

# An Analysis of Allied Capital Questions of Valuation Technique

By

Greenlight Capital, Inc.

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*Funds advised by Greenlight Capital have sold shares of Allied Capital short. This analysis is based upon information about Allied Capital including publicly available information, interviews with Allied Capital's management, the Securities and Exchange Commission and numerous other industry sources. Greenlight presents this analysis "as is" and believes the information contained to be reliable. The opinions expressed in this analysis belong to Greenlight Capital. This analysis is not intended as an investment recommendation to others. Greenlight Capital only provides investment advice to the funds it advises. Greenlight reserves the right to change its investment position and opinion at any time without further notice to any party. The primary purpose of this analysis is to protect Greenlight's reputation for thorough analysis and refute the spurious claims by Allied's management that Greenlight Capital did not talk to management in the course of its analysis and is out to "develop the short thesis to scare people and make a quick buck and move on."*

## Greenlight Capital's Analysis of Allied Capital

### Executive Summary:

Following is a summary of Greenlight's analysis of Allied Capital. A more detailed analysis follows the summary.

1. Allied Appears to have Created Its Own Accounting Methods. Allied has produced a "white paper" with its interpretation of fair value accounting. Allied appears to be openly flaunting SEC requirements. Allied believes that, "the Small Business Administration Policy is far more applicable to the portfolio of a Business Development Company than the valuation guidance set forth by the SEC." Greenlight disagrees. Greenlight has checked with the Douglas Scheidt, Associate Director and Chief Counsel in the SEC's Division of Investment Management. Greenlight believes that the SEC disagrees with Allied's interpretation and believes that Business Development Companies are subject to the same rules as other Investment Companies. As a result, Greenlight doubts Allied complies with the Investment Company Act of 1940 requirements in calculating its earnings and Net Asset Value.
2. Allied Appears to have Mismarked Individual Investments. Greenlight wonders whether the examples Greenlight has been able to identify are isolated or are part of a broader problem. As there is little information available about most of Allied's investments, Greenlight is worried that since Greenlight has identified so many apparent problems in the small number of investments where information is available, many valuations might not stand up to scrutiny if all the circumstances were fully disclosed. Greenlight has identified approximately 35% of Allied's specialty finance portfolio that it believes may be carried above fair value.
3. Allied does not Reflect Temporary Changes in Value in its Net Asset Value Calculation. This is inconsistent with the 1940 Act. According to Mr. Scheidt, "the appropriate standard is, 'what can you get for it today?'" This leads to systemic overstatement of asset values, in Greenlight's opinion. This applies, in particular, to monitor list and non-accrual loans that Allied carries at cost (without any reserve) and impaired loans that Allied carries at ultimate recovery value, rather than current fair value.
4. Allied Recognizes Permanent Impairments in Value as "Unrealized Depreciation." As the value has been permanently impaired, Greenlight believes that such losses should be classified as "charge-offs." In the event of a better than expected recovery on a "charged-off" loan, Allied could recognize a recovery that would be netted against current period charge-offs. Allied's treatment delays the recognition of losses and creates the investor misperception that realized gains

exceed realized losses. Greenlight estimates that through its treatment Allied has deferred over \$65 million of charge-offs.

