5 billion, subject to customary conditions and availability of capital. The revolving line of credit expires on April 11, 2011.

At the Company's option, borrowings under the revolving line of credit effective April 9, 2008, generally bear interest at a rate per annum equal to (i) LIBOR (for the period selected by the Company) plus 2.00% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.50% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR-based loans, and monthly payments of interest on other loans. All principal is due upon maturity.

The revolving credit facility provides for a swing line sub-facility. The swing line sub-facility bears interest at the Bank of America N.A. cost of funds plus 2.00%. The revolving credit facility also provides for a sub-facility for the issuance of letters of credit for up to an aggregate amount of \$175 million. This letter of credit sub-facility will increase to the extent of 15% of the aggregate amount of commitments over \$1.0 billion. The letter of credit fee is 2.00% per annum on letters of credit issued, which is payable quarterly.

The annual cost of commitment fees, other facility fees and amortization of debt financing costs was \$7.3 million and \$3.7 million at September 30, 2008, and December 31, 2007, respectively.

The average debt outstanding on the revolving line of credit was \$158.2 million and \$62.3 million, respectively, for the nine months ended September 30, 2008 and 2007. The maximum amount borrowed under this facility and the weighted average stated interest rate during the nine months ended September 30, 2008 and 2007, were \$403.8 million and 4.7%, respectively, and \$225.5 million and 6.4%, respectively. At September 30, 2008, the amount available under the revolving line of credit was

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 4. Debt, continued**

\$338.7 million, net of amounts committed for standby letters of credit of \$123.8 million issued under the credit facility.

***Debt Covenants***

The Company has various financial and operating covenants required by the revolving line of credit and the privately issued unsecured notes payable outstanding at September 30, 2008, and December 31, 2007. These covenants require the Company to maintain certain financial ratios, including asset coverage, debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of the Company's assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. At September 30, 2008, the Company was in compliance with the financial and operating covenants required under the revolving line of credit and the privately issued unsecured notes payable. The Company experienced a significant reduction in its net worth at September 30, 2008, primarily resulting from net unrealized depreciation on the Company's portfolio, which reflects current market conditions. The Company intends to seek an amendment of the minimum net worth covenant from the lenders in the revolving line of credit and the privately issued unsecured notes payable. There can be no assurance that the Company will obtain such an amendment.

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

**Note 5. Guarantees and Commitments**

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies, including Ciena. All standby letters of credit have been issued through Bank of America, N.A. As of September 30, 2008, and December 31, 2007, the Company had issued guarantees of debt, rental and other obligations aggregating \$22.4 million and \$270.6 million, respectively, and had extended standby letters of credit aggregating \$123.8 million and \$58.5 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of potential future payments was \$146.2 million and \$329.1 million at September 30, 2008, and December 31, 2007, respectively.

At September 30, 2008, and December 31, 2007, \$5.0 million and \$258.7 million, respectively, of the Company's guarantees, and \$102.6 million and \$18.0 million, respectively, of the standby letters of credit related to the Company's investment in Ciena. The reduction in the Ciena-related guaranty since December 31, 2007, relates to Ciena's decision to voluntarily file for bankruptcy protection on September 30, 2008. As a result of Ciena's decision to file for bankruptcy protection, the Company's unconditional guaranty of the obligations outstanding under Ciena's revolving credit facility became due, and the Company, in lieu of paying under its guaranty, purchased the positions of the senior lenders under Ciena's revolving credit facility except for a \$5 million position continued to be held by Citibank,

N.A. See Note 3. Private Finance Ciena Capital LLC. In connection with the Company's continuing

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 5. Guarantees and Commitments, continued**

guaranty of the amounts held by Citibank, the Company has agreed with Citibank that the amounts owing to Citibank under the Ciena revolving credit facility will be paid before any of the secured obligations of Ciena now owed to the Company.

As of September 30, 2008, the guarantees and standby letters of credit expire as follows:

(in millions)	Total	2008	2009	2010	2011	2012	After 2012
Guarantees	\$ 22.4	\$	\$ 7.5	\$ 9.6	\$ 4.4	\$ 0.1	\$ 0.8
Standby letters of credit <sup>(1)</sup>	123.8		1.7		122.1		
Total <sup>(2)</sup>	\$ 146.2	\$	\$ 9.2	\$ 9.6	\$ 126.5	\$ 0.1	\$ 0.8

<sup>(1)</sup> Standby letters of credit are issued under the Company's revolving line of credit that expires in April 2011. Therefore, unless a standby letter of credit is set to expire at an earlier date, it is assumed that the standby letters of credit will expire contemporaneously with the expiration of the Company's line of credit in April 2011.

<sup>(2)</sup> At September 30, 2008, the Company guaranteed \$5 million of Ciena's senior secured loan not held by the Company as well as related interest, fees and related expenses, and also had standby letters of credit issued totaling \$102.6 million in connection with term securitizations completed by Ciena. The Company considered the outstanding letters of credit in its valuation at September 30, 2008. See Note 3. Private Finance - Ciena Capital LLC for additional information.

In the ordinary course of business, the Company enters into agreements with service providers and other parties that may contain provisions for the Company to indemnify and guaranty certain minimum fees to such parties under certain circumstances.

At September 30, 2008, the Company had outstanding commitments to fund investments totaling \$775.5 million, including \$737.0 million related to private finance investments and \$38.5 million related to commercial real estate finance investments. Outstanding commitments to the Unitranche Fund LLC will be funded as investments are funded by the Unitranche Fund. Investments made by the Unitranche Fund must be approved by the investment committee of the Unitranche Fund, which includes a representative from the Company and GE, and the level of investments made by the Unitranche Fund will be dependent on market conditions and the Unitranche Fund's ability to identify attractive investment opportunities during the investment period.

**Note 6. Shareholders' Equity**

Sales of common stock for the nine months ended September 30, 2008 and 2007, were as follows:

(in millions)	2008	2007
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Number of common shares	20.5	3.3
Gross proceeds	\$ 417.1	\$ 97.3
Less costs, including underwriting fees	(14.6)	(3.5)
Net proceeds	\$ 402.5	\$ 93.8

There were no stock options exercised during the nine months ended September 30, 2008. The Company issued 0.5 million shares of common stock upon the exercise of stock options during the nine months ended September 30, 2007. In addition, in July 2007, the Company issued 1.7 million

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 6. Shareholders Equity, continued**

unregistered shares of common stock upon the cancellation of stock options pursuant to a tender offer. See Note 9.

The Company has a dividend reinvestment plan, whereby the Company buys shares of its common stock in the open market or issues new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive trading days immediately prior to the dividend payment date. The Company cannot issue new shares at a price below net asset value. Dividend reinvestment plan activity for the nine months ended September 30, 2008 and 2007, was as follows:

	<b>For the Nine Months Ended September 30, 2008      2007</b>	
<b>(in millions, except per share amounts)</b>		
Shares issued	0.2	0.4
Average price per share	\$19.49	\$30.05
Shares purchased by plan agent for shareholders	0.5	
Average price per share	\$14.43	

**Note 7. Earnings Per Common Share**

Earnings per common share for the three and nine months ended September 30, 2008 and 2007, were as follows:

	<b>For the Three Months Ended September 30, 2008      2007</b>		<b>For the Nine Months Ended September 30, 2008      2007</b>	
<b>(in millions, except per share amounts)</b>				
Net increase (decrease) in net assets resulting from operations	\$ (318.3)	\$ (96.5)	\$ (461.2)	\$ 125.8
Weighted average common shares outstanding - basic	178.7	154.0	171.1	152.0
Dilutive options outstanding				2.7
Weighted average common shares outstanding - diluted	178.7	154.0	171.1	154.7
Basic earnings (loss) per common share	\$ (1.78)	\$ (0.63)	\$ (2.70)	\$ 0.83

Diluted earnings (loss) per common share	\$ (1.78)	\$ (0.63)	\$ (2.70)	\$ 0.81
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**Note 8. Employee Compensation Plans**

In December 2007, the Company's Board of Directors made a determination that it was in the best interests of the Company to terminate its deferred compensation arrangements (each individually a Plan, or collectively, the Plans). The Board of Directors' decision was primarily in response to increased complexity resulting from recent changes in the regulation of deferred compensation arrangements. The Board of Directors resolved that the accounts under these Plans would be distributed to participants in



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 8. Employee Compensation Plans, continued**

full on March 18, 2008, the termination and distribution date, or as soon as was reasonably practicable thereafter, in accordance with the provisions of each of these Plans.

The accounts under the deferred compensation arrangements totaled \$52.5 million at December 31, 2007. The balances on the termination date were distributed to participants in March 2008 subsequent to the termination date in accordance with the transition rule for payment elections under Section 409A of the Code. Distributions from the plans were made in cash or shares of the Company's common stock, net of required withholding taxes.

The Company has an Individual Performance Award (IPA), which is generally determined annually at the beginning of each year but may be adjusted throughout the year. Through December 31, 2007, the IPA was deposited in a deferred compensation trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the trust to require the trustee to use the cash to purchase shares of the Company's common stock in the open market.

Through December 31, 2007, the IPA amounts were contributed into the trust and invested in the Company's common stock. The accounts of the trust were consolidated with the Company's accounts. The common stock was classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represented the amount owed to the employees, was included in other liabilities. Changes in the value of the Company's common stock held in the deferred compensation trust were not recognized. However, the liability was marked to market with a corresponding charge or credit to employee compensation expense. On March 18, 2008, prior to the distribution of the assets held in the trust, the Company was required to record a final mark to market of the liability with a corresponding credit to employee compensation expense.

For 2008, the Compensation Committee has determined that the IPAs will be paid in cash in two equal installments during the year to eligible officers as long as the recipient remains employed by the Company, rather than contributed to a deferred compensation plan and invested in shares of the Company's common stock. If a recipient terminates employment during the year, any remaining cash payments under the IPA would be forfeited.

The IPA expense for the three and nine months ended September 30, 2008 and 2007, was as follows:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
IPA	\$ 2.0	\$ 2.4	\$ 6.6	\$ 7.4
IPA mark to market expense (benefit)		(2.0)	(4.1)	(3.6)
Total IPA expense	\$ 2.0	\$ 0.4	\$ 2.5	\$ 3.8

The Company also has an individual performance bonus ( IPB ), which is distributed in cash to award recipients equally throughout the year (beginning in February of each year) as long as the recipient remains employed by the Company. If a recipient terminates employment during the year, any remaining cash payments under the IPB would be forfeited. For the three months ended September 30, 2008 and

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 8. Employee Compensation Plans, continued**

2007, the IPB expense was \$2.4 million and \$2.6 million, respectively. For the nine months ended September 30, 2008 and 2007, the IPB expense was \$6.8 million and \$7.1 million, respectively. The IPA and IPB expenses are included in employee expenses.

**Note 9. Stock Option Plan**

The purpose of the stock option plan ( Option Plan ) is to provide officers and non-officer directors of the Company with additional incentives. Options are exercisable at a price equal to the fair market value of the shares on the day the option is granted. Each option states the period or periods of time within which the option may be exercised by the optionee, which may not exceed ten years from the date the option is granted. The options granted to officers generally vest ratably over up to a three year period. Options granted to non-officer directors vest on the grant date.

All rights to exercise options terminate 60 days after an optionee ceases to be (i) a non-officer director, (ii) both an officer and a director, if such optionee serves in both capacities, or (iii) an officer (if such officer is not also a director) of the Company for any cause other than death or total and permanent disability. In the event of a change of control of the Company, all outstanding options will become fully vested and exercisable as of the change of control.

At September 30, 2008, and December 31, 2007, there were 37.2 million shares authorized under the Option Plan and the number of shares available to be granted under the Option Plan was 7.6 million and 10.7 million, respectively.

Information with respect to options granted, exercised and forfeited under the Option Plan for the nine months ended September 30, 2008, was as follows:

(in millions, except per share amounts)	Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Remaining Term (Years)	Aggregate Intrinsic Value at September 30, 2008 <sup>(1)</sup>
Options outstanding at January 1, 2008	18.5	\$ 28.36		
Granted	7.7	\$ 22.52		
Exercised		\$		
Forfeited/cancelled	(4.5)	\$ 26.59		
Options outstanding at September 30, 2008	21.7	\$ 26.65	5.58	\$
Exercisable at September 30, 2008 <sup>(2)</sup>	13.9	\$ 28.15	5.22	\$
	19.6	\$ 27.02	5.50	\$

Exercisable and expected to be exercisable at  
September 30, 2008<sup>(3)</sup>

- (1) Represents the difference between the market value of the options at September 30, 2008, and the cost for the option holders to exercise the options.
- (2) Represents vested options.
- (3) The amount of options expected to be exercisable at September 30, 2008, is calculated based on an estimate of expected forfeitures.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 9. Stock Option Plan, continued**

During the nine months ended September 30, 2007, 6.6 million options were granted, 0.5 million options were exercised, 0.5 million options were forfeited and 10.3 million were cancelled in a tender offer as discussed below.

On July 18, 2007, the Company completed a tender offer related to the Company's offer to all optionees who held vested in-the-money stock options as of June 20, 2007, the opportunity to receive an option cancellation payment ( OCP ) equal to the in-the-money value of the stock options cancelled, determined using the Weighted Average Market Price of \$31.75, which would be paid one-half in cash and one-half in unregistered shares of the Company's common stock. The Company accepted for cancellation 10.3 million vested options, which in the aggregate had a weighted average exercise price of \$21.50. This resulted in a total option cancellation payment of approximately \$105.6 million, of which \$52.8 million was paid in cash and \$52.8 million was paid through the issuance of 1.7 million unregistered shares of the Company's common stock, determined using the Weighted Average Market Price of \$31.75. The Weighted Average Market Price represented the volume weighted average price of the Company's common stock over the fifteen trading days preceding the first day of the offer period, or June 20, 2007. See Note 2 Stock Compensation Plans.

The fair value of the shares vested during the nine months ended September 30, 2008 and 2007, was \$13.5 million and \$21.6 million, respectively. The total intrinsic value of the options exercised during the nine months ended September 30, 2007, was \$2.6 million. There were no options exercised during the nine months ended September 30, 2008.

**Note 10. Dividends and Distributions and Taxes**

The Company's Board of Directors declared and the Company paid a dividend of \$0.65 per common share for the first, second and third quarters of 2008 and \$0.63, \$0.64 and \$0.65 per common share for the first, second and third quarters of 2007, respectively. These dividends totaled \$340.4 million and \$293.7 million for the nine months ended September 30, 2008 and 2007, respectively. The Company declared an extra cash dividend of \$0.05 per share during 2006, which was paid to shareholders on January 19, 2007.

The Company's Board of Directors also declared a dividend of \$0.65 per share for the fourth quarter of 2008.

At December 31, 2007, the Company had excess taxable income of \$393.3 million available for distribution to shareholders in 2008. Excess taxable income for 2007 represents approximately \$40.9 million of ordinary income and approximately \$352.4 million of net long-term capital gains.

Dividends paid in 2008 will first be paid out of the excess taxable income carried over from 2007. For the first, second and third quarters of 2008, the Company paid dividends of \$340.4 million. The remainder of 2007 excess taxable income to be distributed during the fourth quarter of 2008 is \$52.9 million. In accordance with regulated investment company distribution rules, the Company was required to declare current year dividends to be paid from carried over excess taxable income from 2007 before the Company filed its 2007 tax return in September 2008, and the Company is required to pay such dividends by December 31, 2008. To comply with these rules, on July 8, 2008, the Company's Board of Directors declared a \$0.65 per share dividend for both the third and fourth quarters of 2008. The third quarter dividend was paid on September 26, 2008, and the fourth quarter dividend will be paid on December 26, 2008 to

shareholders of record on December 12, 2008.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 10. Dividends and Distributions and Taxes, continued**

Given that a substantial portion of the 2008 dividend payments will be made from excess taxable income carried over from 2007, the Company currently expects to carry over excess taxable income earned in 2008 for distribution to shareholders in 2009. The Company will generally be required to pay a nondeductible excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions from such taxable income for the year. The Company has accrued an excise tax expense on the estimated excess taxable income earned for the respective periods. For the three and nine months ended September 30, 2008, the Company recorded an excise tax expense of \$0.9 million and \$5.1 million, respectively. For the three and nine months ended September 30, 2007, the Company recorded an excise tax expense of \$9.0 million and \$16.6 million, respectively. The excise tax expense for the nine months ended September 30, 2008 is lower than for the same period in 2007 as the Company expects that its excess taxable income carried over from 2008 for distribution in 2009 will be lower than the excess taxable income carried over from 2007 for distribution in 2008.

In addition to excess taxable income carried forward, the Company has cumulative deferred taxable income related to installment sale gains of approximately \$236.0 million as of December 31, 2007. These gains have been recognized for financial reporting purposes in the respective years they were realized, but are generally deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash.

The Company's undistributed book earnings of \$535.9 million as of December 31, 2007, resulted from undistributed ordinary income and long-term capital gains. The difference between undistributed book earnings at the end of the year and taxable income carried over from the current year into the next year relates to a variety of timing and permanent differences in the recognition of income and expenses for book and tax purposes.

The Company's consolidated subsidiary, AC Corp, is subject to federal and state income taxes. For the three months ended September 30, 2008 and 2007, AC Corp's income tax expense was \$1.2 million and \$2.2 million, respectively, and for the nine months ended September 30, 2008 and 2007, income tax expense was \$3.0 million and income tax benefit was \$0.5 million, respectively.

**Note 11. Supplemental Disclosure of Cash Flow Information**

The Company paid interest of \$95.9 million and \$81.2 million for the nine months ended September 30, 2008 and 2007, respectively. The Company paid income taxes, including excise taxes (net of refunds), of \$13.0 million and \$20.2 million for the nine months ended September 30, 2008 and 2007, respectively.

Non-cash operating activities for the nine months ended September 30, 2008 and 2007, totaled \$107.7 million and \$58.4 million, respectively. Non-cash operating activity included the exchange of existing debt securities and accrued interest for new debt and equity securities.

Non-cash financing activities included the issuance of common stock in lieu of cash distributions totaling \$3.8 million and \$12.4 million for the nine months ended September 30, 2008 and 2007, respectively. Non-cash financing activities for the nine months ended September 30, 2007, also included the payment of one-half of the value of the option cancellation payment in connection with the tender offer, or \$52.8 million, through the issuance of 1.7 million unregistered shares of the Company's common stock. See Note 9.





## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 12. Financial Highlights

	At and for the Nine Months Ended September 30, 2008 <sup>(1)</sup> 2007		At and for the Year Ended December 31, 2007
<b>Per Common Share Data</b>			
Net asset value, beginning of period	\$ 17.54	\$ 19.12	\$ 19.12
Net investment income <sup>(2)</sup>	1.04	0.54	0.91
Net realized gains (losses) <sup>(2)(3)</sup>	0.28	2.03	1.74
Net investment income plus net realized gains <sup>(2)</sup>	1.32	2.57	2.65
Net change in unrealized appreciation or depreciation <sup>(2)(3)</sup>	(4.02)	(1.76)	(1.66)
Net increase (decrease) in net assets resulting from operations <sup>(2)</sup>	(2.70)	0.81	0.99
Net decrease in net assets from shareholder distributions	(1.95)	(1.92)	(2.64)
Net increase in net assets from capital share transactions <sup>(2)(4)</sup>	0.62	0.23	0.41
Decrease in net assets from cash portion of the option cancellation payment <sup>(2)(6)</sup>		(0.34)	(0.34)
Net asset value, end of period	\$ 13.51	\$ 17.90	\$ 17.54
Market value, end of period	\$ 10.80	\$ 29.39	\$ 21.50
Total return <sup>(5)</sup>	(43.3)%	(4.2)%	(27.6)%
<b>Ratios and Supplemental Data</b>			
(\$ and shares in thousands, except per share amounts)			
Ending net assets	\$ 2,413.4	\$ 2,765.8	\$ 2,771.8
Common shares outstanding at end of period	178.7	154.5	158.0
Diluted weighted average common shares outstanding	171.1	154.7	154.7
Employee, employee stock option and administrative expenses/average net assets <sup>(7)</sup>	3.80%	5.06%	6.10%
Total operating expenses/average net assets <sup>(7)</sup>	7.85%	8.46%	10.70%
Income tax expense (benefit), including excise tax/average net assets <sup>(7)</sup>	0.30%	0.56%	0.47%
Net investment income/average net assets <sup>(7)</sup>	6.59%	2.87%	4.91%
Net increase (decrease) in net assets resulting from operations/average net assets <sup>(7)</sup>	(16.99)%	4.35%	5.34%
Portfolio turnover rate <sup>(7)</sup>	19.38%	24.43%	26.84%
Average debt outstanding	\$ 2,072.8	\$ 1,909.5	\$ 1,924.2



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 13. Litigation**

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

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

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

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Thereafter, the court appointed new lead counsel and approved new lead plaintiffs. On July 30, 2007, plaintiffs served an amended complaint. Plaintiffs claim that, between November 7, 2005, and January 22, 2007, Allied Capital either failed to disclose or misrepresented information about its portfolio company, Business Loan Express, LLC. Plaintiffs seek unspecified compensatory and other damages, as well as other relief. The Company believes the lawsuit is without merit, and intends to defend the lawsuit vigorously. On September 13, 2007, the Company filed a motion to dismiss the lawsuit. The motion is pending.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 13. Litigation, continued**

On October 6, 2008, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned Rena Nadoff v. Walton, et al., 2008 CA 007108, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. The complaint alleges breaches of fiduciary duty by the Board of Directors arising from alleged mismanagement of Business Loan Express, LLC, an Allied Capital portfolio company, the acquisition of certain phone records, and the adequacy of internal controls relating to the valuation of securities in the Company's portfolio. Ms. Nadoff's suit is substantially similar to a derivative action she filed in February 2007, which the Court dismissed in July 2007. Ms. Nadoff sent a letter to the Company's Board of Directors on October 5, 2007, reciting substantially the same claims and requesting that the Board of Directors investigate her allegations and take appropriate action. The Board of Directors subsequently established a committee, which engaged and was advised by its own counsel, to review the matter. The Board's committee evaluated the allegations in Ms. Nadoff's October 5 letter and recommended that the Board take no further action. After considering both Ms. Nadoff's request and the committee's recommendation, the Board accepted the recommendation.