5. Allied has Several Unconsolidated Controlled Investments that Contribute Disproportionately to Allied's Reported Earnings. Allied provides no disclosure of the actual performance of controlled investments. Allied recognized \$29 million in fees from controlled companies last year and charges them interest rates up to 25%. Greenlight wonders whether these fees are arms-length transactions for competitive services at competitive prices, as few non-controlled companies engage Allied on similar terms.
6. Allied's Largest Investment, Business Loan Express, is Analogous to Enron's Raptor. Allied controls Business Loan Express through common share ownership. Allied books income for fees and interest income which Business Loan Express finances through cash investments and third party loans guaranteed by Allied. Yet because of the peculiar rules of Regulated Investment Companies, Allied does not have to provide any data on the actual economics of Business Loan Express. Meanwhile, Business Loan Express appears to be performing poorly as delinquencies reached 14.5% in December 2001 compared to 3.5% in June 1999. Greenlight believes it would be helpful for Allied to provide full financial statements for Business Loan Express and all other controlled companies.
7. Allied has to Finance its Dividend. Allied earned \$65 million in non-cash income that it pays out to shareholders as a dividend. In fact, Allied sold more new equity in each of the last three years than it has paid out in dividends. Allied says the new equity was for new investment. Greenlight believes that money is fungible and the dividend could not have been paid without shrinking the portfolio, new borrowings (which are limited by statute) or equity sales.
8. Promised Dividend Growth Requires Premium Stock Sales. As Allied cannot retain its operating earnings, the principal way it grows its Net Asset Value is through new equity sales at a premium to Net Asset Value. In order to grow its dividend on a sustained basis, Allied must continue this practice.
9. Arthur Andersen Changed Its Language in Allied's Most Recent Audit Letter. Allied's management's explanations on this point have been inconsistent and evolving. Greenlight believes that the change in audit language is a red flag. From Greenlight's point of view, regardless of whether the scope of the audit has changed, whoever approved the Velocita debt and warrant valuations at cost at the end of 2001 and the other criticized investments and valuation methods did not provide appropriate critical scrutiny.

## **An Analysis of Allied Capital Questions of Valuation Technique**

### Background:

On Wednesday, May 15<sup>th</sup>, David Einhorn, Portfolio Manager of Greenlight Capital, presented an example of Greenlight's analysis and investment discipline at the Ira W. Sohn Investment Research Conference, a charity event sponsored by the Tomorrows Children's Fund to support the needs of pediatric cancer and blood disorder victims at the Don Imus/WFAN Pediatric Center at Hackensack University Medical Center in Hackensack, NJ. The conference, now in its seventh year, featured eleven accomplished investment managers, each of whom presented at least one idea currently in his portfolio.

Mr. Einhorn began his remarks by describing the success Greenlight has had on its short portfolio over the last six years, a 30% return on invested capital, including many financial institutions such as Conseco, Compucredit, Sirrom Capital, and Resource America. He explained Greenlight's long-standing general criteria for shorting stocks: overvaluation and deterioration—generally with an insight misunderstood by the market. Finally, Mr. Einhorn explained why Allied Capital (ticker: ALD) met Greenlight's criteria and is a current short investment in the firm's portfolio.

Greenlight has found several examples where Allied's management has not marked its investments to fair value. The reason these examples are important is not only do they provide clear publicly available data by which to judge their market value, but also they indicate that other parts of Allied's portfolio may suffer from similar mismarkings. Greenlight has identified 35% of Allied's specialty finance portfolio that may be carried above fair value.

While Mr. Einhorn did share Greenlight's thesis that Allied Capital has mismarked its portfolio, benefits from low quality earnings streams, and depends on premium stock sales to grow its net asset value and support the dividend, he made no personal attacks against Allied's management. Contrary to press accounts, Mr. Einhorn does not offer investment advice other than to Greenlight's portfolios, and Mr. Einhorn did not recommend a short sale of Allied to anyone else in the audience. Mr. Einhorn pledged on behalf of himself and his partners to donate half of Greenlight's carried interest on its Allied investment to the Tomorrows Children's Fund.

### Conference Calls:

The next morning on May 16<sup>th</sup>, Allied management held a conference call, in evident response to the large negative trading reaction to questions raised by Mr. Einhorn. Management disputed Greenlight's research and conclusions and gave its view of Greenlight's agenda. Unfortunately, Greenlight was unable to directly access the

conference call given “capacity constraints.” Greenlight was able to access an audio transcript of the call after its completion on Allied Capital’s website.

During the conference call, Allied’s CEO Mr. Walton said, “We find it unusual that somebody gets up and gives a speech about a company who never bothers to talk to management. I think most informed investors would appreciate some time spent with us so they can talk these things through unless you are simply trying to develop the short thesis to scare people and make a quick buck and move on.”

While Greenlight never spoke with Mr. Walton, Greenlight spent *several hours* discussing issues and confirming information with company representatives. Greenlight spoke with Ms. Sparrow of Allied’s investor relations on April 24<sup>th</sup> and with Allied’s Chief Financial Officer, Ms. Roll, and Ms. Beane on May 1<sup>st</sup>. Greenlight can only conclude management, through Mr. Walton’s assertions, desperately wants the public to believe Greenlight has been negligent in its homework. Ms. Sparrow’s silence during this portion of the conference call was deafening.

In a subsequent Dow Jones newswire story, Allied reversed its previous public declaration by conceding Greenlight had, in fact, spoken with Ms. Roll and Ms. Sparrow.<sup>1</sup>

Allied conducted a second conference call on May 29<sup>th</sup>. During that conference call Greenlight attended but was unable to ask any questions in the Q&A, as Greenlight was not accepted to ask a question despite following the operator’s instructions.

Now, Greenlight understands that Allied has hired Mr. Lanny Davis to assist them in spinning the media, particularly with conspiracy theories. Greenlight last encountered Mr. Davis a few months ago when he was enthusiastically defending questionable accounting at Seitel, Inc. (NYSE: SEI). Seitel is another company Greenlight is short. Since Mr. Davis was retained, Seitel has restated its earnings, its Chairman and CEO has resigned, its CFO was terminated and it is in default on its recently issued investment grade debt.

#### Fair Value Accounting:

Allied is a Regulated Investment Company (“RIC”). As a RIC it is subject to the Investment Company Act of 1940. As such, it uses “fair value” accounting. As a result, it is not required to take a general loss reserve as a bank or a specialty lender would. Instead, in each period Allied must mark each investment in its portfolio at fair value.

According to Section 2(a)(39) of the 1940 Act “value” is defined as (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors...<sup>2</sup>

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<sup>1</sup> “Allied Capital Call: Nothing Changed with Audit’s Scope”, Dow Jones Newswire, May 16, 2002

<sup>2</sup> ASR 118, p.2.

The SEC has issued two accounting series releases (“ASR”) that amplify the SEC’s interpretation of requirements under the 1940 Act.

In a December 8, 1999 letter by Douglas Scheidt, Associate Director and Chief Counsel in the SEC’s Division of Investment Management to the Investment Company Institute, the SEC’s views on fair value pricing were made clear:

“The Commission has stated that, as a general principle, the fair value of a portfolio security is the price which the fund might reasonably expect to receive upon its current sale. Ascertaining fair value requires a determination of the amount that an arm’s-length buyer, under the circumstances, would currently pay for the security. Fair value cannot be based on what a buyer might pay at some later time, such as when the market ultimately recognizes the security’s true value as currently perceived by the portfolio manager. Funds also may not fair value price portfolio securities at prices which are not achievable on a current basis on the belief that the fund would not currently need to sell those securities. Thus, bond or similar funds generally may not fair value price portfolio securities at par based on the expectation that the funds will hold these securities until maturity, if the fund could not receive par value upon the current sale of those securities.”<sup>3</sup>

Allied has prepared a *white paper* titled, “Valuation of Illiquid Securities Held by Business Development Companies.” According to Ms. Sweeney on the May 29<sup>th</sup> conference call,

“[O]ur net asset value is based upon fair value estimates for the securities in our portfolios. We have a consistent process we’ve used to determine fair value, and that process is clearly outlined in our disclosure document. In addition, if you visit our website, you will see that we have written a white paper on fair value accounting and our interpretation of its application.”