In addition, the Company is party to certain lawsuits in the normal course of business. Furthermore, third parties may try to seek to impose liability on the Company in connection with the activities of its portfolio companies. For a discussion of civil investigations being conducted regarding the lending practice of Ciena Capital LLC, a portfolio company of the Company, see Note 3, Portfolio Ciena Capital LLC.

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

**Report of Independent Registered Public Accounting Firm**

**The Board of Directors and Shareholders**

**Allied Capital Corporation:**

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries (the Company), including the consolidated statement of investments, as of September 30, 2008, the related consolidated statements of operations for the three- and nine-month periods ended September 30, 2008 and 2007, and the consolidated statements of changes in net assets and cash flows and the financial highlights (included in Note 12) for the nine-month periods ended September 30, 2008 and 2007. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of December 31, 2007, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights, for the year then ended; and in our report dated February 28, 2008, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet including the consolidated statement of investments as of December 31, 2007, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Washington, D.C.  
November 10, 2008

## Schedule 12-14

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## SCHEDULE OF INVESTMENTS IN AND ADVANCES TO AFFILIATES

<b>PRIVATE FINANCE</b>				December			September 30,
<b>Portfolio Company</b>				31,	Gross	Gross	2008
(in thousands)	Investment <sup>(1)</sup>	Credited	Interest or	2007	Additions <sup>(3)</sup>	Reductions <sup>(4)</sup>	Value
<b>Companies More Than 25% Owned</b>		to	Dividends	Value			Value
		Income <sup>(6)</sup>	Other <sup>(2)</sup>				
AGILE Fund I, LLC (Private Equity Fund)	Equity Interests			\$	\$ 861	\$ (110)	\$ 751
Alaris Consulting, LLC (Business Services)	Senior Loan <sup>(5)</sup> Equity Interests				1,549	(1,549)	
AllBridge Financial, LLC (Asset Management)	Equity Interests			7,800	21,849	(10,218)	19,431
Allied Capital Senior Debt Fund, L.P. (Private Debt Fund)	Equity Interests			32,811		(846)	31,965
Avborne, Inc. (Business Services)	Preferred Stock Common Stock			1,633		(698)	935
Avborne Heavy Maintenance, Inc. (Business Services)	Preferred Stock Common Stock			2,557 370	526	(2,400)	157 896
Aviation Properties Corporation (Business Services)	Common Stock				3	(3)	
Border Foods, Inc. (Consumer Products)	Senior Loan <sup>(5)</sup> Senior Loan Preferred Stock Common Stock	\$ 619			20,991 23,843 5,383	(2,157) (716)	18,834 23,127 10,031
Calder Capital Partners, LLC (Asset Management)	Senior Loan <sup>(5)</sup> Equity Interests		\$ 218	3,035 3,559	2,026 2	(4,393) (3,561)	668

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Callidus Capital Corporation (Asset Management)	Senior Loan	95		1,750		1,750
	Subordinated Debt	1,251	6,871	9,947	(3,500)	13,318
	Common Stock	3,000	44,587		(4,555)	40,032
Ciena Capital LLC (Financial Services)	Senior Loan			319,031	(138,837)	180,194
	Class A Equity Interests <sup>(5)</sup>		68,609		(68,609)	
	Class B Equity Interests					
	Class C Equity Interests					
CitiPostal Inc. (Business Services)	Senior Loan	36	679	2		681
	Unitranche Debt	4,728	50,597	807		51,404
	Subordinated Debt	1,026	8,049	707		8,756
	Common Stock	27	12,726	2,962		15,688
Coverall North America, Inc. (Business Services)	Unitranche Debt	2,983	34,923	35	(3,019)	31,939
	Subordinated Debt	643	5,979	6	(437)	5,548
	Common Stock		27,597		(9,859)	17,738
CR Holding, Inc. (Consumer Products)	Subordinated Debt	4,936	40,812	1,048	(3,006)	38,854
	Common Stock		40,934		(31,483)	9,451
Crescent Equity Corp. (Business Services/Broadcasting & Cable)	Senior Loan	33	433	11	(11)	433
	Subordinated Debt	2,688	42,977	1,402	(12,486)	31,893
	Subordinated Debt <sup>(5)</sup>		1,583	150	(1,733)	
	Common Stock	36	83,453	5,179	(71,302)	17,330
Direct Capital Corporation (Financial Services)	Subordinated Debt	5,886	39,030	17,287	(2,965)	53,352
	Common Stock		6,906	9,126	(10,608)	5,424
Financial Pacific Company (Financial Services)	Subordinated Debt	9,014	72,850	1,064	(5,314)	68,600
	Preferred Stock	1,281	19,330		(6,864)	12,466
	Common Stock		38,544		(38,544)	
ForeSite Towers, LLC (Tower Leasing)	Equity Interest		878	102		980
Global Communications, LLC (Business Services)	Senior Loan <sup>(5)</sup>		1,822		(487)	1,335
Hot Light Brands, Inc. (Retail)	Senior Loan <sup>(5)</sup>			29,662	(16,406)	13,256
	Common Stock			5,151	(5,151)	

See related footnotes at the end of this schedule.



<b>PRIVATE FINANCE</b>		Amount of Interest or Dividends Credited to	December 31, 2007	Gross	Gross	September 30, 2008	
<b>Portfolio Company</b>	<b>Investment<sup>(1)</sup></b>	Income <sup>(6)</sup>	Other <sup>(2)</sup>	Value	Additions <sup>(3)</sup>	Reductions <sup>(4)</sup>	Value
<b>(in thousands)</b>		\$	\$	\$	\$	\$	\$
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan	2,622		50,752	3,132	(1,225)	52,659
	Subordinated Debt	1,589		29,907	1,335	(31,242)	
	Subordinated Debt <sup>(5)</sup>			1,337		(1,337)	
	Common Stock						
Huddle House, Inc. (Retail)	Subordinated Debt	6,489		59,618	1,327	(4,355)	56,590
	Common Stock			44,154		(11,158)	32,996
IAT Equity, LLC and Affiliates d/b/a Industrial Air Tool (Industrial Products)	Subordinated Debt	147			6,000		6,000
	Common Stock				8,633		8,633
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			320	1		321
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt	6,047		45,041	1,754	(1,297)	45,498
	Subordinated Debt <sup>(5)</sup>			16,796		(1,098)	15,698
	Preferred Stock			1,462		(1,462)	
	Common Stock						
Jakel, Inc. (Industrial Products)	Subordinated Debt <sup>(5)</sup>			1,563		(815)	748
Knightsbridge CLO 2007-1 Ltd. <sup>(8)</sup> (CLO)	Class E Notes	1,345			21,985	(5,554)	16,431
	Income Notes	3,294			39,228	(3,523)	35,705
Knightsbridge CLO 2008-1 Ltd. (CLO)	Class C Notes	435			16,000	(3,200)	12,800
	Class D Notes	298			10,000	(2,000)	8,000
	Class E Notes	388			13,834	(3,300)	10,534
	Income Notes	1,080			32,605	(12,152)	20,453
Legacy Partners Group, Inc. (Business Services)	Senior Loan <sup>(5)</sup>			3,843		(3,000)	843
	Equity Interests			1,332	13	(77)	1,268
Litterer Beteiligungs-GmbH (Business Services)	Subordinated Debt	30		772	56	(828)	
	Equity Interest			700	1,110	(1,810)	
	Subordinated Debt <sup>(5)</sup>				14,329	(14,329)	

MHF Logistical Solutions, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock Common Stock					
MVL Group, Inc. (Business Services)	Senior Loan Subordinated Debt Common Stock	2,773 4,600	30,639 39,943 4,949	18 888		30,657 40,831 21
Old Orchard Brands, LLC (Consumer Products)	Subordinated Debt Equity Interests	2,551	19,544 25,419	572 12,572	(1,428) (2,910)	18,688 35,081
Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt Equity Interests	4,380	39,180 37,965	1,283 13	(2,883) (4,755)	37,580 33,223
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan		1,534		(1,534)	
Service Champ, Inc. (Business Services)	Subordinated Debt Common Stock	3,206	28,351 26,292	540 311	(2,083) (1,877)	26,808 24,726
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt		223	286	(509)	
Startec Equity, LLC (Telecommunications)	Equity Interests		430	16	(232)	214
Sweet Traditions, Inc. (Retail)	Senior Loan <sup>(5)</sup> Preferred Stock Common Stock		35,229	4,865 950 50	(40,094) (950) (50)	
Unitranche Fund LLC (Private Debt Fund)	Subordinated Certificates Equity Interests	4,505	744 1	113,595		114,339 1
Worldwide Express Operations, LLC (Business Services)	Subordinated Debt Equity Interests Warrants	310 796	2,670 21,516 272	212	(212) (5,254) (67)	2,670 16,262 205
<b>Total companies more than 25% owned</b>		<b>\$ 85,167</b>	<b>\$ 1,279,080</b>			<b>\$ 1,433,700</b>

See related footnotes at the end of this schedule.

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PRIVATE FINANCE Portfolio Company  (in thousands) Companies 5% to 25% Owned	Investment <sup>(1)</sup>	Amount of Interest or Dividends Credited to		December 31, 2007	Gross	Gross	September 30, 2008
		Income <sup>(6)</sup>	Other <sup>(2)</sup>	Value	Additions <sup>(3)</sup>	Reductions <sup>(4)</sup>	Value
10th Street, LLC (Business Services)	Subordinated Debt Equity Interests Option	\$ 2,062		\$ 20,645 1,100	\$ 578 25	\$ (25)	\$ 21,223 1,075 25
Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt Equity Interests	14,339		154,854 10,973	2,448 2,027		157,302 13,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan Equity Interests	179 1,010		2,980 10,800	9,885 376	(8,533) (476)	4,332 10,700
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock Common Stock	169		749 262		(749) (263)	
Amerex Group, LLC (Consumer Products)	Subordinated Debt Equity Interests	2,166 2,349		8,400 13,713	995	(611) (51)	8,784 13,662
BB&T Capital Partners/Windsor Mezzanine Fund, LLC (Private Equity Fund)	Equity Interests			11,467	48	(1,169)	10,346
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt Common Stock	2,790		24,798 4,190	543 909	(799)	25,341 4,300
BI Incorporated (Business Services)	Subordinated Debt Common Stock	2,722		30,499 7,382	116	(30,615) (7,382)	
Creative Group, Inc. (Business Services)	Subordinated Debt <sup>(5)</sup> Common Stock Warrant			6,197	8,877	(15,074)	
Drew Foam Companies, Inc. (Business Services)	Preferred Stock Common Stock			396	38 1	(99) (1)	335
Hilden America, Inc. (Consumer Products)	Common Stock				454	(384)	70

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Lydall Transport, Ltd. (Business Services)	Equity Interests			432	(9)	423
MedBridge Healthcare, LLC <sup>(7)</sup> (Healthcare Services)	Senior Loan <sup>(5)</sup>	\$ 321	7,164		(577)	6,587
	Subordinated Debt <sup>(5)</sup>	31	2,406		(1,653)	753
	Convertible Subordinated Debt <sup>(5)</sup>					
	Equity Interests			9	(9)	
MHF Logistical Solutions, Inc. (Business Services)	Subordinated Debt <sup>(5)</sup>		9,280		(9,280)	
	Common Stock Warrants					
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt	993	19,704	77	(16,834)	2,947
	Equity Interests		940	756	(274)	1,422
Progressive International Corporation (Consumer Products)	Subordinated Debt	131	1,545	40	(1,585)	
	Preferred Stock		1,038	65		1,103
	Common Stock		4,900		(300)	4,600
	Warrants					
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan	2				
	Unitranche Debt	979	11,941	265	(1,099)	11,107
	Equity Interests	25	1,681	93	(206)	1,568
SGT India Private Limited (Business Services)	Common Stock		3,075	23	(1,892)	1,206
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt	1,597	13,744	1,911	(11,548)	4,107
	Equity Interests	74	2,686	10	(539)	2,157
Triax Holdings, LLC <sup>(9)</sup> (Consumer Products)	Subordinated Debt			10,316		10,316
	Equity Interests			42,114		42,114
Universal Environmental Services, LLC (Business Services)	Equity Interests			249	(249)	
<b>Total companies 5% to 25% owned</b>		<b>\$ 31,587</b>	<b>\$ 389,509</b>			<b>\$ 360,905</b>

This schedule should be read in conjunction with the Company's consolidated financial statements, including the consolidated statement of investments and Note 3 to the consolidated financial statements. Note 3 includes additional

information regarding activities in the private finance portfolio.

- (1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of September 30, 2008.

- (2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.
- (3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company into this category from a different category. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.
- (4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company out of this category into a different category. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.
- (5) Loan or debt security is on non-accrual status at September 30, 2008, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the period may or may not have been on non-accrual status for the full period.
- (6) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.
- (7) In the first quarter of 2008, the Company exercised its option to acquire a majority of the voting securities of MHF Logistical Solutions, Inc. (MHF). Therefore, MHF was reclassified to companies more than 25% owned in the first quarter of 2008. At December 31, 2007, the Company's investment in MHF was included in the companies 5% to 25% owned category.
- (8) On March 31, 2008, the Company assumed the management of Knightsbridge CLO 2007-1. Therefore, this investment was reclassified to companies more than 25% owned. At December 31, 2007, this investment was included in the companies 5% to 25% owned category.
- (9) During the quarter ended September 30, 2008, the Company's equity interests in Triax Holding, LLC received voting rights. Therefore this investment was reclassified to companies 5% to 25% owned.

**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, 2007. In addition, this quarterly report on Form 10-Q contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth below in the Risk Factors section. Other factors that could cause actual results to differ materially include:*

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

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

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

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

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

**OVERVIEW**

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

Our portfolio composition at September 30, 2008 and 2007, and December 31, 2007, was as follows:

	<b>September 30, 2008</b>	<b>2007</b>	<b>December 31, 2007</b>
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Private finance	97%	97%	97%
Commercial real estate finance	3%	3%	3%



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

There has been a severe disruption in the capital markets and a softening of the economy. Given the current environment, we are focused on how we should allocate increasingly scarce capital resources in what is likely to be a difficult climate for financial firms, including business development companies, for some time. We intend to focus on retaining capital, building liquidity, and creating value in our existing portfolio. We will also continue to harvest capital from the portfolio, especially targeting lower-yielding investments. Given the scarcity of capital resources, our new investing activity will be significantly reduced and we plan to make new investments only in what we believe to be the most attractive long-term investment opportunities or in transactions that strategically enhance our franchise.

In addition to investing for our own portfolio, we have invested in funds that are managed or co-managed by us that are complementary to our business of investing in middle market companies. Through managed funds, we have the opportunity to invest in the funds and earn returns from those investments, to earn fees on the funds under management and to co-invest alongside these funds, thereby expanding our investment capital base. At September 30, 2008, we had \$4.9 billion in committed private investment capital under our management, which includes the Unitranch Fund LLC, the Allied Capital Senior Debt Fund, L.P., Knightsbridge CLO 2007-1 Ltd., Knightsbridge CLO 2008-1 Ltd. and AGILE Fund I, LLC (collectively, the Managed Funds). See [Managed Funds](#) below for further discussion.

In aggregate, including the total assets on our balance sheet and capital committed to our Managed Funds, we have \$9.3 billion in managed capital.

In addition to the funds we already manage or co-manage, we are pursuing additional managed fund opportunities. These potential funds are focused on all levels of a middle market company's capital structure, from senior debt through equity capital. By growing our privately managed capital base, we are seeking to diversify our sources of capital, leverage our core investment expertise and increase fees and other income from asset management activities. There can be no assurance that these new fund raising initiatives will result in additional funds under management.

We are also interested in expanding our origination platform through acquisitions, including acquisitions of other platforms, portfolios or financial services companies, including other business development companies.

**PORTFOLIO AND INVESTMENT ACTIVITY**

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three and nine months ended September 30, 2008 and 2007, and at and for the year ended December 31, 2007, were as follows:

(\$ in millions)	At and for the Three Months Ended September 30,		At and for the Nine Months Ended September 30,		At and for the Year Ended December 31,
	2008	2007	2008	2007	2007
Portfolio at value	\$ 4,208.5	\$ 4,326.9	\$ 4,208.5	\$ 4,326.9	\$ 4,780.5
Investments funded	\$ 433.8	\$ 577.5	\$ 1,027.8	\$ 1,236.7	\$ 1,846.0
Payment-in-kind interest and dividends, net of cash collections	\$ 11.4	\$ (1.2)	\$ 35.9	\$ 5.5	\$ 12.0
Principal collections related to investment repayments or sales	\$ 280.6	\$ 351.1	\$ 878.2	\$ 1,086.5	\$ 1,211.6
Yield on interest-bearing portfolio investments <sup>(1)</sup>	11.9%	11.9%	11.9%	11.9%	12.1%

<sup>(1)</sup> The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, plus the effective interest yield on the preferred shares/income notes of CLOs, plus the annual stated interest (LIBOR plus 7.5%) on the subordinated certificates in the Unitranche Fund LLC divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

**Private Finance**

The private finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three and nine months ended September 30, 2008 and 2007, and at and for the year ended December 31, 2007, were as follows:

	At and for the Three Months Ended September 30,				At and for the Nine Months Ended September 30,				At and for the Year Ended December 31,
	2008		2007		2008		2007		2007
(Millions)	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value
at value:									
and debt securities:									
loans	\$ 434.9	4.2%	\$ 481.6	9.3%	\$ 434.9	4.2%	\$ 481.6	9.3%	\$ 344.3
the debt	579.3	12.0%	698.1	11.5%	579.3	12.0%	698.1	11.5%	653.9
subordinated debt	2,062.6	13.1%	1,927.1	12.6%	2,062.6	13.1%	1,927.1	12.6%	2,416.4
loans and debt									
securities:									
preferred shares/income	3,076.8	11.7%	3,106.8	11.8%	3,076.8	11.7%	3,106.8	11.8%	3,414.6
subordinated certificates in									
the Fund LLC <sup>(2)</sup>	218.3	17.1%	131.5	15.1%	218.3	17.1%	131.5	15.1%	203.0
equity securities	114.3	10.3%			114.3	10.3%			0.7
equity securities	692.5		968.8		692.5		968.8		1,041.0
equity securities	1,025.1		1,100.3		1,025.1		1,100.3		1,244.7
portfolio	\$ 4,101.9		\$ 4,207.1		\$ 4,101.9		\$ 4,207.1		\$ 4,659.3
investments funded	\$ 428.9		\$ 576.1		\$ 1,020.7		\$ 1,219.9		\$ 1,828.0
at-in-kind interest									
dividends, net									
collections	\$ 11.4		\$		\$ 35.8		\$ 6.2		\$ 12.7
net collections related									
investment									
investments or sales <sup>(3)</sup>	\$ 280.6		\$ 346.2		\$ 861.5		\$ 1,063.3		\$ 1,188.2

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value. The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest (LIBOR plus 7.5%) divided by (b) total investment at value. The weighted average yields are computed as of the balance sheet date. See Results of Operations Total Interest and Related Portfolio Income below for discussion of the portfolio yield.