This *white paper* appears to be a description of the accounting policies Allied actually uses. The general thesis of the paper is that the 1940 Act was not designed to accommodate the special needs of Business Development Companies (“BDC”) and that the Small Business Administration (“SBA”) accounting principles are more appropriate for BDC portfolios.

Greenlight observes that a portion of Allied’s stated accounting policy in its 10-K appears to reflect SBA rather than SEC accounting principles.

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<sup>3</sup> “December 1999 Letter to the ICI Regarding Valuation Issues,” from Douglas Scheidt Associate Director and Chief Counsel of the SEC Division of Investment, December 8, 1999.

“The Company’s valuation policy considers the fact that privately negotiated securities increase in value over a long period of time, that the Company does not intend to trade the securities, and that no ready market exists. The Company’s valuation policy is intended to provide a consistent, conservative basis for establishing the fair value of the portfolio . . . The Company will record unrealized depreciation on investments when it believes that an asset has been impaired and full collection for the loan or realization of an equity security is doubtful. Conversely, the Company will record unrealized appreciation if it has a clear indication that the underlying portfolio company has appreciated in value and, therefore, the Company’s security has also appreciated in value. Under its valuation policy, the Company does not consider temporary changes in the capital markets, such as interest rate movements or changes in the public equity markets, in order to determine whether an investment in a private company has been impaired or whether a private investment has increased in value.”<sup>4</sup>

In the *white paper* Allied argues, “the SBA Policy is far more applicable to the portfolio of a BDC than the valuation guidance set forth by the SEC in the ASRs.”<sup>5</sup>

Greenlight believes that Allied wants to legislate its own regulatory treatment, where it gets the best benefits of being a RIC or an SBIC on a line item by line item basis.

Though the SEC has made it clear that illiquid investments must be valued based upon what they are worth in a current sale, Allied does not use the current sale test. Even so, Allied concedes if it did use the “current sale” test it would cause a material change in its NAV. In its *white paper* Allied states, “The concept of ‘current sale’ in ASR 118 is particularly troubling if applied to a BDC’s illiquid portfolio, because if such a portfolio were subject to a current sale test, the portfolio would need to carry a significant discount from the face value of its underlying securities.”<sup>6</sup>

Ms. Sweeney continued to explain why current value should not be used on the May 29<sup>th</sup> conference call,

“The idea that we should be marking long-term, illiquid investments to some artificial or theoretical markets instead of telling shareholders what we really think we have made in gains or lost in principal seems theoretical at best and at least confusing. We don’t hide what we’ve lost by claiming a temporary decline in market. When you read our income statement and look at net income, you know where we think we actually are and don’t think

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<sup>4</sup> Allied Capital Corporation 2001 Annual Report, p. 18.

<sup>5</sup> Allied Capital White Paper, p.11.

<sup>6</sup> Ibid, p.6.

it serves any purpose to cloud our results with a lot of temporary unsustainable ups and downs.”

The problem here is that ASR 113 clearly states otherwise,

“As a general principle, the current fair value of restricted securities would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. This depends upon their inherent worth, without regard to the restricted feature, adjusted for any diminution in value resulting from the restrictive feature. Consequently, the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for most unusual situations, be improper. Further, the continued valuation of such securities at cost would be improper if, as a result of the operations of the issuer, change in general market conditions or otherwise, cost has ceased to represent fair value. In such circumstances, maintaining the value of the restricted securities at cost would mislead investors as to the value of the portfolio of the investment company which holds restricted securities.”<sup>7</sup>

There are many items in the *white paper* that seem inaccurate or out of context. Here are some quotes that seem faulty.

- “However, ASR 118 does not contemplate a privately negotiated, highly structured illiquid security held for investment until maturity in its explanation of what a ‘current sale’ means.”<sup>8</sup>
- “The concept of ‘current sale’ for purposes of determining fair value in ASR 118 is difficult, if not impossible, to apply in the case of a BDC’s portfolio.”<sup>9</sup>
- “Over the expected investment period, it is natural for a BDC to expect temporary increases and decreases in perceived investment value, however, these temporary anomalies have little to do with the expected investment return.”<sup>10</sup>
- “Clearly, since the BDC plans to hold a debt security until its repayment, fluctuations in interest rates in the capital markets are not relevant to the value of the principal amount of the note that will ultimately be collected. If the BDC were to change the value of debt securities solely because of market interest rate fluctuations, it could erroneously record appreciation or depreciation that has no chance of ever being realized when the debt security is repaid.”<sup>11</sup>

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<sup>7</sup> ASR 113, p. 2.

<sup>8</sup> Allied Capital White Paper, p.4.

<sup>9</sup> Ibid, p.5.

<sup>10</sup> Ibid, pp.5-6.

<sup>11</sup> Ibid, p.7.



- “The SEC has recently confirmed, with little further guidance, that in fact fair value is *not* intended to be a ‘fire sale’ price. In In Re Parnassus Investments, an administrative law judge found that the fund had violated the requirement that the fund’s board of directors fair value restricted securities in good faith. Respondent had argued that the ‘current sale’ requirement was tantamount to a ‘fire sale.’ The judge responded that ‘[r]espondents are correct in that fire sale pricing was never the intention of the Commission.’”<sup>12</sup>

Here, Allied leaves out the next sentence which reads, “However, while it is clear that the current sale principle recognizes a reasonable time frame in which to arrange sales it does not ignore the fact that a security may suffer from a thin market or other unenviable variables.”

Without providing detailed analysis of each of these points, it seems clear that Allied has adopted policies that are inconsistent with SEC policy. If so, Allied’s statements of earnings and NAV are inconsistent with statutory requirements.

Greenlight spoke with Mr. Scheidt at the SEC about Allied’s claims that BDC’s should be treated differently than other investment companies. While Mr. Scheidt did not comment about Allied specifically, he did address the argument that BDC’s should have special treatment. Greenlight asked for and received explicit permission from Mr. Scheidt to quote him and the following is an excerpt from our conversation:

Mr. Einhorn: There’s a BDC out there in the public market that is making the general argument that the general standards for the 1940 Act that the SEC has given out are mostly for mutual funds closed and open ended that have to value their assets on an NAV basis on a daily basis to let investors in and out. And since they are a business development company with a portfolio of assets that they could hold for five to ten years, they really are much more like a small business lender, and as a result, they should be held to sort of the SBA standards for accounting which is instead of a current fair value test, more of an impairment test as investments go bad, and I guess we’re sort of wondering what you think of that analysis.

Mr. Scheidt: Disagree. We said in either or both of the two letters that James [Lin of Greenlight] mentioned yesterday that I wrote that the guidance that we were providing applied to all investment companies, open end and closed end. And here’s the reason. The BDC is right to one extent. Since open end funds do have to redeem and since they’re continuously offered, it is very important for those funds to accurately calculate their NAVs. It’s essential to their operations. Closed end funds and BDCs, though, publish their NAVs if they’re trading on an exchange, the exchange usually requires them to do that at least weekly or monthly, and they are required to provide financial statements that set forth their NAV and all of these

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<sup>12</sup> Ibid, p.6.

NAV calculations that they are required to make or that they do make are subject to the 40 Act and regardless of whether they redeem or repurchase or sell their shares. So it is, and for example, their publication of their NAV may have an effect on market prices.

Mr. Einhorn: It may also affect their ability for one-to-one debt/equity limitations.

Mr. Scheidt: Yeah, so I know of no reason why and I have never -- I know that closed end funds have tried to argue that they shouldn't be subject to the same standards because of the differences between closed end funds and open end funds. For that same reason that the BDC ... but the Act and the law doesn't differentiate between the two. It says for all investment companies, they are required to use market quotes and do fair value. And we have had closed end funds make the same argument that since they don't have to do redemptions, that if they invest in a bank loan participation fund, they typically hold until maturity then they should be able to value it at what they can get for it at maturity unless there is some sort of impairment in the credit or the collateral that's underlying the bank loan.