- (2) Investments in the preferred shares/income notes of CLOs and the subordinated certificates in the Unitranche Fund LLC earn a current return that is included in interest income in the consolidated statement of operations.
- (3) Includes collections from the sale or repayment of senior loans totaling \$101.2 million and \$76.4 million for the three months ended September 30, 2008 and 2007, respectively, \$225.4 million and \$312.6 million for the nine months ended September 30, 2008 and 2007, respectively, and \$393.4 million for the year ended December 31, 2007.

Our investment activity is primarily focused on making long-term investments in the debt and equity of primarily private middle market companies. We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains.

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

We may also invest in funds that are managed or co-managed by us that are complementary to our business of investing in middle market companies, such as the Managed Funds discussed below. Investments in funds may provide current interest and related portfolio income, including management fees.

**Investment Activity.** Investments funded and the weighted average yield on interest-bearing investments funded for the nine months ended September 30, 2008 and 2007, and for the year ended December 31, 2007, consisted of the following:

(\$ in millions)	For the Nine Months Ended September 30, 2008					
	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 155.0	7.3%	\$ 12.6	6.0%	\$ 167.6	7.2%
Senior secured loan to Ciena Capital LLC			319.0	0.0% <sup>(2)</sup>	319.0	0.0% <sup>(2)</sup>
Unitranche debt <sup>(3)</sup>	15.3	10.5%	0.5	6.6%	15.8	10.4%
Subordinated debt	243.4 <sup>(4)</sup>	12.6%	50.5	15.2%	293.9	13.0%
Total loans and debt securities	413.7	10.5%	382.6	2.2%	796.3	6.5% <sup>(7)</sup>
Preferred shares/income notes of CLOs <sup>(5)</sup>	35.6	18.6%			35.6	18.6%
Subordinated certificates in Unitranche Fund LLC	113.6	10.8%			113.6	10.8%
Equity	37.7		37.5		75.2	
Total	\$ 600.6		\$ 420.1		\$ 1,020.7	

(\$ in millions)	For the Nine Months Ended September 30, 2007					
	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 285.6	10.3%	\$ 83.0	10.7%	\$ 368.6	10.4%
Unitranche debt <sup>(3)</sup>	104.0	10.8%			104.0	10.8%
Subordinated debt	279.0	12.4%	186.3	12.1%	465.3	12.3%
Total loans and debt securities	668.6	11.3%	269.3	11.7%	937.9	11.4%
Preferred shares/income notes on CLOs <sup>(5)</sup>	42.4	17.8%			42.4	17.8%
Equity	112.8 <sup>(6)</sup>		126.8		239.6	
Total	\$ 823.8		\$ 396.1		\$ 1,219.9	



(\$ in millions)	For the Year Ended December 31, 2007					
	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 249.0	9.2%	\$ 63.1	8.8%	\$ 312.1	9.1%
Unitranche debt <sup>(3)</sup>	109.1	10.8%	74.9	13.0%	184.0	11.7%
Subordinated debt	719.4 <sup>(4)</sup>	12.8%	197.6	12.1%	917.0	12.6%
Total loans and debt securities	1,077.5	11.7%	335.6	11.7%	1,413.1	11.7%
Preferred shares/income notes of CLOs <sup>(5)</sup>	116.2	16.4%			116.2	16.4%
Subordinated certificates in Unitranche Fund LLC	0.7	12.4%			0.7	12.4%
Equity	152.0 <sup>(6)</sup>		146.0		298.0	
Total	\$ 1,346.4		\$ 481.6		\$ 1,828.0	

- (1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest or effective interest yield on accruing loans and debt securities, divided by (b) total loans and debt securities funded. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs funded. The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest (LIBOR plus 7.5%) divided by (b) total investment funded. The weighted average yield is calculated using yields as of the date an investment is funded.
- (2) The senior secured loan to Ciena acquired on September 30, 2008, was placed on non-accrual on the purchase date.
- (3) Unitranche debt is an investment that combines both senior and subordinated financing, generally in a first lien position. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt.
- (4) Subordinated debt investments for the nine months ended September 30, 2008, and year ended December 31, 2007, included \$43.8 million and \$45.3 million, respectively, in investments in the bonds of collateralized loan obligations (CLOs). Certain of these CLOs are managed by us or by Callidus Capital Corporation (Callidus), a portfolio company controlled by us. These CLOs primarily invest in senior corporate loans.
- (5) CLO equity investments included preferred shares/income notes of CLOs that primarily invest in senior corporate loans. Certain of these CLOs are managed by us or by Callidus.
- (6) Equity investments for the nine months ended September 30, 2007, and for the year ended December 31, 2007, included \$19.1 million and \$31.8 million, respectively, invested in the Allied Capital Senior Debt Fund, L.P. See **Managed Funds** below.
- (7) Excluding the senior secured loan to Ciena Capital LLC, the weighted average yield for the nine months ended September 30, 2008, on new investments was 10.9%.

For the nine months ended September 30, 2008, we made private finance investments totaling \$1,020.7 million, including \$319.0 million related to our investment in Ciena. Excluding the investment in Ciena, our focus for investments in 2008 generally has been on higher return junior capital investments. Senior loans (except for the Ciena senior secured loan) funded by us generally are funded with the intent to sell the loan or for the portfolio company to

refinance the loan at some point in the future as discussed below. Investments in unitranche debt made directly by us have been lower than historical fundings as a result of the establishment of the Unitranche Fund LLC (Unitranche Fund) in the fourth quarter of 2007. Unitranche loans sourced by us generally are referred to the Unitranche Fund. For the nine months ended September 30, 2008, we invested \$113.6 million in the Unitranche Fund, which supported its closing of investments totaling \$694.3 million. The 10.8% yield on the subordinated certificates in the Unitranche Fund at September 30, 2008 represents the contractual coupon (LIBOR plus 7.5%) earned on the subordinated certificates and excludes any return from potential future excess cash flows from portfolio earnings available to the subordinated certificate holders and from related structuring fees and management and sourcing fees. We currently estimate that the aggregate internal rate of return on our investment in the Unitranche Fund may be in the mid-teens to low twenty percent. However, there can be no assurance that such returns will be achieved. See Managed Funds Unitranche Fund LLC below.



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

We may underwrite or arrange senior loans related to our portfolio investments or for other companies that are not in our portfolio. When we underwrite or arrange senior loans, we may earn a fee for such activities. Senior loans underwritten or arranged by us may be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, or funds managed by Callidus or by us, including the Allied Capital Senior Debt Fund, L.P., Knightsbridge CLO 2007-1 Ltd. and Knightsbridge CLO 2008-1 Ltd. (discussed below). After completion of loan sales, we may retain a position in these senior loans. We generally earn a fee on the senior loans we underwrite or arrange whether or not we fund the underwritten commitment. In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Principal collections include repayments of senior debt funded by us that was subsequently sold by us or refinanced or repaid by the portfolio companies.

We are currently focused on selling or encouraging the recapitalization or refinancing of some of our lower yielding debt investments. We may offer to sell loans or debt securities to one or more of our Managed Funds. See Managed Funds below. Principal collections related to private finance investment repayments or sales were \$861.5 million for the nine months ended September 30, 2008, which included \$186.2 million sold to Managed Funds.

**Outstanding Investment Commitments.** At September 30, 2008, we had outstanding private finance investment commitments as follows:

(\$ in millions)	Companies		Companies		Total
	More Than 25% Owned <sup>(1)</sup>	Companies 5% to 25% Owned	Less Than 5% Owned		
Senior loans	\$ 6.7	\$ 11.4	\$ 112.4	\$ 130.5 <sup>(2)</sup>	
Unitranche debt	3.0		36.3	39.3	
Subordinated debt	26.5	4.3	6.1	36.9	
Total loans and debt securities	36.2	15.7	154.8	206.7	
Unitranche Fund <sup>(3)</sup>	399.6			399.6	
Equity securities	78.1	10.5	42.1	130.7 <sup>(4)</sup>	
Total	\$ 513.9	\$ 26.2	\$ 196.9	\$ 737.0	

(1) Includes various commitments to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, which owns 100% of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized loan obligations (CLOs), collateralized debt obligations (CDOs), and other related investments, as follows:

(\$ in millions)	Committed Amount	Amount Drawn	Amount Available to be Drawn
Revolving line of credit for working capital	\$ 4.0	\$ 1.8	\$ 2.2
Subordinated debt to support warehouse facilities & warehousing activities <sup>(*)</sup>	18.0	0.5	17.5
Total	\$ 22.0	\$ 2.3	\$ 19.7

(\*) Callidus has a synthetic credit facility with a third party for up to approximately \$0.9 million. We have agreed to designate our subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support this facility.

(2) Includes \$145.7 million in the form of revolving senior debt facilities to 31 companies.

(3) Represents our commitment to the Unitranche Fund LLC (see *Managed Funds* Unitranche Fund LLC ). Outstanding commitments to the Unitranche Fund LLC will be funded as investments are funded by the Unitranche Fund. Investments made by the Unitranche Fund must be approved by the investment committee of the Unitranche Fund, which includes a representative from us and GE, and the level of investments made by the Unitranche Fund will be dependent on market conditions and the Unitranche Fund's ability to identify attractive investment opportunities during the investment period.

(4)

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Includes \$51.5 million to 12 private equity and venture capital funds, including \$3.5 million in co-investment commitments to one private equity fund.

In addition to these outstanding investment commitments at September 30, 2008, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees. See Financial Condition, Liquidity and Capital Resources.

**Investments in Collateralized Loan Obligations and Collateralized Debt Obligations (CLO/CDO Assets).** At both September 30, 2008, and December 31, 2007, we had investments in CLO issuances and a CDO bond, which totaled as follows:

(\$ in millions)	Cost	2008 Value	Yield <sup>(1)</sup>	Cost	2007 Value	Yield <sup>(1)</sup>
CLO/CDO bonds <sup>(2)</sup>	\$ 127.2	\$ 115.8	14.0%	\$ 90.7	\$ 89.9	13.3%
Preferred shares/income notes of CLOs	247.2	218.3	17.1%	218.3	203.0	14.6%
Total	\$ 374.4	\$ 334.1		\$ 309.0	\$ 292.9	
Percentage of total assets		7.2%			5.6%	

<sup>(1)</sup> The weighted average yield is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective interest yield on the preferred shares/income notes, divided by (b) CLO/CDO Assets at value.

The market yield used in the valuation of the CLO/CDO Assets may be different than the yields shown above. See discussion below.

<sup>(2)</sup> Included in private finance subordinated debt.

The CLO and CDO issuances in which we have invested are primarily invested in senior corporate loans. Certain of these funds are managed by Callidus Capital, our portfolio company, and certain of these funds are managed by us through a wholly-owned subsidiary. See also Note 3, Portfolio from our Notes to the Consolidated Financial Statements included in Item 1.

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

The CLO/CDO Assets in which we have invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes will bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes. At September 30, 2008, and December 31, 2007, the face value of the CLO/CDO Assets held by us was subordinate to as much as 94% of the face value of the securities outstanding in these CLOs and CDO.

At September 30, 2008, and December 31, 2007, the underlying collateral assets of these CLO and CDO issuances, consisting primarily of senior corporate loans, were issued by 658 issuers and 671 issuers, respectively, and had balances as follows:

(\$ in millions)	2008	2007
Bonds	\$ 273.2	\$ 288.5
Syndicated loans	4,435.3	4,122.7
Cash <sup>(1)</sup>	107.8	104.4
Total underlying collateral assets <sup>(2)</sup>	\$ 4,816.3	\$ 4,515.6

(1) Includes undrawn liability amounts.

(2) At September 30, 2008, and December 31, 2007, the total face value of defaulted obligations was \$28.5 million and \$18.4 million, respectively, or approximately 0.6% and 0.4%, respectively, of the total underlying collateral assets.

Beginning in the third quarter of 2007, market yields for CLO securities increased. As the market yields for our investments in CLO preferred shares/income notes increased, the fair value of certain of our investments in these assets decreased. In the third quarter of 2008, market yields for CLO securities increased from the second quarter 2008 levels. At September 30, 2008, the market yield used to value our preferred shares/income notes was 25%, as compared to 20% to 22% at June 30, 2008. Net change in unrealized appreciation or depreciation for the three and nine months ended September 30, 2008, included a net decrease of \$21.6 million and \$24.4 million, respectively, related to our investments in CLO/CDO Assets. We received third-party valuation assistance for our investments in the CLO/CDO Assets in each quarter of 2007 and in the first three quarters of 2008. See Results of Operations Valuation Methodology Private Finance below for further discussion of the third-party valuation assistance we received.

Subsequent to September 30, 2008, the debt capital markets have continued to show significant volatility and yield spreads have further widened. With respect to the CLO market, investor demand for pricing has continued to increase. As a result, we believe that the market yields for our investments in

CLOs may have increased subsequent to September 30, 2008, and as a result, the fair value of our investments may have decreased.

**Ciena Capital LLC.** Ciena Capital LLC (Ciena) has provided loans to commercial real estate owners and operators. Ciena has been a participant in the SBA's 7(a) Guaranteed Loan Program, and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). Ciena remains subject to SBA rules and regulations. Ciena is headquartered in New York, NY.

At both September 30, 2008, and December 31, 2007, we held all of the Class A equity interests, all of the Class B equity interests and 94.9% of the Class C equity interests. At September 30, 2008, we also held \$319 million of the \$324 million of senior secured loans to Ciena.

At September 30, 2008, our investment in Ciena totaled \$646.7 million at cost and \$180.2 at value, after the effect of unrealized depreciation of \$466.5 million. Other assets includes amounts receivable from or related to Ciena totaling \$15.4 million, which have a value of \$2.2 million at September 30, 2008. At December 31, 2007, our investment in Ciena totaled \$327.8 million at cost and \$68.6 million at value, after the effect of unrealized depreciation of \$259.2 million.

Net change in unrealized appreciation or depreciation included depreciation related to our investment in Ciena of \$151.9 million and \$220.5 million for the three and nine months ended September 30, 2008, respectively. Net change in unrealized appreciation or depreciation included depreciation related to our investment in Ciena of \$84.1 million and \$103.2 million for the three and nine months ended September 30, 2007, respectively.

Ciena has continued to experience significant deterioration in the value of its assets as a result of a continued increase in the uncertainty in the financial markets, decreasing bid prices and a further reduction in the number of loan buyers. Ciena, therefore, believes that the value of its assets is insufficient to cover all of its liabilities and it is insolvent. On September 30, 2008, Ciena voluntarily filed for bankruptcy protection under Chapter 11 of Title 11 of the United States Code (the Bankruptcy Code) in the United States Bankruptcy Court for the Southern District of New York (the Court).

Ciena intends to continue to operate its servicing business and manage its assets as a debtor-in-possession under the jurisdiction of the Court and in accordance with the applicable provisions of the Bankruptcy Code and the orders of the Court. Ciena believes that by filing for bankruptcy protection it will be able to proceed with an orderly sale of its assets over time in more favorable market conditions in the future and thereby maximize the value of its assets and reduce costs in order to repay its debts.

As a result of Ciena's decision to file for bankruptcy protection, our unconditional guaranty of the obligations outstanding under Ciena's revolving credit facility became due, and, in lieu of paying under our guaranty, we purchased the positions of the senior lenders under Ciena's revolving credit facility except for a \$5 million position held by Citibank, N.A. We paid \$325.4 million to fund the purchase, which included \$319.0 million of principal, \$1.4 million of interest, and \$5.0 million of other payments related to the revolving credit facility and the bankruptcy. On October 6, 2008, \$6.4 million of the purchase was funded. As of September 30, 2008, the senior secured loan had a cost basis of \$319.0 million and a value of \$180.2 million. We continue to guarantee the remaining principal balance of \$5 million, plus related interest, fees and expenses payable to Citibank. In connection with our continuing guaranty of the amounts held by Citibank, we have agreed with Citibank that the amounts owing to Citibank under the Ciena revolving credit facility will be paid before any of the secured obligations of Ciena now owed to us.

Total interest and related portfolio income earned from our investment in Ciena for the nine months ended September 30, 2008 and 2007, was as follows:

(\$ in millions)	2008	2007
Interest income on Class A equity interests	\$	\$
Fees and other income		4.1
Total interest and related portfolio income	\$	\$ 4.1

In the fourth quarter of 2006, we placed our investment in Ciena's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from our investment in Ciena for the nine months ended September 30, 2008 and 2007. In consideration for providing a guaranty on Ciena's revolving credit facility and standby letters of credit, we earned fees of \$1.3 million and \$4.1 million for the three and nine months ended September 30, 2007, respectively, which were included in fees and other income. These fees were \$5.4 million for the year ended December 31, 2007. Ciena has not yet paid the \$5.4 million in such fees earned by us during 2007, and at September 30, 2008, and December 31, 2007, such fees were included as a receivable in other assets with a carrying amount, net of depreciation, of zero and \$5.4 million, respectively. We considered this outstanding receivable in our valuation of Ciena at September 30, 2008, and December 31, 2007. We did not accrue the fees earned from Ciena for providing the guaranty and standby letters of credit for the three and nine months ended September 30, 2008. Subsequent to September 30, 2008, we will not earn any fees from Ciena for continuing to provide the guaranty or letters of credit.

At September 30, 2008, we had standby letters of credit issued under our line of credit of \$102.6 million in connection with term securitization transactions completed by Ciena. We considered these standby letters of credit in our valuation of Ciena at September 30, 2008.

Ciena maintains two non-recourse securitization warehouse facilities, both of which have matured. In order to pay down debt under the conventional loan warehouse facility, Ciena is in the process of selling loans on behalf of the conventional loan warehouse facility providers. Ciena is also working with the providers of the SBA loan warehouse facility with regard to the prepayment of that facility. We have issued performance guaranties whereby we agreed to indemnify the warehouse providers for any damages, losses, liabilities and related costs and expenses that they may incur as a result of Ciena's failure to perform any of its obligations as loan originator, loan seller or loan servicer under the warehouse securitizations.

The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA-guaranteed loans issued by Ciena. Specifically, on or about January 9, 2007, Ciena became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleged that a former Ciena employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. We understand that Ciena is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. On October 1, 2007, the former Ciena employee pled guilty to one count of conspiracy to fraudulently originate SBA-guaranteed loans and one count of making a false statement before a grand jury.

On March 6, 2007, Ciena entered into an agreement with the SBA. According to the agreement, Ciena would remain a preferred lender in the SBA 7(a) Guaranteed Loan Program and would retain the ability to sell loans into the secondary market. As part of this agreement, Ciena immediately paid approximately \$10 million to the SBA to cover

amounts paid by the SBA with respect to some of the SBA-guaranteed loans that have been the subject of the charges by the U.S. Attorney's Office for the Eastern District of Michigan against Mr. Harrington. Ciena also entered into an escrow agreement with the SBA pursuant to which Ciena deposited \$10 million with the escrow agent for any additional payments Ciena may be obligated to pay to the SBA in the future under the agreement. The agreement provided that, during its term, an independent third party selected by the SBA would review loans originated by Ciena before they could be sold into the



secondary market and would review defaulted loans repurchased from the secondary market by Ciena before the SBA would reimburse Ciena. Ciena and the SBA have disagreed regarding the operation of the agreement, particularly the SBA's repurchase obligations for defaulted loans subject to third party review. Further, Ciena's position is that the agreement terminated on September 6, 2008.

Ciena is also subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of Ciena's lending practices under the Business and Industry Loan (B&I) program. The OIG and the U.S. Department of Justice are also conducting a civil investigation of Ciena's lending practices in various jurisdictions. We are unable to predict the outcome of these inquiries, and it is possible that third parties could try to seek to impose liability against us in connection with certain defaulted loans in Ciena's portfolio. These investigations, audits and reviews are ongoing.

On or about January 16, 2007, Ciena (f/k/a Business Loan Express, LLC) and its subsidiary Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC). The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans. On December 18, 2007, the United States District Court for the Northern District of Georgia dismissed all claims in this matter. The plaintiffs appealed the dismissal. Ciena's bankruptcy filing automatically stayed the appeal; however, pursuant to Ciena's request, the Court lifted the automatic stay to permit the appeal to proceed. Ciena and BLC's request to have oral argument on the appeal placed back on the appellate calendar is currently pending before the U.S. Court of Appeals for the 11th Circuit.

These investigations, audits, reviews, and litigation have had and may continue to have a material adverse impact on Ciena and, as a result, could continue to negatively affect our financial results. We have considered Ciena's voluntary filing for bankruptcy protection, current regulatory issues, ongoing investigations and litigation in performing the valuation of Ciena at September 30, 2008.

**Mercury Air Centers, Inc.** In April 2004, we completed the purchase of a majority ownership in Mercury. At June 30, 2007, our investment in Mercury totaled \$85.3 million at cost and \$320.1 million at value, which included unrealized appreciation of \$234.8 million. In August 2007, we completed the sale of our majority equity interest in Mercury. For the year ended December 31, 2007, we realized a gain of \$262.4 million, subject to post-closing adjustments. For the nine months ended September 30, 2008, we realized an additional gain of \$3.3 million resulting from these post-closing adjustments. In addition, we were repaid approximately \$51 million of subordinated debt outstanding to Mercury at closing.

Mercury owned and operated fixed base operations generally under long-term leases from local airport authorities, which consisted of terminal and hangar complexes that serviced the needs of the general aviation community. Mercury was headquartered in Richmond Heights, OH.

Total interest and related portfolio income earned from our investment in Mercury for the nine months ended September 30, 2007, was as follows:

(\$ in millions)	2007
Interest income	\$ 5.1
Fees and other income	0.2

Total interest and related portfolio income

\$ 5.3

Net change in unrealized appreciation or depreciation for the nine months ended September 30, 2007, included an increase in unrealized appreciation totaling \$74.9 million for the first half of 2007 and

the reversal of \$234.8 million associated with the sale of our majority equity interest in the third quarter of 2007.

### Commercial Real Estate Finance

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three and nine months ended September 30, 2008 and 2007, and at and for the year ended December 31, 2007, were as follows:

(\$ in millions)	At and for the Three Months Ended September 30,				At and for the Nine Months Ended September 30,				At and for the Year Ended December 31,	
	2008		2007		2008		2007		2007	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Portfolio at value:										
Commercial mortgage loans	\$ 51.4	7.4%	\$ 64.2	6.4%	\$ 51.4	7.4%	\$ 64.2	6.4%	\$ 65.4	6.8%
Real estate owned	24.0		22.0		24.0		22.0		21.3	
Equity interests	31.2		33.5		31.2		33.5		34.5	
Total portfolio	\$ 106.6		\$ 119.7		\$ 106.6		\$ 119.7		\$ 121.2	
Investments funded	\$ 4.9		\$ 1.4		\$ 7.1		\$ 16.8		\$ 18.0	
Payment-in-kind interest, net of cash collections	\$		\$ (1.2)		\$ 0.1		\$ (0.7)		\$ (0.7)	
Principal collections related to investment repayments or sales	\$		\$ 4.9		\$ 16.7		\$ 23.2		\$ 23.4	

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

At September 30, 2008, we had outstanding funding commitments related to the commercial real estate portfolio of \$38.5 million, and commitments in the form of standby letters of credit and guarantees related to equity interests of \$7.5 million.

### Managed Funds

We manage funds that invest in the debt and equity of primarily private middle market companies in a variety of industries (together, the Managed Funds). As of September 30, 2008, the funds that we manage had total committed capital of \$4.9 billion and total assets of \$2.0 billion. During 2007, we established the Unitranche Fund LLC and the Allied Capital Senior Debt Fund, L.P. In the first quarter of 2008, we formed the AGILE Fund I, LLC and assumed the management of Knightsbridge CLO 2007-1 Ltd. In the second quarter of 2008, we formed Knightsbridge

CLO 2008-1 Ltd. Our responsibilities to the Managed Funds may include origination, underwriting, and portfolio monitoring and development services consistent with the activities that we perform for our portfolio. Each of the Managed Funds may separately invest in the debt or equity of a company depending on each fund's investment strategy and other factors. Our portfolio may include debt or equity investments issued by the same portfolio company as investments held by one or more Managed Funds, and these investments may be senior, pari passu or junior to the debt and equity investments held by the Managed Funds. We may or may not participate in investments made by investment funds managed by us or one of our affiliates. See Risk Factors There are potential conflicts of interest between us and the funds managed by us under Item 1A.

***Unitranche Fund LLC.*** In December 2007, we formed the Unitranche Fund LLC (Unitranche Fund), which we co-manage with an affiliate of General Electric Capital Corporation (GE). The Unitranche Fund is a private fund that generally focuses on making first lien unitranche loans to middle market companies with EBITDA of at least \$15 million. The Unitranche Fund may invest up to \$270 million in a single borrower. For financing needs greater than \$270 million, we and GE may jointly

underwrite additional financing for a total unitranche financing of up to \$500 million. Allied Capital, GE and the Unitranche Fund may co-invest in a single borrower, with the Unitranche Fund holding at least a majority of the issuance. GE has committed \$3.075 billion to the Unitranche Fund consisting of \$3.0 billion of senior notes and \$0.075 billion of subordinated certificates and we have committed \$525.0 million of subordinated certificates. The Unitranche Fund is capitalized as transactions are completed. Transactions must be approved by the investment committee of the Unitranche Fund, which includes a representative from us and GE. At September 30, 2008, the Unitranche Fund had total assets of approximately \$702 million, and our investment in the Unitranche Fund totaled \$114.3 million at cost and at value. Given current market conditions, we expect a decrease in the lending activities of the Unitranche Fund.

The Unitranche Fund is governed by an investment committee with equal representation from Allied Capital and GE and both Allied Capital and GE provide origination, underwriting and portfolio management services to the Unitranche Fund and its affiliates. We earn a management and sourcing fee totaling 0.375% per annum of managed assets. In addition to the management and sourcing fee, we earn structuring fees on investments made by the Unitranche Fund. See Results of Operations Total Interest and Related Portfolio Income below.

**Allied Capital Senior Debt Fund, L.P.** The Allied Capital Senior Debt Fund, L.P. (ACSDF) is a private fund that generally invests in senior, unitranche and second lien debt. ACSDF has closed on \$125 million in equity capital commitments and had total assets of approximately \$424 million at September 30, 2008. AC Corp, our wholly-owned subsidiary, is the investment manager and Callidus acts as special manager to ACSDF. A subsidiary of AC Corp is the general partner of ACSDF, and AC Corp serves as collateral manager to a warehouse financing vehicle associated with ACSDF. AC Corp will earn a management fee of up to 2% per annum of the net asset value of ACSDF and will pay Callidus 25% of that management fee to compensate Callidus for its role as special manager.

We are a special limited partner in ACSDF, which is a portfolio investment, and have committed and funded \$31.8 million to ACSDF. At September 30, 2008, our investment in ACSDF totaled \$31.8 million at cost and \$32.0 million at value. As a special limited partner, we will earn an incentive allocation to the extent of 20% of ACSDF's annual net income earned in excess of a specified minimum return, subject to certain performance benchmarks. The value of our investment in ACSDF is based on the net asset value of ACSDF, which reflects the capital invested plus our allocation of the net earnings of ACSDF, including the incentive allocation.

We may offer to sell loans to ACSDF or the warehouse financing vehicle. ACSDF or the warehouse financing vehicle may purchase loans from us. In connection with ACSDF's formation in June 2007 and during the second half of 2007, we sold \$224.2 million of seasoned assets with a weighted average yield of 10.0% to a warehouse financing vehicle associated with ACSDF. For the nine months ended September 30, 2008, we sold \$72.3 million of seasoned assets with a weighted average yield of 9.2% to the warehouse financing vehicle. ACSDF also purchases loans from other third parties. Due to the lack of liquidity in the securitization markets, ACSDF is not currently purchasing loans and at September 30, 2008, the ACSDF warehouse financing vehicle has completed its reinvestment period and any investment repayments are used to repay outstanding balances under the warehouse facility.

**Knightsbridge CLO 2007-1 Ltd.** On March 31, 2008, we assumed, through a wholly-owned subsidiary, the management of Knightsbridge CLO 2007-1 Ltd. (Knightsbridge 2007), which invests primarily in middle market senior loans.

At September 30, 2008, Knightsbridge 2007 had total assets of approximately \$500 million and our investment in this CLO totaled \$59.4 million at cost and \$52.1 million at value. We earn a management fee of up to 0.6% per annum of the assets of Knightsbridge 2007, up to 7.5% of which is paid to an unaffiliated third party in its capacity as special equity holder. In addition, Callidus assists us in the



management of Knightsbridge 2007 and we pay Callidus a portion of the management fee earned for this assistance.

We may offer to sell loans to Knightsbridge 2007 and Knightsbridge 2007 may purchase loans from us or from other third parties. During the three and nine months ended September 30, 2008, we sold loans totaling \$17.3 million and \$84.8 million, respectively, with a weighted average yield of 9.0% and 8.5%, respectively, to Knightsbridge 2007.

**Knightsbridge CLO 2008-1 Ltd.** In June 2008, we formed Knightsbridge 2008-1 Ltd. (Knightsbridge 2008). Upon its formation, Knightsbridge 2008 completed its initial purchase of assets from a third party. We manage Knightsbridge 2008 through a wholly-owned subsidiary. Knightsbridge 2008 invests primarily in middle market senior loans.

At September 30, 2008, Knightsbridge 2008 had total assets of approximately \$241 million and our investment in this CLO totaled \$51.8 million at cost and at value. We earn a management fee of up to 0.6% per annum of the assets of Knightsbridge 2008, up to 10% of which is paid to an unaffiliated third party in its capacity as special equity holder. In addition, Callidus assists us in the management of Knightsbridge 2008 and we pay Callidus a portion of the management fee earned for this assistance.

We may offer to sell loans to Knightsbridge 2008 and Knightsbridge 2008 may purchase loans from us or from other third parties. During both the three and nine months ended September 30, 2008, we sold loans totaling \$29.1 million with a weighted average yield of 9.9% to Knightsbridge 2008.

**AGILE Fund I, LLC.** In January 2008, we entered into an investment agreement with the Goldman Sachs Private Equity Group, part of Goldman Sachs Asset Management (Goldman Sachs).

As part of the investment agreement, we agreed to sell a pro-rata strip of private equity and debt investments to AGILE Fund I, LLC (AGILE), a private fund in which a fund managed by Goldman Sachs owns substantially all of the interests, for a total transaction value of \$167 million. The sales of the assets closed in the first quarter of 2008. The sale to AGILE included 13.7% of our equity investments in 23 of our buyout portfolio companies and 36 of our minority equity portfolio companies for a total purchase price of \$104 million, which resulted in a net realized gain of \$8.3 million (subsequent to post-closing adjustments) and dividend income of \$5.4 million. In addition, we sold approximately \$63 million in debt investments, which represented 7.3% of our unitranche, second lien and subordinated debt investments in the buyout investments included in the equity sale. AGILE generally has the right to co-invest in its proportional share of any future follow-on investment opportunities presented by the companies in its portfolio.

We are the managing member of AGILE, and are entitled to an incentive allocation subject to certain performance benchmarks. We own the remaining interests in AGILE not held by Goldman Sachs. At September 30, 2008, AGILE had total assets of approximately \$150 million and our investment in AGILE totaled \$0.8 million at cost and at value.

In addition, pursuant to the investment agreement Goldman Sachs has committed to invest at least \$125 million in future investment vehicles managed by us and will have future opportunities to invest in our affiliates, or vehicles managed by them, and to coinvest alongside us in the future, subject to various terms and conditions.

As part of this transaction, we sold ten venture capital and private equity limited partnership investments for approximately \$28 million to a fund managed by Goldman Sachs, which assumed the \$5.3 million of unfunded commitments related to these limited partnership investments. The sales of these limited partnership investments closed in the first half of 2008, and resulted in a net realized loss of \$7.0 million (subsequent to post-closing adjustments) for the nine months ended September 30, 2008.





**PORTFOLIO ASSET QUALITY**

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

At September 30, 2008, and December 31, 2007, our portfolio was graded as follows:

Grade (\$ in millions)	2008		2007	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
1	\$ 817.2	19.4%	\$ 1,539.6	32.2%
2	2,886.9	68.6	2,915.7	61.0
3	125.3	3.0	122.5	2.6
4	108.7	2.6	157.2	3.3
5	270.4	6.4	45.5	0.9
	\$ 4,208.5	100.0%	\$ 4,780.5	100.0%

The amount of the portfolio in each grading category may vary substantially from period to period resulting primarily from changes in the composition of the portfolio as a result of new investment, repayment, and exit activity, changes in the grade of investments to reflect our expectation of performance, and changes in investment values. We expect that a number of investments will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number and amount of investments included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with portfolio companies in order to recover the maximum amount of our investment.

Total Grade 4 and 5 portfolio assets were \$379.1 million and \$202.7 million, respectively, or were 9.0% and 4.2%, respectively, of the total portfolio value at September 30, 2008, and December 31, 2007. Grade 4 and 5 assets include loans, debt securities, and equity securities. The increase in total Grade 4 and 5 portfolio assets from December 31, 2007, to September 30, 2008, was primarily related to the acquisition of the Ciena senior secured loan in the third quarter of 2008, which was valued at \$180.2 million at September 30, 2008, and was classified as Grade 5. At September 30, 2008, and December 31, 2007, our Class A equity interests in Ciena, valued at zero and \$68.6 million, respectively, were classified as Grade 5 and Grade 4, respectively, and our Class B and Class C equity interests, which had no value, were classified as Grade 5 at both periods. See Private Finance Ciena Capital LLC above.

**Loans and Debt Securities on Non-Accrual Status.** In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. In addition, interest may not accrue on loans to portfolio companies that are more than 50% owned by us

depending on such company's capital requirements. To the extent interest payments are received on a loan that is not accruing interest, we may use such payments to reduce our cost basis in the investment in lieu of recognizing interest income.

At September 30, 2008, and December 31, 2007, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

(\$ in millions)	2008	2007
Loans and debt securities in workout status (classified as Grade 4 or 5) <sup>(1)</sup>		
Private finance		
Companies more than 25% owned	\$ 197.0	\$114.1
Companies 5% to 25% owned	0.8	11.7
Companies less than 5% owned	136.6	23.8
Commercial real estate finance	7.6	12.4
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	34.5	21.4
Companies 5% to 25% owned	6.6	13.4
Companies less than 5% owned		13.3
Commercial real estate finance		1.9
Total	\$ 383.1	\$212.0
Percentage of total portfolio	9.1%	4.4%

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

Private finance non-accruals included our senior secured debt and Class A equity interests in Ciena, which were \$180.2 million or 4.3% and \$68.6 million or 1.4% of the total portfolio at value at September 30, 2008, and December 31, 2007, respectively. The increase in loans and debt securities not accruing interest was primarily related to the acquisition of the Ciena senior secured loan in the third quarter of 2008, which was placed on non-accrual status upon its purchase. See Private Finance Ciena Capital LLC above.

**Loans and Debt Securities Over 90 Days Delinquent.** Loans and debt securities greater than 90 days delinquent at value at September 30, 2008, and December 31, 2007, were as follows:

(\$ in millions)	2008	2007
Private finance	\$20.0	\$139.9
Commercial mortgage loans	1.4	9.2
Total	\$21.4	\$149.1
Percentage of total portfolio	0.5%	3.1%

Loans and debt securities over 90 days delinquent include our investment in the Class A equity interests of Ciena, which became over 90 days delinquent in the first quarter of 2007. At September 30, 2008, and December 31, 2007, the value of the Class A equity interests were zero and \$68.6 million or 1.4% of the total portfolio at value, respectively. These equity interests were placed on non-accrual during the fourth quarter of 2006. See Private

Finance, Ciena Capital, LLC above.

The amount of the portfolio that is on non-accrual status or greater than 90 days delinquent may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$21.4 million and \$149.1 million at September 30, 2008, and December 31, 2007, respectively.

The senior secured loan to Ciena that was purchased on September 30, 2008, was not delinquent on the date of purchase. However, this loan will become delinquent as no payments will be made to us while Ciena is under bankruptcy reorganization. See Private Finance, Ciena Capital, LLC above.

## **PORTFOLIO RETURNS**

Since our merger on December 31, 1997, through September 30, 2008, our combined aggregate cash flow internal rate of return, or IRR, has been approximately 21% for private finance and real estate-related CMBS/CDO investments exited during this period. The IRR is calculated using the aggregate portfolio cash flow for all investments exited over this period and does not reflect any unrealized appreciation or depreciation on such investments prior to exit. For investments exited during this period, we invested capital totaling \$5.1 billion. The weighted average holding period of these investments was 40 months. Investments are considered to be exited when the original investment objective has been achieved through the receipt of cash and/or non-cash consideration upon the repayment of our debt investment or sale of an equity investment, or through the determination that no further consideration was collectible and, thus, a loss may have been realized. The aggregate cash flow IRR for private finance investments was approximately 20% and for CMBS/CDO investments was approximately 24% for the same period. The weighted average holding period of the private finance and CMBS/CDO investments was 50 months and 22 months, respectively, for the same period. These IRR results represent historical results. Historical results are not necessarily indicative of future results.

## **OTHER ASSETS AND OTHER LIABILITIES**

Other assets is primarily composed of fixed assets, prepaid expenses, deferred financing and offering costs, and accounts receivable, which includes amounts received in connection with the sale of portfolio companies, including amounts held in escrow, and other receivables from portfolio companies. At September 30, 2008, and December 31, 2007, other assets totaled \$131.9 million and \$157.9 million, respectively. The decrease in other assets since year end 2007 was primarily the result of the March 2008 distribution of the assets held in deferred compensation trusts, which totaled \$21.1 million at December 31, 2007.

Accounts payable and other liabilities is primarily composed of the liabilities related to accrued interest, bonus and taxes, including excise tax. At September 30, 2008, and December 31, 2007, accounts payable and other liabilities totaled \$81.3 million and \$153.3 million, respectively. The decrease in accounts payable and other liabilities since year end 2007 was in part the result of the termination of the deferred compensation plans in March 2008, the liability for which totaled \$52.5 million at December 31, 2007. In addition, accounts payable and other liabilities at December 31, 2007, were reduced by the payment of liabilities related to accrued 2007 bonuses of \$40.1 million and excise tax of \$16.0 million, offset by an increase in liabilities in 2008 related to accrued bonuses and excise tax totaling approximately \$15.6 million. Accrued interest payable fluctuates from period to period depending on the amount of debt outstanding and the contractual payment dates of the interest on such debt.

**RESULTS OF OPERATIONS****Comparison of the Three and Nine Months Ended September 30, 2008 and 2007**

The following table summarizes our operating results for the three and nine months ended September 30, 2008 and 2007.