Mr. Einhorn: Exactly.

Mr. Scheidt: So, and we said no, and in fact in the first of the two letters, as I mentioned yesterday, we specifically included in response to those kinds of claims the statement that it's inappropriate for a fund to value it at what the fund would expect to get for it at some point in the future because the appropriate standard is, 'what can you get for it today?' So, a closed-end fund made the same sort of argument with a bank participation fund and we specifically included that in response to that claim. And we told them privately that they can't value their securities that way and I don't even know if you followed that market at all, but all the primary or other bank loan participation funds all of a sudden went from a fairly stable net asset value to a much more fluctuating net asset value and they took hits because they used a fair value approach which required them to lower the valuations of their securities.

Mr. Einhorn: Right. Then what do you say in response to somebody who says well we have, we custom tailor every loan we make to every one of these private companies and these loans are very illiquid and custom tailored and we know these credits better than anybody else and than any potential buyer ever would, and we tend to hold these things for five to ten years. If you actually forced us to sell these things, pretty much any sale that we would make would constitute a fire sale.

Mr. Scheidt: I would say we're not forcing you to sell. The way that I've told people when they raise the argument about how do you value illiquid securities, how do you apply the standard that says you use the value that you would

get today from a willing buyer when it would take me months or weeks to sell this thing. I say assume that weeks or months ago you started beating the bushes for a buyer. And it took however long it took and now today you have a willing buyer who is willing to buy from you, what would they buy it from you for? So it's not a fire sale like "Oh my God, I've got to get rid of this, will somebody take this off my hands?"

Mr. Einhorn: Right, but their commentary, their response would be, look, nobody ever sells these loans and the only time anybody ever sells these loans is when they're in financial distress or when the owner's in financial distress and has to conduct a fire sale. Even if you told me to go sell it to somebody, if I got somebody there and I got them interested in the credit, whether I was having a fire sale or I wasn't having a fire sale, they would perceive it as a fire sale because it's so abnormal to sell a loan such as this in any circumstance that is not a fire sale.

Mr. Scheidt: I would say that would be all the more reason to hold it at a lower value because that's what it's worth.

#### The Manifestations of Allied's Self Created Accounting:

Greenlight observes that mezzanine loans to middle market companies are generally riskier than high yield bonds. Mezzanine loans charge higher rates to compensate for the greater possibility of loss. Middle market companies tend to be smaller than high yield issuers and usually do not have access to public equity capital as many high yield issuers do. According to Moody's, over 12% of high yield issues defaulted last year. Some public portfolios of senior loans to middle market companies, such as Finova's, performed awfully. Therefore, Greenlight questions how Allied has survived the recession with a credit loss rate of less than 1%.

Allied has a long-term successful investment record. However, this record was largely achieved under prior portfolio managers who were investing mostly in different classes of assets such as small business loans and commercial real estate loans—not today's mix of subordinated mezzanine loans and first loss tranches of commercial mortgage backed securities. Greenlight questions how Allied's portfolio outperformed its asset class by such a wide margin during such a difficult period. If the losses exist, but have not been recognized yet, then they will come eventually.

Management has responded that the portfolio is not similar to high yield bonds. They say that high yield bonds have few covenants. In fact, Greenlight has substantial experience with high yield bonds. Greenlight observes that many high yield bonds are senior obligations and many have substantial covenant packages. Allied's loans are mostly subordinated obligations. As a result of the greater risk Allied takes in subordinated investments, Allied charges a higher cost of capital and needs to take a more active role in overseeing management decisions than high yield investors. In this sense, Allied acts more like an equity investor. This seems appropriate as Allied is

further out on the risk curve than high yield investors. This supports Greenlight's analysis that Allied should have reported losses much greater than 1% through the recession.