Results, except per share amounts)	For the Three Months Ended September 30,				For the Nine Months Ended September 30,		
	2008 (unaudited)	2007	Change	Percent Change	2008 (unaudited)	2007	Change
Related Portfolio Income:							
Dividends	\$ 112,207	\$ 105,669	\$ 6,538	6%	\$ 366,079	\$ 310,466	\$ 55,613
Other income	8,455	12,699	(4,244)	(33)%	34,105	33,530	575
Net income and related portfolio income	120,662	118,368	2,294	2%	400,184	343,996	56,188
Operating expenses:							
Cost of sales	35,949	33,744	2,205	7%	109,974	98,368	11,606
Research and development	21,443	26,306	(4,863)	(18)%	57,439	76,845	(19,406)
Stock options	1,477	18,312	(16,835)	(92)%	9,531	31,492	(21,961)
Other	14,138	10,496	3,642	35%	36,100	38,225	(2,125)
Operating expenses	73,007	88,858	(15,851)	(18)%	213,044	244,930	(31,886)
Operating income before income taxes	47,655	29,510	18,145	61%	187,140	99,066	88,074
Income tax expense, including excise tax	2,060	11,192	(9,132)	(82)%	8,141	16,073	(7,932)
Operating income	45,595	18,318	27,277	149%	178,999	82,993	96,006
Other Income and Unrealized Gains (Losses):							
Net gains	62,042	212,370	(150,328)	*	47,330	314,915	(267,585)
Change in unrealized appreciation or depreciation	(425,899)	(327,156)	(98,743)	*	(687,506)	(272,132)	(415,374)
Other gains (losses)	(363,857)	(114,786)	(249,071)	*	(640,176)	42,783	(682,959)
Other income (loss)	\$ (318,262)	\$ (96,468)	\$ (221,794)	(230)%	\$ (461,177)	\$ 125,776	\$ (586,953)
Operating income (loss) per common share	\$ (1.78)	\$ (0.63)	\$ (1.15)	(183)%	\$ (2.70)	\$ 0.81	\$ (3.51)
Average common shares							
Basic	178,692	154,025	24,667	16%	171,084	154,708	16,376
Diluted							

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



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

**Interest and Dividends.** Interest and dividend income for the three and nine months ended September 30, 2008 and 2007, was composed of the following:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Interest				
Private finance loans and debt securities	\$ 95.8	\$ 94.1	\$ 311.0	\$ 280.4
Preferred shares/income notes of CLOs	9.4	4.3	24.8	11.5
Subordinated certificates in Unitranche Fund LLC	2.9		4.5	
Commercial mortgage loans	0.9	1.1	3.1	4.9
Cash, U.S. Treasury bills, money market and other securities	1.2	5.6	3.6	11.8
Total interest	110.2	105.1	347.0	308.6
Dividends	2.0	0.6	19.1	1.9
Total interest and dividends	\$ 112.2	\$ 105.7	\$ 366.1	\$ 310.5

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period and the weighted average yield of these investments. The interest-bearing investments in the portfolio at value and the yield on these investments at September 30, 2008 and 2007, were as follows:

(\$ in millions)	2008		2007	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Private finance:				
Loans and debt securities:				
Senior loans	\$ 434.9	4.2%	\$ 481.6	9.3%
Unitranche debt	579.3	12.0%	698.1	11.5%
Subordinated debt	2,062.6	13.1%	1,927.1	12.6%
Equity securities:				
Preferred shares/ income notes of CLOs	218.3	17.1%	131.5	15.1%
Subordinated certificates in Unitranche Fund LLC	114.3	10.3%		
Commercial real estate:				
Commercial mortgage loans	51.4	7.4%	64.2	6.4%
Total interest-bearing investments	\$ 3,460.8	11.9%	\$ 3,302.5	11.9%



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

The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value. The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest (LIBOR plus 7.5%) divided by (b) total investment at value. This yield excludes any return from the potential future excess cash flows from portfolio earnings available to the subordinated certificate holders and from related structuring fees and management and sourcing fees. See Fees and Other Income below. The weighted average yields are computed as of the balance sheet date.

Our interest income has increased over the prior year periods primarily as a result of the growth in the interest-bearing portfolio and improved overall yield on these investments during the period. The yield on the interest-bearing investments at September 30, 2008, excluding the senior secured loan to Ciena acquired on September 30, 2008, was 12.5%. Interest-bearing investments represented 82% as compared to 76% of the total portfolio at value at September 30, 2008 and 2007, respectively. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments, the yield on interest-bearing investments funded, the yield on amounts repaid, the amount of interest-bearing investments for which interest is not accruing, changes in value of interest-bearing investments and the mix of interest-bearing investments in the portfolio, including the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period.

Interest income also includes the effective interest yield on our investments in the preferred shares/income notes of CLOs. Interest income from these investments has increased period over period primarily as a result of the growth in these assets. The weighted average yield on the preferred shares/income notes of the CLOs at September 30, 2008, was 17.1%, as compared to 15.1% at September 30, 2007.

The value and weighted average yield of the cash and money market and other securities was \$215.3 million and 0.8%, respectively, at September 30, 2008, and \$305.9 million and 5.2%, respectively, at September 30, 2007. As the capital markets became increasingly uncertain in the first quarter of 2008, we moved our investments in money market securities into cash and very short-term treasuries. The current turmoil and uncertainty in the capital markets have resulted in minimal yields on these types of investments, which has driven the decrease in investment yield. See *Financial Condition, Liquidity and Capital Resources* below.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income for the nine months ended September 30, 2008, was \$19.1 million as compared to \$1.9 million for the nine months ended September 30, 2007. The increase period over period was primarily a result of a \$7.1 million dividend received in the first quarter of 2008 in connection with the recapitalization of Norwesco, Inc., a portfolio company, and \$5.4 million of dividends received in connection with the sale to AGILE Fund I, LLC during the first quarter of 2008. See *Portfolio and Investment Activity* *Managed Funds* above. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests.

*Fees and Other Income.* Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management and consulting services to portfolio companies and Managed Funds, commitments, guarantees, and other services and loan prepayment premiums. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes, but is not limited to, management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters.

Fees and other income for the three and nine months ended September 30, 2008 and 2007, included fees relating to the following:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Structuring and diligence	\$ 2.3	\$7.3	\$ 15.8	\$15.3
Management, consulting and other services provided to portfolio companies	2.9	3.2	8.9	7.3
Commitment, guaranty and other fees from portfolio companies <sup>(1)</sup>	1.1	2.0	4.7	7.0
Fund management fees <sup>(2)</sup>	1.8		4.0	
Loan prepayment premiums	0.3	0.1	0.6	3.7
Other income	0.1	0.1	0.1	0.2
Total fees and other income	\$ 8.5	\$12.7	\$ 34.1	\$33.5

(1) Commitment, guaranty and other fees from portfolio companies for the three and nine months ended September 30, 2007, included guaranty and other fees from Ciena of \$1.3 million and \$4.1 million, respectively. See Private Finance, Ciena Capital, LLC above.

(2) See Portfolio and Investment Activity Managed Funds above.

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level of investment activity and types of services provided and the level of assets in Managed Funds for which we earn management or other fees. Given our outlook for future investment activity for our balance sheet as well as for certain Managed Funds, we expect that fee income in the future will reflect lower new investment levels. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Structuring and diligence fees for the three and nine months ended September 30, 2008, included \$2.1 million and \$9.3 million, respectively, earned by us in connection with investments made by the Unitranche Fund, LLC. See Managed Funds above. The remainder of the structuring and diligence fees primarily relate to the level of new investment originations, which were lower in 2008 than 2007. Private finance investments funded were \$428.9 million and \$1.0 billion for the three and nine months ended September 30, 2008, respectively, as compared to \$576.1 million and \$1.2 billion for the three and nine months ended September 30, 2007, respectively.

While the scheduled maturities of private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

See Portfolio and Investment Activity above for further information regarding our total interest and related portfolio income for Ciena and Mercury.

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

*Interest Expense.* The fluctuations in interest expense during the three and nine months ended September 30, 2008 and 2007, were primarily attributable to changes in the level of our borrowings under various notes payable and our revolving line of credit as well as an increase in our weighted average cost of debt capital. Our borrowing activity and weighted average cost of debt, including fees

and debt financing costs, at and for the three and nine months ended September 30, 2008 and 2007, were as follows:

(\$ in millions)	At and for the Three Months Ended September 30,		At and for the Nine Months Ended September 30,	
	2008	2007	2008	2007
Total outstanding debt	\$ 2,131.0	\$ 1,922.4	\$ 2,131.0	\$ 1,922.4
Average outstanding debt	\$ 1,967.2	\$ 1,921.1	\$ 2,072.8	\$ 1,909.5
Weighted average cost <sup>(1)</sup>	6.8%	6.6%	6.8%	6.6%

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

In addition, interest expense included interest paid to the Internal Revenue Service related to installment sale gains totaling \$2.0 million for both the three months ended September 30, 2008 and 2007, and \$5.8 million and \$4.3 million for the nine months ended September 30, 2008 and 2007, respectively. Installment interest expense for the year ended December 31, 2008, is estimated to be a total of \$7.7 million. See *Dividends and Distributions* below.

*Employee Expense.* Employee expenses for the three and nine months ended September 30, 2008 and 2007, were as follows:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Salaries and employee benefits	\$ 17.0	\$ 23.3	\$ 48.1	\$ 65.9
Individual performance award (IPA)	2.0	2.4	6.6	7.4
IPA mark to market expense (benefit)		(2.0)	(4.1)	(3.6)
Individual performance bonus (IPB)	2.4	2.6	6.8	7.1
Total employee expense <sup>(1)</sup>	\$ 21.4	\$ 26.3	\$ 57.4	\$ 76.8
Number of employees at end of period	155	178	155	178

<sup>(1)</sup> Excludes stock options expense. See below.

Salaries and employee benefits include an accrual for employee bonuses, which are generally paid annually after the completion of the fiscal year. The quarterly accrual is based upon an estimate of annual bonuses and is subject to change. Salaries and employee benefits, excluding \$3.4 million and \$5.3 million of severance expense for the three and nine months ended September 30, 2008, respectively, were \$13.6 million and \$42.8 million. Salaries and employee benefits excluding severance expenses were lower than the same periods in 2007, primarily as a result of the reduction to the 2008 bonus pool. Salaries and employee benefits for the three months ended September 30, 2008 and 2007, included accrued bonuses of \$4.0 million and \$11.1 million, respectively. Accrued bonuses totaled \$10.5 million and \$32.7 million for the nine months ended September 30, 2008 and 2007, respectively. The actual amount of the current year bonuses will be finalized by the Compensation Committee and the Board of Directors at

the end of the year.

During the third quarter of 2008, we consolidated our investment execution activities to our Washington, DC headquarters and our office in New York in an effort to improve our operating efficiencies; we continue to maintain offices in Los Angeles and Chicago for business development activities. As we transitioned and consolidated our operations, we reduced our headcount by approximately 30 employees in the third quarter of 2008. As a result of this headcount reduction, we incurred

severance expense of \$3.4 million for the three months ended September 30, 2008. Total severance expense for the nine months ended September 30, 2008 was \$5.3 million. Severance expense is included in salaries and employee benefits. We expect to have further headcount reductions in the fourth quarter of 2008, and may incur additional severance expense.

The IPA is an incentive compensation program for certain officers and is generally determined annually at the beginning of each year but may be adjusted throughout the year. Through December 31, 2007, the IPA was deposited in a deferred compensation trust in four equal installments, generally on a quarterly basis, in the form of cash. The trustee was required to use the cash to purchase shares of our common stock in the open market.

Through December 31, 2007, the IPA amounts were contributed into the trust and invested in our common stock. The accounts of the trust were consolidated with our accounts. The common stock was classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represented the amount owed to the employees, was included in other liabilities. Changes in the value of our common stock held in the deferred compensation trust were not recognized. However, the liability was marked to market with a corresponding charge or credit to employee compensation expense. On March 18, 2008, prior to the distribution of the assets held in the trust (see below), we were required to record a final mark to market of the liability with a corresponding credit to employee compensation expense.

In December 2007, our Board of Directors made a determination that it was in Allied Capital's best interest to terminate our deferred compensation arrangements. The Board of Directors' decision was primarily in response to increased complexity resulting from recent changes in the regulation of deferred compensation arrangements. The Board of Directors resolved that the accounts under these Plans would be distributed to participants in full on March 18, 2008, the termination and distribution date, or as soon as was reasonably practicable thereafter, in accordance with the provisions of each of these Plans.

The accounts under the deferred compensation arrangements totaled \$52.5 million at December 31, 2007. The balances on the termination date were distributed to participants in March 2008 subsequent to the termination date, in accordance with the transition rule for payment elections under Section 409A of the Code. Distributions from the plans were made in cash or shares of our common stock, net of required withholding taxes. The distribution of the accounts under the deferred compensation arrangements will result in a tax deduction for 2008, subject to the limitations set by Section 162(m) of the Code for persons subject to such section.

The IPB is distributed in cash to award recipients throughout the year (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2008; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. For 2008, the Compensation Committee has determined that the IPAs will be paid in cash in two equal installments during the year, as long as the recipient remains employed by us. If a recipient terminates employment during the year, any remaining cash payments under the IPA or IPB would be forfeited. After giving effect to the headcount reduction and other hires and terminations in 2008, the total IPA (excluding any mark to market benefit) and IPB for 2008 are currently estimated to be approximately \$8.5 million and \$8.8 million, respectively.

*Stock Options Expense.* Effective January 1, 2006, we adopted FASB Statement No. 123 (Revised 2004), *Share-Based Payment* (SFAS 123R) using the modified prospective method of application, which required us to recognize compensation costs on a prospective basis beginning January 1, 2006. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006, using the





fair value amounts determined for proforma disclosure under SFAS 123R. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized in the consolidated statement of operations over the service period. Our employee stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the related service period.

For the three and nine months ended September 30, 2008, the Compensation Committee of our Board of Directors granted options of 0.2 million and 7.7 million, respectively. The options vest ratably over a three-year period beginning on June 30, 2009.

The stock option expense for the three and nine months ended September 30, 2008 and 2007, was as follows:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Employee Stock Option Expense:				
Options granted:				
Previously awarded, unvested options as of January 1, 2006	\$	\$ 1.7	\$ 3.9	\$ 8.2
Options granted on or after January 1, 2006	1.5	2.2	5.6	8.9
Total options granted	1.5	3.9	9.5	17.1
Options cancelled in connection with tender offer (see below)		14.4		14.4
Total employee stock option expense	\$ 1.5	\$ 18.3	\$ 9.5	\$ 31.5

In addition to employee stock option expense, administrative expense included \$0.1 million and \$0.2 million for the nine months ended September 30, 2008 and 2007, respectively, for options granted to non-officer directors. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

We estimate that the employee-related stock option expense will be approximately \$11.8 million, \$4.8 million, and \$3.1 million for the years ended December 31, 2008, 2009, and 2010, respectively. This estimate may change if our assumptions related to future option forfeitures change. This estimate does not include any expense related to stock option grants after September 30, 2008, as the fair value of those stock options will be determined at the time of grant.

*Administrative Expense.* Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, travel costs, stock record expenses, directors' fees and stock option expense, and various other expenses.

Administrative expenses for the three months ended September 30, 2008 and 2007, were \$14.1 million and \$10.5 million, respectively, and \$36.1 million and \$38.2 million for the nine months ended September 30, 2008 and 2007, respectively. For the three months ended September 30, 2008, administrative expenses were higher than the 2007 period primarily due to increased expenses related to evaluating potential new investments of \$2.3 million. For the nine months ended September 30, 2008, administrative expenses were lower due to a reduction in investigation and litigation costs, net of insurance reimbursements, of \$4.4 million. Administrative expenses for the nine months ended September 30, 2007, also included costs of \$1.4 million incurred in the first quarter of 2007 to engage a third

party to conduct a review of Ciena's internal control systems, and \$2.5 million in placement fees related to securing equity commitments to the Allied Capital Senior Debt Fund, L.P.

**Income Tax Expense (Benefit), Including Excise Tax.** Income tax expense (benefit) for the three and nine months ended September 30, 2008 and 2007, was as follows:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Income tax expense (benefit)	\$ 1.2	\$ 2.2	\$ 3.0	\$ (0.5)
Excise tax expense <sup>(1)</sup>	0.9	9.0	5.1	16.6
Income tax expense (benefit), including excise tax	\$ 2.1	\$ 11.2	\$ 8.1	\$ 16.1

<sup>(1)</sup> While excise tax expense is presented in the Consolidated Statement of Operations as a reduction to net investment income, excise tax relates to both net investment income and net realized gains.

Our wholly-owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period.

Our excess taxable income carried over from 2007 plus our estimated annual taxable income for 2008 currently exceeds our estimated dividend distributions to shareholders in 2008, accordingly, we expect to carry over excess taxable income earned in 2008 for distribution in 2009. Therefore, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income available for distribution exceeds the distributions or deemed distributions for the year. We have recorded an estimated excise tax expense of \$0.9 million and \$5.1 million for the three and nine months ended September 30, 2008, respectively. The excise tax expense for the nine months ended September 30, 2008, is lower than for the same period in 2007 as we expect that our excess taxable income carried over from 2008 for distribution in 2009 will be lower than the excess taxable income carried over from 2007 for distribution in 2008. The amount of excise tax expense is based on an estimate of full year taxable income and therefore is subject to change. See Dividends and Distributions.

**Realized Gains and Losses.** Net realized gains primarily 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 and commercial mortgage loans, offset by losses on investments. Net realized gains for the three and nine months ended September 30, 2008 and 2007, were as follows:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Realized gains	\$ 97.5	\$ 275.8	\$ 135.2	\$ 396.4
Realized losses	(35.5)	(63.4)	(87.9)	(81.5)
Net realized gains	\$ 62.0	\$ 212.4	\$ 47.3	\$ 314.9

Realized gains and losses for the nine months ended September 30, 2008, included a net realized gain totaling \$8.3 million (subsequent to post-closing adjustments) from the sale of certain investments to AGILE Fund I, LLC in the first quarter of 2008. In addition, realized losses for the nine months ended September 30, 2008, included \$7.0 million (subsequent to post-closing adjustments) related to the sale of certain venture capital and private equity limited partnership investments to a fund managed by Goldman Sachs. For the three and nine months ended September 30, 2008, net realized gains and losses also included net realized losses totaling \$0.7 million and \$3.8 million, respectively, resulting from the sale of loans and debt securities totaling \$46.5 million and \$186.2 million, respectively, to the Allied Capital

Senior Debt Fund, L.P., Knightsbridge CLO 2007-1 Ltd. and Knightsbridge CLO 2008-1 Ltd. See Managed Funds above.

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three and nine months ended September 30, 2008 and 2007, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended	
	2008	2007	September 30, 2008	2007
Reversal of previously recorded net unrealized appreciation associated with realized gains	\$ (80.4)	\$ (243.9)	\$ (115.1)	\$ (330.9)
Reversal of previously recorded net unrealized appreciation associated with dividends received	(1.6)		(15.1)	(1.1)
Reversal of previously recorded net unrealized depreciation associated with realized losses	34.8	65.8	80.2	89.2
Total reversal	\$ (47.2)	\$ (178.1)	\$ (50.0)	\$ (242.8)

Realized gains for the three months ended September 30, 2008 and 2007, were as follows:

(\$ in millions)

Portfolio Company	2008	Amount
<b>Private Finance:</b>		
Norwesco, Inc.		\$86.9
BI Incorporated		7.4
Passport Health Communications, Inc.		1.8
Other		1.3
Total private finance		97.4
<b>Commercial Real Estate:</b>		
Other		0.1
Total commercial real estate		0.1
Total realized gains		\$97.5

2007

<b>Portfolio Company</b>	<b>Amount</b>
<b>Private Finance:</b>	
Mercury Air Centers, Inc.	\$ 259.5
Woodstream Corporation	14.6
Mogas Energy, LLC	1.2
Other	0.5
Total realized gains	\$ 275.8

Realized losses for the three months ended September 30, 2008 and 2007, were as follows:

(\$ in millions)

2008

<b>Portfolio Company</b>	<b>Amount</b>
<b>Private Finance:</b>	
Pendum, Inc.	\$34.0
Other	1.5
Total realized losses	\$35.5

2007

<b>Portfolio Company</b>	<b>Amount</b>
<b>Private Finance:</b>	
Jakel, Inc.	\$ 24.8
Startec Global Communications Corporation	20.2
Gordian Group, Inc.	9.7
Universal Environmental Services, LLC	8.6
Other	0.1
Total realized losses	\$ 63.4

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Realized gains for the nine months ended September 30, 2008 and 2007 were as follows:

(\$ in million)

<b>Portfolio Company</b>	<b>2008</b>	<b>Amount</b>
<b>Private Finance:</b>		
Norwesco, Inc.	\$	97.6
BI Incorporated		7.4
BenefitMall, Inc.		4.9
Advantage Sales & Marketing, Inc. <sup>(1)</sup>		3.4
Mercury Air Centers, Inc.		3.3
Financial Pacific Company		3.1
Passport Health Communications, Inc.		1.8
Service Champ, Inc.		1.7
Penn Detroit Diesel Allison, LLC		1.4
Coverall North America, Inc.		1.4
MedAssets, Inc.		1.3
CR Holding, Inc.		1.0
Other		6.5
Total private finance		134.8
<b>Commercial Real Estate:</b>		
Other		0.4
Total commercial real estate		0.4
Total realized gains	\$	135.2
<b>Portfolio Company</b>	<b>2007</b>	<b>Amount</b>
<b>Private Finance:</b>		
Mercury Air Centers, Inc.		\$259.5
HMT, Inc.		39.9
Healthy Pet Corp.		36.6
Palm Coast Data, LLC		20.0
Woodstream Corporation		14.6
Wear Me Apparel Corporation		6.1
Mogas Energy, LLC		5.7
Tradesmen International, Inc.		3.8
ForeSite Towers, LLC		3.8
Advantage Sales & Marketing, Inc.		3.1
Geotrace Technologies, Inc.		1.1
Other		2.2
		223

Total realized gains \$396.4

(1) Includes an additional realized gain of \$1.9 million related to the release of escrowed funds from the sale of our majority equity investment in 2006.

Realized losses for the nine months ended September 30, 2008 and 2007, were as follows:

**(\$ in millions)**

<b>Portfolio Company</b>	<b>2008</b>	<b>Amount</b>
<b>Private Finance:</b>		
Pendum, Inc.	\$	34.0
Creative Group, Inc.		15.6
Crescent Equity Corp. Longview Cable & Data, LLC		8.4
Mid-Atlantic Venture Fund IV, L.P.		5.2
WMA Equity Corporation and Affiliates		4.5
Driven Brands, Inc.		1.9
Direct Capital Corporation		1.7
EarthColor, Inc.		1.7
Sweet Traditions, Inc.		1.5
Walker Investment Fund II, LLLP.		1.4
Other		9.5
Total private finance		85.4
<b>Commercial Real Estate:</b>		
Other		2.5
Total commercial real estate		2.5
Total realized losses	\$	87.9

<b>Portfolio Company</b>	<b>2007</b>	<b>Amount</b>
<b>Private Finance:</b>		
Jakel, Inc.		\$24.8
Startec Global Communications, Inc.		20.2
Powell Plant Farms, Inc.		11.6
Gordian Group, Inc.		9.7
Universal Environmental Services, LLC		8.6
Legacy Partners Group, LLC		5.8
Other		0.8



Total realized losses

\$81.5

***Change in Unrealized Appreciation or Depreciation.*** We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940 (1940 Act), is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors in accordance with our valuation policy and the provisions of the 1940 Act and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement). We determine fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. At September 30, 2008, portfolio investments recorded at fair value using level 3 inputs (as defined under the Statement) were approximately 91% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market quotation in an active market, 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 approach for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we are required to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and we will record unrealized appreciation when we determine that the fair value is greater than its cost basis. Changes in fair value are recorded in the statement of operations as net change in unrealized appreciation or depreciation.

As a business development company, we invest in illiquid securities including debt and equity securities of portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. The structure of each debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments may be subject to certain restrictions on resale and generally have no established trading market.

Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

***Valuation Methodology.*** We adopted SFAS 157 on a prospective basis in the first quarter of 2008. SFAS 157 requires us to assume that the portfolio investment is to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. In accordance with the Statement, we have considered our principal market, or the market in which we exit our portfolio investments with the greatest volume and level of activity.

We have determined that for our buyout investments, where we have control or could gain control through an option or warrant security, both the debt and equity securities of the portfolio investment would exit in the merger and acquisition (M&A) market as the principal market generally through a sale or recapitalization of the portfolio company. We believe that the in-use premise of value (as defined in



SFAS 157), which assumes the debt and equity securities are sold together, is appropriate as this would provide maximum proceeds to the seller. As a result, we will continue to use the enterprise value methodology to determine the fair value of these investments under SFAS 157. Enterprise value means the entire value of the company to a market participant, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. Enterprise value is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. We allocate the enterprise value to these securities in order of the legal priority of the securities.

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. However, we must derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. This financial and other information is generally obtained from the portfolio companies, and may represent unaudited, projected or pro forma financial information. We generally require portfolio companies to provide annual audited and quarterly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by U.S. generally accepted accounting principles and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by U.S. generally accepted accounting principles. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

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

While we typically exit our securities upon the sale or recapitalization of the portfolio company in the M&A market, for investments in portfolio companies where we do not have control or the ability to gain control through an option or warrant security, we cannot typically control the exit of our investment into the principal market (the M&A market). As a result, in accordance with SFAS 157, we are required to determine the fair value of these investments assuming a sale of the individual investment (the in-exchange premise of value) in a hypothetical market to a hypothetical market participant. We continue to perform an enterprise value analysis for investments in this category to assess the credit risk of the loan or debt security and to determine the fair value of our equity investment in these portfolio companies. The determined equity values are generally discounted when we have a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors, which we believe would lead a market participant to discount such securities. For loan and debt securities, we perform a yield analysis assuming a hypothetical current sale of the investment. The yield analysis requires us to estimate the expected repayment date of the instrument and a market participant's required yield. Our



estimate of the expected repayment date of a loan or debt security is generally shorter than the legal maturity of the instruments as our loans have historically been repaid prior to the maturity date. The yield analysis considers changes in interest rates and changes in leverage levels of the loan or debt security as compared to our estimates of market interest rates and leverage levels at the balance sheet date. Assuming the credit quality of the loan or debt security remains stable, we will use the value determined by the yield analysis as the fair value for that security. A change in the assumptions that we use to estimate the fair value of our loans and debt securities using the yield analysis could have a material impact on the determination of fair value. If there is deterioration in credit quality or a loan or debt security is in workout status, we may consider other factors in determining the fair value of a loan or debt security, including the value attributable to the loan or debt security from the enterprise value of the portfolio company or the proceeds that would be received in a liquidation analysis.

Our equity investments in private debt and equity funds are generally valued at such fund's net asset value, unless other factors lead to a determination of fair value at a different amount. The value of our equity securities in public companies for which quoted prices in an active market are readily available is based on the closing public market price on the measurement date.

The fair value of our CLO/CDO Assets is generally based on a discounted cash flow model that utilizes prepayment, re-investment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar bonds and preferred shares/ income notes, when available. We recognize unrealized appreciation or depreciation on our CLO/CDO Assets as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment, re-investment or loss assumptions in the underlying collateral pool, or changes in redemption assumptions for the CLO/CDO Assets, if applicable. We determine the fair value of our CLO/CDO Assets on an individual security-by-security basis. If we were to sell a group of these CLO/CDO Assets in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual assets.

We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and will record unrealized appreciation when we determine that the fair value is greater than its cost basis. Because of the inherent uncertainty of valuation, the values determined at the measurement date 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. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the values determined at the measurement date.

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

We work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis. In addition, we may receive third-party assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process.



The valuation analysis prepared by management is submitted to our Board of Directors who is ultimately responsible for the determination of fair value of the portfolio in good faith. Valuation assistance from Duff & Phelps, LLC (Duff & Phelps) for our private finance portfolio consisted of certain limited procedures (the Procedures) we identified and requested them to perform. Based upon the performance of the Procedures on a selection of our final portfolio company valuations, Duff & Phelps concluded that the fair value of those portfolio companies subjected to the Procedures did not appear unreasonable. In addition, we also received third-party valuation assistance from other third-party consultants for certain private finance portfolio companies. For the three and nine months ended September 30, 2008 and 2007, we received third-party valuation assistance as follows:

	Q1	2008 Q2	Q3	Q1	2007 Q2	Q3
Number of private finance portfolio companies reviewed	124	119	128	88	92	135
Percentage of private finance portfolio reviewed at value	94.0%	94.9%	97.2%	91.8%	92.1%	92.1%

Professional fees for third-party valuation assistance were \$1.8 million for the year ended December 31, 2007, and are estimated to be approximately \$2.2 million for 2008.

*Net Change in Unrealized Appreciation or Depreciation.* Net change in unrealized appreciation or depreciation for the three and nine months ended September 30, 2008 and 2007, consisted of the following:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008 <sup>(1)</sup>	2007 <sup>(1)</sup>	2008 <sup>(1)</sup>	2007 <sup>(1)</sup>
Net unrealized appreciation (depreciation)	\$ (378.7)	\$ (149.1)	\$ (637.5)	\$ (29.3)
Reversal of previously recorded unrealized appreciation associated with realized gains	(80.4)	(243.9)	(115.1)	(330.9)
Reversal of previously recorded net unrealized appreciation associated with dividends received	(1.6)		(15.1)	(1.1)
Reversal of previously recorded unrealized depreciation associated with realized losses	34.8	65.8	80.2	89.2
Net change in unrealized appreciation or depreciation	\$ (425.9)	\$ (327.2)	\$ (687.5)	\$ (272.1)

(1) The net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.

The primary drivers of the net unrealized depreciation of \$378.7 million related to changes in portfolio value for the three months ended September 30, 2008, were (i) additional depreciation of \$151.9 million related to our investment in Ciena resulting from the decline in value of their residual interest assets and other financial assets as discussed below, (ii) depreciation on non-buyout debt investments totaling \$32.4 million as a result of using a yield analysis, (iii) depreciation of \$63.8 million on four companies in the automotive/RV parts and services industry, (iv) depreciation in our other financial services and asset management portfolio companies and our CLO/CDO



investments, which totaled \$38.5 million, and (v) decreased enterprise values as a result of lower EBITDA generally driven by current economic conditions, including rising oil and food prices.

The primary drivers of the net unrealized depreciation of \$637.5 million related to changes in portfolio value for the nine months ended September 30, 2008, were (i) additional depreciation of \$220.5 million related to our investment in Ciena resulting from the decline in value of their residual interest assets and other financial assets, (ii) depreciation on non-buyout debt investments totaling

\$39.4 million as a result of using a yield analysis, (iii) depreciation of \$76.4 million on four companies in the automotive/RV parts and services industry, (iv) depreciation in our other financial services and asset management portfolio companies and our CLO/CDO investments, which totaled \$101.6 million, and (v) decreased enterprise values as a result of lower EBITDA generally driven by current economic conditions, including rising oil and food prices.

Subsequent to September 30, 2008, the debt capital markets have continued to show significant volatility and yield spreads have further widened. As a result, we believe that the market yields for our investments in non-buyout loan and debt securities and in CLOs may have increased subsequent to September 30, 2008, and as a result, the fair value of our investments in these securities may have decreased subsequent to September 30, 2008.

**Valuation of Ciena Capital LLC.** Our investment in Ciena totaled \$646.7 million at cost and \$180.2 million at value, which included unrealized depreciation of \$466.5 million, at September 30, 2008. Other assets includes amounts receivable from or related to Ciena totaling \$15.4 million, which have a value of \$2.2 million at September 30, 2008. Our investment totaled \$327.8 million at cost and \$68.6 million at value, which included unrealized depreciation of \$259.2 million, at December 31, 2007.

To value our investment at September 30, 2008, we considered the effect of Ciena's voluntary filing for bankruptcy protection and our purchase of the positions of the senior lenders under Ciena's revolving line of credit except for a \$5 million position continued to be held by Citibank, N.A. See Private Finance, Ciena Capital LLC above. Ciena's origination platform has been discontinued, and we continue to attribute no value to Ciena's enterprise due to the state of the securitization markets, among other factors. We valued our investment in Ciena at September 30, 2008, solely based on the estimated net realizable value of Ciena's assets, including the estimated net realizable value of the cash flows generated from Ciena's retained interests in its current servicing portfolio, which includes portfolio servicing fees as well as cash flows from Ciena's equity investments in its securitizations and its interest only strip. We considered the outstanding letters of credit that we have issued in connection with Ciena's securitization transactions in our determination of the net realizable value of Ciena's retained interests at September 30, 2008. This resulted in a value to our investment of \$180.2 million at September 30, 2008. The decrease in value from the prior quarter is a result of the continued decline in the fair value of the assets supporting Ciena's retained interests and assets held on Ciena's balance sheet. This decrease is primarily a result of decreasing bid prices and a reduction in the number of loan buyers in the market resulting from the current economic environment and continued disruption in the financial markets.

We also continued to consider Ciena's current regulatory issues and ongoing investigations and litigation in performing the valuation analysis at September 30, 2008. (See Private Finance, Ciena Capital LLC above.)

Net change in unrealized appreciation or depreciation included depreciation related to our investment in Ciena of \$151.9 million and \$220.5 million for the three and nine months ended September 30, 2008, respectively, and depreciation of \$84.1 million and \$103.2 million for the three and nine months ended September 30, 2007, respectively. We received valuation assistance from Duff & Phelps for our investment in Ciena at September 30, 2008 and December 31, 2007. See Valuation Methodology Private Finance above for further discussion of the third-party valuation assistance we received.

**Per Share Amounts.** 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 common shares used to compute diluted earnings per share, which were 178.7 million and 154.0 million for the three months ended September 30, 2008 and 2007, respectively, and were 171.1 million and 154.7 million for the nine months ended September 30, 2008 and 2007, respectively.



## **OTHER MATTERS**

**Regulated Investment Company Status.** We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986 (the Code). In order to maintain our status as a regulated investment company and obtain regulated investment company tax benefits, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet asset diversification requirements as defined in the Code; and (4) timely distribute to shareholders at least 90% of our annual investment company taxable income (i.e., net ordinary investment income) as defined in the Code. With respect to taxable realized net long-term capital gains, we may choose to (i) distribute, (ii) deem to distribute, or (iii) retain and pay corporate level tax on such gains. We qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis.

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

Taxable income available for distribution includes investment company taxable income and, to the extent not deemed to be distributed or retained, net long-term capital gains. To the extent that annual taxable income available for distribution exceeds dividends paid or deemed distributed from such taxable income for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Code (see discussion below). Such excess income will be treated under the Code as having been distributed during the prior year for purposes of our qualification for RIC tax treatment for such year. The maximum amount of excess taxable income that we may carry over for distribution in the next year under the Code is the total amount of dividends paid in the following year, subject to certain declaration and payment guidelines. Excess taxable income carried over and paid out in the next year is generally subject to a nondeductible 4% excise tax.

## **DIVIDENDS AND DISTRIBUTIONS**

Our Board of Directors reviews the dividend quarterly. The Board of Directors is currently evaluating the Company's dividend strategy for 2009 and we currently anticipate that 2009 dividends will be reduced to a level that more closely approximates net investment income.

Dividends to common shareholders for the nine months ended September 30, 2008 and 2007, were \$340.4 million and \$293.7 million, respectively, or \$1.95 per common share for the nine months ended



September 30, 2008, and \$1.92 per common share for the nine months ended September 30, 2007. An extra cash dividend of \$0.05 per common share was declared during 2006 and was paid to shareholders on January 19, 2007. The Board of Directors has declared a dividend of \$0.65 per common share for the fourth quarter of 2008.

Our annual taxable income for 2007 exceeded our dividend distributions to shareholders for 2007 from such taxable income, and, therefore, we have carried over excess taxable income of \$393.3 million, for distribution to shareholders in 2008. Excess taxable income for 2007 represents approximately \$40.9 million of ordinary income and approximately \$352.4 million of net long-term capital gains.

Dividends paid in 2008 are first paid out of the excess taxable income carried over from 2007. For the nine months ended September 30, 2008, we paid dividends of \$340.4 million. The remainder of 2007 estimated excess taxable income to be distributed during the fourth quarter of 2008 is \$52.9 million. In accordance with regulated investment company distribution rules, we must declare current year dividends to be paid from carried over excess taxable income from 2007 before we file our 2007 tax return in September 2008, and we are required to pay such dividends by December 31, 2008. To comply with these rules, on July 8, 2008, our Board of Directors declared a \$0.65 per share dividend for both the third and fourth quarters of 2008. The third quarter dividend was paid on September 26, 2008, and the fourth quarter dividend will be paid on December 26, 2008 to shareholders of record at December 12, 2008.

Given that a substantial portion of the 2008 dividend payments are being made from excess taxable income carried forward from 2007, we currently expect to carry over excess taxable income earned in 2008 for distribution to shareholders in 2009. We expect that we will generally be required to pay a 4% excise tax expense on the excess of 98% of our taxable income for 2008 over the amount of actual distributions from such taxable income in 2008. For the nine months ended September 30, 2008, we have recorded an excise tax expense of \$5.1 million. See Results of Operations Income Tax Expense (Benefit), Including Excise Tax. Excise taxes are accrued based upon estimated excess taxable income as estimated taxable income is earned, therefore, the excise tax accrued to date in 2008 may be adjusted as appropriate in the remainder of 2008 to reflect changes in our estimate of the carry over amount. Our ability to earn the estimated annual taxable income for 2008 depends on many factors, including our ability to make new investments at attractive yields, the level of repayments in the portfolio, the realization of gains or losses from portfolio exits, and the level of operating expenses incurred. See Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors.

In addition, we have cumulative deferred taxable income related to installment sale gains of \$236.0 million as of December 31, 2007. These gains have been recognized for financial reporting purposes in the respective years they were realized, but will be deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. See Other Matters Regulated Investment Company Status above.

To the extent that installment sale gains are deferred for recognition in taxable income, we pay interest to the Internal Revenue Service. Installment-related interest expense for the nine months ended September 30, 2008 and 2007, was \$5.8 million and \$4.3 million, respectively. This interest is included in interest expense in our Consolidated Statement of Operations. See Results of Operations above.

**FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES**

At September 30, 2008, and December 31, 2007, our cash, investments in money market and other securities, total assets, total debt outstanding, total shareholders' equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

(\$ in millions)	2008	2007
Cash and investments in money market and other securities (including money market and other securities: 2008-\$13.4; 2007-\$201.2)	\$ 215.3	\$ 204.8
Total assets	\$ 4,625.7	\$ 5,214.6
Total debt outstanding	\$ 2,131.0	\$ 2,289.5
Total shareholders' equity	\$ 2,413.4	\$ 2,771.8
Debt to equity ratio	0.88	0.83
Asset coverage ratio <sup>(1)</sup>	213%	221%

<sup>(1)</sup> As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.

Cash generated from the portfolio includes cash flow from net investment income and net realized gains and principal collections related to investment repayments or sales. Cash flow provided by our operating activities before new investment activity for the nine months ended September 30, 2008 and 2007, was as follows:

(\$ in millions)	2008	2007
Net cash provided by operating activities	\$ 298.5	\$ 240.8
Add: portfolio investments funded	1,019.8	1,236.7
Total cash provided by operating activities before new investments	\$ 1,318.3	\$ 1,477.5

In addition to the net cash flow provided by our operating activities before funding investments, which includes principal collections related to investment repayments or sales, we have sources of liquidity through our cash, investments in money market and other securities and revolving line of credit as discussed below.

At September 30, 2008, and December 31, 2007, the value and yield of the cash and investments in money market and other securities were as follows:

(\$ in millions)	2008		2007	
	Value	Yield	Value	Yield
Money market and other securities	\$ 13.4	2.6%	\$ 201.2	4.6%
Cash	201.9	0.7%	3.6	2.9%
Total	\$ 215.3	0.8%	\$ 204.8	4.6%

We maintain this pool of liquid assets within our balance sheet given that our investment portfolio is primarily composed of private, illiquid assets for which there is no readily available market. We assess the amount held in and the composition of these investments throughout the year.

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 securities. We place our cash with financial institutions and cash held in checking accounts in financial institutions may be in excess of the Federal Deposit Insurance Corporation insured limit.

We employ an asset-liability management approach that focuses on matching the estimated maturities of our investment portfolio to the estimated maturities of our borrowings. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate debt portfolio and



our equity portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

During the nine months ended September 30, 2008 and 2007, and the year ended December 31, 2007, we sold new equity of \$402.5 million, \$93.8 million, and \$171.3 million, respectively, in public offerings. In addition, shareholders equity increased through capital share transactions by \$4.6 million, \$25.9 million, and \$31.5 million through the exercise of stock options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the nine months ended September 30, 2008 and 2007, and the year ended December 31, 2007, respectively. In addition, shareholders equity increased by \$26.4 million during the nine months ended September 30, 2008, as a result of the distribution of the common stock held in deferred compensation trusts. See Note 8, Employee Compensation Plans from our Notes to Consolidated Financial Statements included in Item 1.

We generally target a debt to equity ratio ranging between 0.50:1.00 to 0.70:1.00 because we believe that it is prudent to operate with a larger equity capital base and less leverage. At September 30, 2008, our debt to equity ratio net of cash and other securities was 0.79:1.00.