#### Allied's Losses:

Greenlight suspects that Allied has not taken certain losses on its financial statements that it should have taken. Greenlight believes both anecdotal evidence and methodological valuation flaws suggest that Allied's portfolio investments have not been marked to current "fair value" according to Allied's own standards or as required by the Investment Company Act of 1940.

Sell-side analysts have noted that the remaining exposure to the identified questionable investments is low. However, this misses the point entirely. The point of discussing individual investments is to shine a brighter light on the valuation treatment Allied employs more generally.

#### *Specific Anecdotes:*

The point of highlighting individual investments is not to expose potential risk in the portfolio. Rather, such investments demonstrate cases where management's willingness to own up to its problems was inadequate. If one can find so many problems in Allied's small public market portfolio, Greenlight wonders what would be discovered in a detailed analysis of Allied's private holdings.

Below are several investments where Allied appears to have marked its position above fair value. The facts of these investments as Greenlight understands them from public documents and conversations with Allied's management and industry sources are as follows:

- Point 1—Velocita, Inc.

Velocita, Inc. (formerly P.F. Net) is an investment that was sponsored by Cisco. On the May 16<sup>th</sup> conference call, Mr. Walton said, "We do understand that Cisco has written down its investment. But Cisco is in the equity, which of course is the first thing to go in a troubled telecom situation. We're in with a fairly sophisticated group of bondholders here and we think there are some interesting recovery possibilities."

Mr. Walton's statement is misleading. In fact, in addition to its \$200 million equity investment, Cisco also holds \$50 million of Velocita's vendor financing facility.<sup>13</sup> This facility is senior to Velocita's publicly traded bonds and equity warrants that Allied owns.

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<sup>13</sup> Velocita, Inc. Form 10-K, December 31, 2001, Note 6. Credit Facility, p. F-15.

Greenlight understands Cisco fully reserved for both its equity and vendor financing exposure during 2001.<sup>14</sup> On the other hand, at year-end Allied carried its subordinate bond investment at par and its equity warrants at cost. Even after taking an apparently belated write-down in March 2002, Allied continues to mark its debt investment in Velocita at about 37% of cost, even as it trades in the low single digits.

In contrast to Allied, Prospect Street Income Shares Inc., a high yield mutual fund, carried its investment in the same Velocita bonds at 20% of par at year-end. Greenlight understands that CS First Boston traded \$20 million face of the Velocita bonds on March 29, 2002 at 1.25% of par.

On the May 29<sup>th</sup> conference call, Ms. Sweeney replied to Greenlight's criticism,

“Now, let's discuss Velocita. There is no quoted market price for these bonds. You can go to Bloomberg and search for a quote and you will not find one. You can go to a trading desk and try to buy these bonds and assuming they find a seller, the buyer and seller will negotiate and agree to a price for their transaction. When we determine that a security is illiquid with no quoted market price, our valuation procedures require us to determine its fair value in good faith as required by our regulations. Our good faith fair value estimate for the \$15 million Velocita bonds was determined as follows: we carried the Velocita bonds at cost at December 31, 2001. We just received our November interest payment on these bonds. They pay our interest semi-annually. And a review of the financial information then available to us did not indicate doubtful collection. We did inquire with a broker to see if any market for these bonds had developed, and the reply to us was there was no trading market for these bonds and they are not quoted.”

What does this say about Allied's portfolio monitoring techniques? How could this fund with a 40-year track record of superior returns not know how to find a quote? This was a \$225 million registered high yield issue. Who was this unidentified broker? Did they think to call the underwriter? Did CS First Boston stop quoting the bonds? Did the auditors require a documented record of the good faith effort to determine that there was no quoted market? Did Allied notice any problems such as the capital conservation program and the 24% workforce reduction that Velocita disclosed in the September 10-Q? Is the value of every loan cost until the debtor stops paying the interest?