At September 30, 2008, and December 31, 2007, we had outstanding debt as follows:

(\$ in millions)	2008			2007		
	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>
Notes payable and debentures:						
Privately issued unsecured notes payable	\$ 1,081.0	\$ 1,081.0	6.6%	\$ 1,042.2	\$ 1,042.2	6.1%
Publicly issued unsecured notes payable	880.0	880.0	6.7%	880.0	880.0	6.7%
Total notes payable and debentures	1,961.0	1,961.0	6.6%	1,922.2	1,922.2	6.4%
Revolving line of credit	632.5	170.0	5.0% <sup>(2)</sup>	922.5	367.3	5.9% <sup>(2)</sup>
Total debt	\$ 2,593.5	\$ 2,131.0	6.8% <sup>(3)</sup>	\$ 2,844.7	\$ 2,289.5	6.5% <sup>(3)</sup>

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

(2) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit in effect at the balance sheet date. In addition to the current interest rate payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$7.3 million and \$3.7 million at September 30, 2008, and December 31, 2007, respectively.

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

***Privately Issued Unsecured Notes Payable.*** We have privately issued unsecured long-term notes to institutional investors, primarily insurance companies. The notes have five- or seven-year maturities and fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity. At September 30, 2008, the notes had maturities from March 2009 to June 2015. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreements.

We have issued five-year unsecured long-term notes denominated in Euros and Sterling for a total U.S. dollar equivalent of \$15.2 million. The notes have fixed interest rates and have substantially the same terms as our other unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. These notes mature in March 2009. Simultaneous with issuing the notes, we entered into a cross currency swap with a financial institution which fixed our interest and principal payments in U.S. dollars for the life of the debt.

On May 14, 2008, we repaid \$153.0 million of unsecured long-term debt that matured. This debt had a fixed interest rate of 5.45%.

On June 20, 2008, we issued \$140.5 million of five-year, unsecured notes and \$52.5 million of seven-year, unsecured notes with fixed interest rates of 7.82% and 8.14%, respectively. The debt matures in June 2013 and June 2015, respectively. The proceeds from the issuance of the notes were used to repay amounts outstanding on our revolving line of credit, as well as to fund new portfolio investments and for other general corporate purposes.

**Publicly Issued Unsecured Notes Payable.** At September 30, 2008, we had outstanding publicly issued unsecured notes as follows:

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

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

On March 28, 2007, we completed the issuance of \$200.0 million of 6.875% Notes due 2047 for net proceeds of \$193.0 million. In April 2007, we issued additional notes, through an over-allotment option, totaling \$30.0 million for net proceeds of \$29.1 million. Net proceeds are net of underwriting discounts and estimated offering expenses. The notes are listed on the New York Stock Exchange under the trading symbol AFC.

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

**Revolving Line of Credit.** At December 31, 2007, we had an unsecured revolving line of credit with a committed amount of \$922.5 million that was scheduled to expire on September 30, 2008. On April 9, 2008, we entered into a three-year unsecured revolving line of credit with total commitments of \$632.5 million, with Bank of America, N.A., as a lender and as administrative agent, and the other lenders thereunder, which replaced our previous revolving line of credit. We may obtain additional commitments up to a total committed facility of \$1.5 billion, subject to customary conditions and availability of capital. The revolving line of credit expires on April 11, 2011. At September 30, 2008, there was \$170.0 million outstanding under our revolving line of credit. At September 30, 2008, the amount available under the revolving line of credit was \$338.7 million, net of amounts committed for standby letters of credit of \$123.8 million issued under the credit facility.

At our option, borrowings under the revolving line of credit effective April 9, 2008, generally bear interest at a rate per annum equal to (i) LIBOR (for the period selected by us) plus 2.00% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.50% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly,

on LIBOR-based loans, and monthly payments of interest on other loans. All principal is due upon maturity.

The revolving credit facility provides for a swingline sub-facility. The swingline sub-facility bears interest at the Bank of America N.A. cost of funds plus 2.00%. The revolving credit facility also provides

for a sub-facility for the issuance of letters of credit for up to an aggregate amount of \$175 million. This letter of credit sub-facility will increase to the extent of 15% of the aggregate amount of commitments over \$1.0 billion. The letter of credit fee is 2.00% per annum on letters of credit issued, which is payable quarterly.

**Debt Covenants.** We have various financial and operating covenants required by the revolving line of credit and the privately issued unsecured notes payable outstanding at September 30, 2008. These covenants require us to maintain certain financial ratios, including asset coverage, debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. Our credit facilities limit our ability to declare dividends if we default under certain provisions. At September 30, 2008, we were in compliance with the financial and operating covenants required under the revolving line of credit and the privately issued unsecured notes payable. We experienced a significant reduction in our net worth at September 30, 2008, primarily resulting from net unrealized depreciation on our portfolio, which reflects current market conditions. See *Results of Operations* *Change in Unrealized Appreciation or Depreciation*. We intend to seek an amendment of the minimum net worth covenant from the lenders in the revolving line of credit and the privately issued unsecured notes payable. There can be no assurance that we will obtain such an amendment.

We have certain financial and operating covenants that are required by the publicly issued unsecured notes payable, including that we will maintain a minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding.

**Contractual Obligations.** The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of September 30, 2008.

(\$ in millions)	Total	Payments Due By Year					After 2012
		2008	2009	2010	2011	2012	
Unsecured notes payable	\$ 1,961.0	\$	\$ 268.5	\$ 408.0	\$ 472.5	\$ 339.0	\$ 473.0
Revolving line of credit <sup>(1)</sup>	170.0				170.0		
Operating leases	16.9	1.1	4.6	4.5	1.8	1.8	3.1
Total contractual obligations	\$ 2,147.9	\$ 1.1	\$ 273.1	\$ 412.5	\$ 644.3	\$ 340.8	\$ 476.1

<sup>(1)</sup> At September 30, 2008, \$338.7 million remained unused and available on the revolving line of credit, net of amounts committed for standby letters of credit of \$123.8 million issued under the credit facility.

## Off-Balance Sheet Arrangements

In the ordinary course of business, we have issued guarantees and have extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. We have generally issued guarantees of debt, rental and other and lease obligations. Under these arrangements, we would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The following table shows our guarantees and standby letters of credit that may have the effect of creating, increasing, or accelerating our liabilities as of September 30, 2008.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2008	2009	2010	2011	2012	After 2012
Guarantees	\$ 22.4	\$	\$ 7.5	\$ 9.6	\$ 4.4	\$ 0.1	\$ 0.8
Standby letters of credit <sup>(1)</sup>	123.8		1.7		122.1		
Total commitments <sup>(2)</sup>	\$ 146.2	\$	\$ 9.2	\$ 9.6	\$ 126.5	\$ 0.1	\$ 0.8

(1) Standby letters of credit are issued under our revolving line of credit that expires in April 2011. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit will expire contemporaneously with the expiration of our line of credit that expires in April 2011.

(2) On September 30, 2008, Ciena voluntarily filed for bankruptcy protection as discussed above. As a result of Ciena's decision to file for bankruptcy protection, our unconditional guaranty of the obligations outstanding under Ciena's revolving credit facility became due, and we, in lieu of paying under our guaranty, purchased the positions of the senior lenders under Ciena's revolving credit facility except for a \$5 million position continued to be held by Citibank, N.A. We continue to guaranty the \$5 million position, including interest, fees and related expenses, held by Citibank. See Note 3. Private Finance Ciena Capital LLC for additional information. At September 30, 2008, we also had standby letters of credit issued totaling \$102.6 million in connection with term securitizations completed by Ciena. We considered the outstanding letters of credit in our valuation at September 30, 2008. See Note 3. Private Finance Ciena Capital LLC.

In addition, we had outstanding commitments to fund investments totaling \$775.5 million at September 30, 2008, including \$737.0 million related to private finance investments and \$38.5 million related to commercial real estate finance investments. Outstanding commitments related to private finance investments included \$399.6 million to the Unitranche Fund LLC, which will be funded as investments are funded by the Unitranche Fund. Investments made by the Unitranche Fund must be approved by the investment committee of the Unitranche Fund, which includes a representative from us and GE, and the level of investments made by the Unitranche Fund will be dependent on market conditions and the Unitranche Fund's ability to identify attractive investment opportunities during the investment period. See Portfolio and Investment Activity Outstanding Commitments above. We intend to fund these commitments and prospective investment opportunities through available sources of capital, which may include existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

## CRITICAL ACCOUNTING POLICIES

The consolidated financial statements are based on the selection and application of critical accounting policies, which require management to make significant estimates and assumptions. 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, certain revenue recognition matters and certain tax matters as discussed below.

***Valuation of Portfolio Investments.*** We, as a BDC, have invested in illiquid securities including debt and equity securities of portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. Our investments may be subject to certain 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 and the provisions of the Investment Company Act of 1940 and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement). We determine fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest and that fair value for our investments must typically be determined using unobservable inputs. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio.

We adopted SFAS 157 on a prospective basis in the first quarter of 2008. SFAS 157 requires us to assume that the portfolio investment is to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. In accordance with the Statement, we have considered our principal market, or the market in which we exit our portfolio investments with the greatest volume and level of activity.

We have determined that for our buyout investments, where we have control or could gain control through an option or warrant security, both the debt and equity securities of the portfolio investment would exit in the merger and acquisition (M&A) market as the principal market generally through a sale or recapitalization of the portfolio company. We believe that the in-use premise of value (as defined in SFAS 157), which assumes the debt and equity securities are sold together, is appropriate as this would provide maximum proceeds to the seller. As a result, we will continue to use the enterprise value methodology to determine the fair value of these investments under SFAS 157. Enterprise value means the entire value of the company to a market participant, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. Enterprise value is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. We allocate the enterprise value to these securities in order of the legal priority of the securities.

While we typically exit our securities upon the sale or recapitalization of the portfolio company in the M&A market, for investments in portfolio companies where we do not have control or the ability to gain control through an option or warrant security, we cannot typically control the exit of our investment into our principal market (the M&A market). As a result, in accordance with SFAS 157, we are required to determine the fair value of these investments assuming a sale of the individual investment (the in-exchange premise of value) in a hypothetical market to a hypothetical market participant. We continue to perform an enterprise value analysis for the investments in this category to assess the credit risk of the loan or debt security and to determine the fair value of our equity investment in these portfolio companies. The determined equity values are generally discounted when we have a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors, which we believe would lead a market participant to discount such securities. For loan and debt securities, we perform a yield analysis assuming a hypothetical current sale of the investment. The yield analysis requires us to estimate the expected repayment date of the instrument and a market participant's required yield. Our estimate of the expected repayment date of a loan or debt security is generally shorter than the legal maturity of the instruments as our loans have historically been repaid prior to the maturity date. The yield analysis considers changes in interest rates and changes in leverage levels of the loan or debt security as compared to our estimates of market interest rates and leverage levels at the balance sheet date. Assuming the credit quality of the loan or debt security remains stable, we will use the value determined by the yield analysis as the fair value for that security. A change in the assumptions that we use to estimate the fair value of our loans and debt



securities using the yield analysis could have a material impact on the determination of fair value. If there is deterioration in credit quality or a loan or debt security is in workout status, we may consider other factors in determining the fair value of a loan or debt security, including the value attributable to the loan or debt security from the enterprise value of the portfolio company or the proceeds that would be received in a liquidation analysis.

Our equity investments in private debt and equity funds are generally valued at such fund's net asset value, unless other factors lead to a determination of fair value at a different amount. The value of our equity securities in public companies for which quoted prices in an active market are readily available is based on the closing public market price on the measurement date.

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

We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and will record unrealized appreciation when we determine that the fair value is greater than its cost basis. Because of the inherent uncertainty of valuation, the values determined at the measurement date 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. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the values determined at the measurement date.

See **Results of Operations - Change in Unrealized Appreciation or Depreciation** above for more discussion on portfolio valuation.

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

***Interest and Dividend Income.*** 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. In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status generally do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us depending on such company's capital requirements.



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. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain.

We recognize interest income on the CLO preferred shares/income notes using the effective interest method, based on the anticipated yield that is determined using the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred shares/income notes from the date the estimated yield was changed. CLO and CDO bonds have stated interest rates. The weighted average yield on the CLO/CDO Assets is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective yield on the preferred shares/income notes, divided by (b) CLO/CDO Assets at value. The weighted average yields are computed as of the balance sheet date.

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

**Fee Income.** Fee income includes fees for loan prepayment premiums, guarantees, commitments, and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Loan prepayment premiums are recognized at the time of prepayment. Guaranty and commitment fees are generally recognized as income over the related period of the guaranty or commitment, respectively. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management, consulting and other services fees, including fund management fees, are generally recognized as income as the services are rendered. Fees are not accrued if we have doubt about collection of those fees.

**Federal and State Income Taxes and Excise Tax.** We intend to comply with the requirements of the Internal Revenue Code that are applicable to regulated investment companies (RIC) and real estate investment trusts (REIT). We and any of our subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of our current year taxable income to shareholders; therefore, we have made no provision for income taxes exclusive of excise taxes for these entities.

If we do not distribute or treat as a deemed distribution at least 98% of our annual taxable income available for distribution in the year earned, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such taxable income during the year earned. To the extent that we determine that our estimated current year annual taxable income will be in excess of estimated current year dividend distributions, including deemed distributions, from such taxable income, we accrue excise taxes on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying

amounts of existing assets and liabilities and their respective tax bases as

well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

**Recent Accounting Pronouncements.** In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We have adopted this statement on a prospective basis beginning in the quarter ended March 31, 2008. Adoption of this statement did not have a material effect on our consolidated financial statements. However, the impact on our consolidated financial statements for future periods cannot be determined at this time as it will be influenced by the estimates of fair value for those periods, the number and amount of investments we originate, acquire or exit, and the effect of any additional guidance or any changes in the interpretation of this statement.

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

There has been no material change in quantitative or qualitative disclosures about market risk since December 31, 2007.

### **Item 4. *Controls and Procedures***

(a) As of the end of the period covered by this quarterly report on Form 10-Q, the Company's chief executive officer, chief financial officer and chief accounting officer evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934). Based upon this evaluation, the Company's chief executive officer, chief financial officer and chief accounting officer concluded that the Company's disclosure controls and procedures are effective to ensure information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act of 1934 is accumulated and communicated to the Company's management, including its principal executive, principal financial and principal accounting officers, as appropriate, to allow timely decisions regarding required disclosure.

(b) There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended September 30, 2008, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. *Legal Proceedings*

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

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

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

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

On October 6, 2008, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned *Rena Nadoff v. Walton, et al.*, 2008 CA 007108, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. The complaint alleges breaches of fiduciary duty by the Board of Directors arising from alleged mismanagement of Business Loan Express, LLC, an

Allied Capital portfolio company, the acquisition of certain phone records, and the adequacy of internal controls relating to the valuation of securities in our

portfolio. Ms. Nadoff's suit is substantially similar to a derivative action she filed in February 2007, which the Court dismissed in July 2007. Ms. Nadoff sent a letter to our Board of Directors on October 5, 2007 reciting substantially the same claims and requesting that the Board of Directors investigate her allegations and take appropriate action. The Board of Directors subsequently established a committee, which engaged and was advised by its own counsel, to review the matter. The Board's committee evaluated the allegations in Ms. Nadoff's October 5 letter and recommended that the Board take no further action. After considering both Ms. Nadoff's request and the committee's recommendation, the Board accepted the recommendation.

In addition to the above matters, we are party to certain lawsuits in the normal course of business. Furthermore, third parties may try to seek to impose liability on us in connection with the activities of our portfolio companies. For a discussion of civil investigations being conducted regarding the lending practices of Ciena Capital LLC, one of our portfolio companies, see Note 3, Portfolio Ciena Capital LLC.

While the outcome of any of the open legal proceedings described above cannot at this time be predicted with certainty, we do not expect these matters will materially affect our financial condition or results of operations; however, there can be no assurance whether any pending legal proceedings will have a material adverse effect on our financial condition or results of operations in any future reporting period.

#### **Item 1A. Risk Factors.**

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

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

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



company's financial condition and prospects may be accompanied by deterioration in the collateral for a loan, if any.

**Substantially all of our portfolio investments, which are generally illiquid, are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments.** At September 30, 2008, portfolio investments recorded at fair value were 91% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no market quotation in an active 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 approach for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. In determining fair value in good faith, we generally obtain financial and other information from portfolio companies, which may represent unaudited, projected or proforma financial information. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and unrealized appreciation when we determine that the fair value of a security is greater than its cost basis. Without a market quotation in an active market and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material. Our net asset value could be affected if our determination of the fair value of our investments is materially different than the value that we ultimately realize.

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

Beginning in the quarter ended March 31, 2008, we adopted the provisions of FASB Statement No. 157, *Fair Value Measurements*, on a prospective basis. Adoption of this statement did not have a material effect on our consolidated financial statements. However, the impact on our consolidated financial statements for future periods cannot be determined at this time as it will be influenced by the estimates of fair value for those periods, the number and amount of investments we originate, acquire or exit and the effect of any additional guidance or any changes in the interpretation of this statement. See Note 2, *Summary of Significant Accounting Policies* from our Notes to the Consolidated Financial Statements included in Item 1.

**We are currently in a period of capital markets disruption and recession and we do not expect these conditions to improve in the near future.** The U.S. capital markets have been experiencing extreme volatility and disruption for more than 12 months and we believe that the U.S. economy has entered into a period of recession. Disruptions in the capital markets have increased the spread between the yields realized on risk-free and higher risk securities, resulting in illiquidity in parts of the capital markets. We believe these conditions may continue for a prolonged period of time or worsen in the future. A prolonged period of market illiquidity may have an adverse effect on our business, financial condition, and results of operations. Unfavorable economic conditions also could increase our funding costs, limit our access to the capital markets or result in a decision by lenders not to extend credit to us. These events could limit our investment originations, limit our ability to grow and negatively impact our operating results.

**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 are susceptible to economic slowdowns or recessions. We believe that the U.S. economy has entered into a period of recession. An economic slowdown, including the current and any future slowdowns, may affect the ability of a company to repay our loans or engage in a liquidity event such as a sale, recapitalization, or initial public offering. Our nonperforming assets are likely to increase and the value of our portfolio is likely to decrease during these periods. Adverse economic conditions also may decrease the value of any collateral securing some of our loans. These conditions could lead to losses of value in our portfolio and a decrease in our revenues, net income, assets and net worth.

Our business of making private equity investments and positioning them for liquidity events also may be affected by current and future market conditions. Current economic and capital markets conditions in the U.S. have severely reduced capital availability, senior lending activity and middle market merger and acquisition activity. The absence of an active senior lending environment or a slowdown in middle market merger and acquisition activity has slowed 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, including the recent extreme volatility and disruption, has had and may continue to have a negative effect on the valuations of our investments, and on the potential for liquidity events involving such investments. This could affect the timing of exit events in our portfolio, reduce the level of net realized gains from exit events in a given year, and could negatively affect the amount of gains or losses upon exit.

**Our borrowers may default on their payments, which may have a negative effect on our financial performance.** We make long-term loans and invest in equity securities primarily in private middle market companies, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources, may be highly leveraged and may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. A portfolio company's failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of its loans or foreclosure on its secured assets, which could trigger cross defaults under other agreements and jeopardize our portfolio company's ability to meet its obligations under the loans or debt securities that we hold. In addition, our portfolio companies may have, or may be permitted to incur, other debt that ranks senior to or equally with our securities. This means that payments on such senior-ranking securities may have to be made before we receive any payments on our subordinated loans or debt securities. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in any related collateral and may have a negative effect on our financial results.

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

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

At September 30, 2008, our investment in Ciena Capital LLC (Ciena) totaled \$646.7 million at cost and \$180.2 million at value, after the effect of unrealized depreciation of \$466.5 million. Other assets includes additional amounts receivable from or related to Ciena totaling \$15.4 million, which have a value of \$2.2 million at September 30, 2008. In addition, we have provided standby letters of credit, issued in connection with term securitization transactions completed by Ciena, that totaled \$102.6 million at September 30, 2008, and we have issued performance guarantees in connection with two non-recourse warehouse facilities, both of which have matured. On September 30, 2008, Ciena voluntarily filed for bankruptcy protection.

Ciena has been a participant in the SBA's 7(a) Guaranteed Loan Program and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). Ciena remains subject to SBA rules and regulations. The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA-guaranteed loans issued by Ciena. Ciena is also subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of Ciena's lending practices under the Business and Industry Loan program. The OIG and the U.S. Department of Justice are also conducting a civil investigation of Ciena's lending practices in various jurisdictions. These investigations, audits, and reviews are ongoing. These investigations, audits, and reviews have had and may continue to have a material adverse impact on Ciena and, as a result, could negatively affect our financial results. See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations—Private Finance, Ciena Capital LLC, and Valuation of Ciena Capital LLC.

**We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us.** Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders or investors. Holders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique. We and, indirectly, our stockholders will bear the cost associated with our leverage activity. Our revolving line of credit and notes payable contain financial and operating covenants that could restrict our business activities, including our ability to declare dividends if we default under certain provisions. Breach of any of those covenants could cause a default under those instruments. Such a default, if not cured or waived, could have a material adverse effect on us.

At September 30, 2008, we had \$2.1 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.8% and a debt to equity ratio of 0.88 to 1.00. We may incur additional debt in the future. If our portfolio of investments fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due. In order for us to cover annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 3.2% as of September 30, 2008, which returns were achieved.

**In addition to regulatory restrictions that restrict our ability to raise capital, our revolving line of credit and privately issued unsecured notes payable contain various covenants which, if not**

**complied with, could accelerate repayment under these debt obligations, thereby materially and adversely affecting our liquidity, financial condition, results of operations and ability to pay dividends.** The agreements governing our revolving line of credit and privately issued unsecured notes payable require us to comply with certain financial and operational covenants. These covenants require us to, among other things, maintain certain financial ratios, including asset coverage, debt to equity and interest coverage, and a minimum net worth. As of September 30, 2008, we were in compliance with these covenants. However, our continued compliance with these covenants depends on many factors, some of which are beyond our control. For example, during the quarter ended September 30, 2008, net unrealized depreciation in our portfolio increased and, given the further deterioration in the capital markets and pricing levels subsequent to this period, net unrealized depreciation in our portfolio may continue to increase in the future and, absent an amendment, could result in non-compliance with certain covenants.

Accordingly, there are no assurances that we will continue to comply with these covenants. Failure to comply with these covenants would result in a default which, if we were unable to obtain a waiver from the lenders, could accelerate repayment under the facilities and thereby have a material adverse impact on our liquidity, financial condition, results of operations and ability to pay dividends.

**Regulations governing our operation as a BDC affect our ability to, and the way in which, we raise additional capital.** Under the 1940 Act and the covenants applicable to our public debt, we must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders or investors on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, or if we are unable to refinance maturing debt, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of September 30, 2008, our asset coverage for senior indebtedness was 213%.

**Our common stock may trade below its net asset value per share, which limits our ability to raise additional equity capital.** If our common stock is trading below its net asset value per share, we will generally not be able to issue additional shares of our common stock at its market price without first obtaining the approval for such issuance from our stockholders and our independent directors. Shares of business development companies, including shares of our common stock, have been trading at discounts to their net asset values. If our common stock trades below net asset value, the higher cost of equity capital may result in it being unattractive to raise new equity, which may limit our ability to grow. The risk of trading below net asset value is separate and distinct from the risk that our net asset value per share may decline. We cannot predict whether shares of our common stock will trade above, at or below our net asset value.

**We will continue to need additional capital to grow because we must distribute our income. If we are unable to obtain additional capital because of either regulatory or market price constraints, we may have to curtail or cease our new lending and investment activities.** We will continue to need capital to fund growth in our investments. Historically, we have borrowed from financial institutions or other investors and have issued debt and equity securities to grow our portfolio. Our ability to grow could be limited if there is a reduction in the availability of new debt or equity capital or if our common stock trades below net asset value. We must distribute at least 90% of our investment company taxable ordinary income (as defined in the Code), which excludes realized net long-term capital gains, to our shareholders to maintain our eligibility for the tax benefits available to regulated investment companies. As a result, such earnings will not be available to fund investment originations. As a business development company, we (i) are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances and (ii) may only issue new equity capital at a price, net of discounts and commissions, above our net asset value unless



we have received shareholder approval. In addition, new debt may not be available to refinance maturing debt. If we fail to obtain funds through additional debt or equity capital raises, it could limit our ability to grow, which could have a material adverse effect on the value of our debt securities or common stock.

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

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

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

Assuming that the balance sheet as of September 30, 2008, were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected net income by approximately 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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

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

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

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

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

**Changes in the law or regulations that govern us could have a material impact on us or our operations.** We are regulated by the SEC. In addition, changes in the laws or regulations that govern business development companies, regulated investment companies, asset managers, and real estate investment trusts may significantly affect our business. There are proposals being considered by the current administration to change the regulation of financial institutions that may affect, possibly adversely, investment managers or investment funds. Any change in the law or regulations that govern our business could have a material impact on us or our operations. Laws and regulations may be changed from time to time, and the interpretations of the relevant laws and regulations also are subject to change,

which may have a material effect on our operations.



**Failure to invest a sufficient portion of our assets in qualifying assets could preclude us from investing in accordance with our current business strategy.** As a business development company, we may not acquire any assets other than qualifying assets unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets. Therefore, we may be precluded from investing in what we believe are attractive investments if such investments are not qualifying assets for purposes of the 1940 Act. If we do not invest a sufficient portion of our assets in qualifying assets, we could lose our status as a business development company, which would have a material adverse effect on our business, financial condition and results of operations. Similarly, these rules could prevent us from making additional investments in existing portfolio companies, which could result in the dilution of our position, or could require us to dispose of investments at inopportune times in order to comply with the 1940 Act. If we were forced to sell nonqualifying investments in the portfolio for compliance purposes, the proceeds from such sale could be significantly less than the current value of such investments.

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

**Our common stock price may be volatile.** The trading price of our common stock may fluctuate substantially. The capital and credit markets have been experiencing extreme volatility and disruption for more than 12 months. In recent weeks, the volatility and disruption have reached unprecedented levels, and we have experienced greater than usual stock price volatility. In general, the price of the common stock may be higher or lower than the price paid by stockholders, depending on many factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include, but are not limited to, the following:

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

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

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

the financial performance of the specific industries in which we invest on a recurring basis;

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

**The trading market or market value of our publicly issued debt securities may be volatile.** Our publicly issued debt securities may or may not have an established trading market. We cannot assure that a trading market for our publicly issued debt securities will ever develop or be maintained if

developed. In addition to our creditworthiness, many factors may materially adversely affect the trading market for, and market value of, our publicly issued debt securities. These factors include, but are not limited to, the following:

- the time remaining to the maturity of these debt securities;
- the outstanding principal amount of debt securities with terms identical to these debt securities;
- the supply of debt securities trading in the secondary market, if any;
- the redemption or repayment features, if any, of these debt securities;
- the level, direction and volatility of market interest rates generally; and
- market rates of interest higher or lower than rates borne by the debt securities.

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

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

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

**Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds***

No unregistered sales of equity securities occurred during the quarter ended September 30, 2008. During the quarter ended September 30, 2008, 250,198 shares of our common stock were purchased in the open market in order to satisfy dividend reinvestment requests.

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

Not applicable.

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

None.

**Item 5. *Other Information***

On April 28, 2008, we announced that Joan M. Sweeney, our Chief Operating Officer, intended to retire from Allied Capital at the end of 2008. Ms. Sweeney will no longer retire at the end of 2008 and, as of the date of this filing, does not currently have an intention to retire.

**Item 6. Exhibits**

## (a) List of Exhibits

Exhibit Number	Description
3.1	Restated Articles of Incorporation. <i>(Incorporated by reference to Exhibit a.2 filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-141847) filed on June 1, 2007).</i>
3.2	Amended and Restated Bylaws. <i>(Incorporated by reference to Exhibit 3.1. filed with Allied Capital's Form 8-K on March 14, 2008).</i>
4.1	Specimen Certificate of Allied Capital's Common Stock, par value \$0.0001 per share. <i>(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).</i>
4.3	Form of Note under the Indenture relating to the issuance of debt securities. <i>(Contained in Exhibit 4.4). (Incorporated by reference to Exhibit d.1 filed with Allied Capital's registration statement on Form N-2/A (File No. 333-133755) filed on June 21, 2006).</i>
4.4	Indenture by and between Allied Capital Corporation and The Bank of New York, dated June 16, 2006. <i>(Incorporated by reference to Exhibit d.2 filed with Allied Capital's registration statement on Form N-2/A (File No. 333-133755) filed on June 21, 2006).</i>
4.5	Statement of Eligibility of Trustee on Form T-1. <i>(Incorporated by reference to Exhibit d.3 filed with Allied Capital's registration statement on Form N-2 (File No. 333-133755) filed on May 3, 2006).</i>
4.6	Form of First Supplemental Indenture by and between Allied Capital Corporation and the Bank of New York, dated as of July 25, 2006. <i>(Incorporated by reference to Exhibit d.4 filed with Allied Capital's Post-Effective Amendment No. 1 to the registration statement on Form N-2/A (File No. 333-133755) filed on July 25, 2006).</i>
4.7	Form of 6.625% Note due 2011. <i>(Incorporated by reference to Exhibit d.5 filed with Allied Capital's Post-Effective Amendment No. 1 to the registration statement on Form N-2/A (File No. 333-133755) filed on July 25, 2006).</i>
4.8	Form of Second Supplemental Indenture by and between Allied Capital Corporation and The Bank of New York, dated as of December 8, 2006. <i>(Incorporated by reference to Exhibit d.6 filed with Allied Capital's Post-Effective Amendment No. 2 to the registration statement on Form N-2/A (File No. 333-133755) filed on December 8, 2006).</i>
4.9	Form of 6.000% Notes due 2012. <i>(Incorporated by reference to Exhibit d.7 filed with Allied Capital's Post-Effective Amendment No. 2 to the registration statement on Form N-2/A (File No. 333-133755) filed on December 8, 2006).</i>
4.10	Form of Third Supplemental Indenture by and between Allied Capital Corporation and The Bank of New York, dated as of March 28, 2007. <i>(Incorporated by reference to Exhibit d.8 filed with Allied Capital's Post-Effective Amendment No. 3 to the registration statement on Form N-2/A (File No. 333-133755) filed on March 28, 2007).</i>
4.11	Form of 6.875% Notes due 2047. <i>(Incorporated by reference to Exhibit d.9 filed with Allied Capital's Post-Effective Amendment No. 3 to the registration statement on Form N-2/A (File No. 333-133755) filed on March 28, 2007).</i>
4.11(a)	Form of 6.875% Notes due 2047. <i>(Incorporated by reference to Exhibit d.9(a) filed with Allied Capital's Post-Effective Amendment No. 4 to the registration statement on Form N-2/A (File</i>

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*No. 333-133755) filed on April 2, 2007).*

- 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 Credit Agreement, dated April 9, 2008. *(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K on April 10, 2008).*
- 10.3 Note Agreement, dated October 13, 2005. *(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K on October 14, 2005).*

Exhibit Number	Description
10.3(a)	Amendment dated February 29, 2008, to Note Agreement dated as of October 13, 2005. <i>(Incorporated by reference to Exhibit f.3(a) filed with Allied Capital s Form N-2 (File No. 333-150006) filed on April 1, 2008).</i>
10.4	Note Agreement, dated May 1, 2006. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital s Form 8-K on May 1, 2006).</i>
10.4(a)	Amendment dated February 29, 2008, to Note Agreement dated as of May 1, 2006. <i>(Incorporated by reference to Exhibit f.11(a) filed with Allied Capital s Form N-2 (File No. 333-150006) filed on April 1, 2008).</i>
10.15	Second Amended and Restated Control Investor Guaranty, dated as of January 30, 2008, between Allied Capital and CitiBank, N.A., as Administrative Agent. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital s Form 8-K filed on February 5, 2008).</i>
10.17	The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan II. <i>(Incorporated by reference to Exhibit 10.2 filed with Allied Capital s Form 8-K filed on December 21, 2005).</i>
10.17(a)	Amendment to The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan II, dated January 20, 2006. <i>(Incorporated by reference to Exhibit 10.17(a) filed with Allied Capital s Form 10-K for the year ended December 31, 2005).</i>
10.17(b)	Amendment to The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan II, dated December 14, 2007. <i>(Incorporated by reference to Exhibit 10.2 filed with Allied Capital s Form 8-K filed on December 19, 2007).</i>
10.18	The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital s Form 8-K filed on December 21, 2005).</i>
10.18(a)	Amendment to The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan, dated January 20, 2006. <i>(Incorporated by reference to Exhibit 10.18(a) filed with Allied Capital s Form 10-K for the year ended December 31, 2005).</i>
10.18(b)	Amendment to The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan, dated December 14, 2007. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital s Form 8-K filed on December 19, 2007).</i>
10.19	Amended Stock Option Plan. <i>(Incorporated by reference to Appendix B of Allied Capital s definitive proxy statement for Allied Capital s 2007 Annual Meeting of Stockholders filed on April 3, 2007).</i>
10.20(a)	Allied Capital Corporation 401(k) Plan, dated September 1, 1999. <i>(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).</i>
10.20(b)	Amendment to Allied Capital Corporation 401(k) Plan, dated April 15, 2004. <i>(Incorporated by reference to Exhibit 10.20(b) filed with Allied Capital s Form 10-Q for the period ended June 30, 2004).</i>
10.20(c)	Amendment to Allied Capital Corporation 401(k) plan, dated November 1, 2005. <i>(Incorporated by reference to Exhibit 10.20(c) filed with Allied Capital s Form 10-Q for the quarter ended September 30, 2005).</i>
10.20(d)	Amendment to Allied Capital Corporation 401(k) plan, dated April 21, 2006. <i>(Incorporated by reference to Exhibit i.4(c) filed with Allied Capital s Form N-2 (File No. 333-133755) filed on May 3, 2006).</i>
10.20(e)	Amendment to Allied Capital Corporation 401(k) plan, adopted December 18, 2006. <i>(Incorporated by reference to Exhibit 10.20(e) filed with Allied Capital s Form 10-K for the year ended December 31, 2006).</i>
10.20(f)	

Amendment to Allied Capital Corporation 401(k) plan, dated June 21, 2007. *(Incorporated by reference to Exhibit 10.20(f) filed with Allied Capital's Form 10-Q for the quarter ended June 30, 2007).*



Exhibit Number	Description
10.20(g)	Amendment to Allied Capital Corporation 401(k) plan, dated June 21, 2007. <i>(Incorporated by reference to Exhibit 10.20(g) filed with Allied Capital's Form 10-Q for the quarter ended June 30, 2007).</i>
10.20(h)	Amendment to Allied Capital Corporation 401(k) plan, dated September 14, 2007, with an effective date of January 1, 2008. <i>(Incorporated by reference to Exhibit 10.20(h) filed with Allied Capital's Form 10-Q for the quarter ended September 30, 2007).</i>
10.21	Employment Agreement, dated January 1, 2004, between Allied Capital and William L. Walton. <i>(Incorporated by reference to Exhibit 10.21 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.21(a)	Amendment to Employment Agreement, dated March 29, 2007, between Allied Capital and William L. Walton. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K filed on April 3, 2007).</i>
10.22	Employment Agreement, dated January 1, 2004, between Allied Capital and Joan M. Sweeney. <i>(Incorporated by reference to Exhibit 10.22 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.22(a)	Amendment to Employment Agreement, dated March 29, 2007, between Allied Capital and Joan M. Sweeney. <i>(Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 8-K filed on April 3, 2007).</i>
10.23	Employment Agreement, dated January 1, 2004, between Allied Capital and Penelope F. Roll. <i>(Incorporated by reference to Exhibit 10.23 filed with Allied Capital's Form 10-K for the year ended December 31, 2006).</i>
10.23(a)	Amendment to Employment Agreement, dated March 29, 2007, between Allied Capital and Penelope F. Roll. <i>(Incorporated by reference to Exhibit 10.3 filed with Allied Capital's Form 8-K filed on April 3, 2007).</i>
10.25	Form of Custody Agreement with Riggs Bank N.A., which was assumed by PNC Bank through merger. <i>(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).</i>
10.26	Custodian Agreement with Chevy Chase Trust. <i>(Incorporated by reference to Exhibit 10.26 filed with Allied Capital's Form 10-K for the year ended December 31, 2005).</i>
10.27	Custodian Agreement with Bank of America. <i>(Incorporated by reference to Exhibit 10.27 filed with Allied Capital's Form 10-K for the year ended December 31, 2005).</i>
10.28	Code of Ethics. <i>(Incorporated by reference to Exhibit 10.28 filed with Allied Capital's Form 10-K for the year ended December 31, 2006).</i>
10.29	Custodian Agreement with Union Bank of California. <i>(Incorporated by reference to Exhibit 10.29 filed with Allied Capital's Form 10-Q for the quarter ended June 30, 2006).</i>
10.30	Custodian Agreement with M&T Bank. <i>(Incorporated by reference to Exhibit 10.30 filed with Allied Capital's Form 10-Q for the quarter ended June 30, 2006).</i>
10.31	Note Agreement, dated as of May 14, 2003. <i>(Incorporated by reference to Exhibit 10.31 filed with Allied Capital's Form 10-Q for the quarter ended March 31, 2003).</i>
10.31(a)	Amendment dated February 29, 2008, to Note Agreement dated as of May 14, 2003. <i>(Incorporated by reference to Exhibit f.19(a) filed with Allied Capital's Form N-2 (File No. 333-150006) filed on April 1, 2008).</i>
10.32	Custodian Agreement with Branch Banking and Trust Company. <i>(Incorporated by reference to Exhibit 10.32 filed with Allied Capital's Form 10-Q for the quarter ended March 31, 2008).</i>
10.33	

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- Note Agreement, dated June 20, 2008. *(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K on June 23, 2008).*
- 10.37 Form of Indemnification Agreement between Allied Capital and its directors and certain officers. *(Incorporated by reference to Exhibit 10.37 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).*
- 10.38 Note Agreement, dated as of March 25, 2004. *(Incorporated by reference to Exhibit 10.38 filed with Allied Capital's Form 10-Q for the period ended March 31, 2004.)*

Exhibit Number	Description
10.38(a)	Amendment dated February 29, 2008, to Note Agreement dated as of March 25, 2004. <i>(Incorporated by reference to Exhibit f.25(a) filed with Allied Capital s Form N-2 (File No. 333-150006) filed on April 1, 2008).</i>
10.38(b)	First Waiver and Second Amendment dated as of July 25, 2008, to the Note Agreement dated as of March 25, 2004. <i>(Incorporated by reference to Exhibit 10.38(b) filed with Allied Capital s Form 10-Q for the period ended June 30, 2008.)</i>
10.39	Note Agreement, dated as of November 15, 2004. <i>(Incorporated by reference to Exhibit 99.1 filed with Allied Capital s current report on Form 8-K filed on November 18, 2004.)</i>
10.39(a)	Amendment dated February 29, 2008, to Note Agreement dated as of November 15, 2004. <i>(Incorporated by reference to Exhibit f.26(a) filed with Allied Capital s Form N-2 (File No. 333-150006) filed on April 1, 2008).</i>
10.40	First Omnibus Waiver and Amendment to the Note Agreements, dated as of July 25, 2008. <i>(Incorporated by reference to Exhibit 10.40 filed with Allied Capital s Form 10-Q for the period ended June 30, 2008.)</i>
11	Statement regarding computation of per share earnings is included in Note 7 to Allied Capital s Notes to the Consolidated Financial Statements.
15*	Letter regarding unaudited interim financial information.
21	Subsidiaries of Allied Capital and jurisdiction of incorporation/organization:
	A.C. Corporation Delaware
	Allied Capital REIT, Inc. Maryland
	Allied Capital Holdings, LLC Delaware
	Allied Investment Holdings, LLC Delaware
	Allied Capital Beteiligungsberatung GmbH (inactive) Germany
31.1*	Certification of the Chief Executive Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
31.2*	Certification of the Chief Financial Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
31.3*	Certification of the Chief Accounting Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
32.1*	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.
32.2*	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.
32.3*	Certification of the Chief Accounting Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.

\* Filed herewith.

**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)

Dated: November 10, 2008

/s/ William L. Walton

William L. Walton  
Chairman and Chief Executive Officer

/s/ Penni F. Roll

Penni F. Roll  
Chief Financial Officer

/s/ John C. Wellons

John C. Wellons  
Chief Accounting Officer

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description</b>
15	Letter regarding Unaudited Interim Financial Information.
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
31.3	Certification of the Chief Accounting Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
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