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<sup>14</sup> In a March 20, 2002 Bloomberg news article entitled “Cisco May Lose \$200 Million From Velocita Investment” Cisco spokeswoman Robyn Jenkins is quoted as saying: “[T]he company has set aside enough money for the potential loss of its Velocita investment and financing.” In a call to Cisco investor relations, Greenlight Capital confirmed that Cisco had established reserves for its loan and equity to Velocita in 2001.

Greenlight has obtained historical quoted prices for the Velocita bonds from Chase Securities. According to Chase, at various quarter ends the bonds were quoted:

<u>Date</u>	<u>Quoted Price</u>	<u>Allied's Price</u>
September 28, 2000	76.5%	100.0%
December 28, 2000	96.5%	100.0%
March 29, 2001	60.0%	100.0%
June 28, 2001	60.0%	100.0%
September 27, 2001	60.0%	100.0%
December 27, 2001	10.0%	100.0%
March 28, 2002	0.5%	36.8% <sup>15</sup>

- Point 2—Startec Global Communications

Allied recorded its \$20 million debt investment in Startec Global Communications at cost throughout 2001 and even increased its investment in the company in June 2001 by an additional \$15 million despite significant evidence that Startec was failing. Arthur Andersen's auditor letter to Startec in the 2000 10-K filed on April 17, 2001 stated:

“ . . . the Company has suffered recurring losses from operations and has a net capital deficiency and working capital deficit. These facts raise substantial doubt about the Company's ability to continue as a going concern.”

Similar language was repeated in subsequent filings with emphasis on the significant risk that Startec could miss a critical November interest payment. Allied did not write down its debt investment in Startec until the fourth quarter of 2001 after Startec filed for bankruptcy. According to Startec's SEC filings, Allied's initial investment in Startec was *pari passu* with Startec's publicly traded 12% Senior Notes.<sup>16</sup>

Greenlight has obtained historical quoted prices for the Startec 12% Senior Notes from Chase Securities. According to Chase, at various quarter ends the bonds were quoted:

<sup>15</sup> Allied has said on the May 29<sup>th</sup> conference call that it carries this debt is carried at 28%. According to the March 31, 2002 form 10-Q, the Velocita debt has a cost of \$11,718,000 and a fair value of \$4,318,000.

<sup>16</sup> Disclosure in Startec's 2000 10K stated that the company's publicly traded 12% senior unsecured notes rank *pari passu* in right of payment with all other existing and future unsecured and unsubordinated obligations. The loan agreement with Allied Capital was filed as an amendment to Startec's 10Q for the period ending June 30, 2000 and clearly stated in the terms that the loan “is intended to have payment rights in parity with those of the High Yield/Public Debt.”

<u>Date</u>	<u>Quoted Price</u>	<u>Allied's Price<sup>17</sup></u>
June 29, 2000	80.0%	100.0%
September 28, 2000	80.0%	100.0%
December 28, 2000	60.0%	100.0%
March 29, 2001	45.0%	100.0%
June 28, 2001	3.0%	100.0%
September 27, 2001	4.25%	100.0%
December 27, 2001	2.0%	0.0%
March 28, 2002	2.0%	0.0%

- Point 3—NetTel Communications

NetTel Communications filed for bankruptcy in late 2000 and a Chapter 7 auction of its assets was held in December 2000. Allied valued its \$13 million unsecured debt investment in NetTel at cost in the third and fourth quarter of 2000 and continues to value its investment in the defunct NetTel at about 40% of cost. Greenlight does not understand how the investment could have been worth cost after NetTel had already filed for bankruptcy.

- Point 4—The Loewen Group

Allied owned publicly traded high yield bonds throughout Loewen's reorganization. The company carried its bonds at a premium to where the bonds traded and at a premium to the recovery value estimated in the disclosure document. Greenlight asked Ms. Roll why the company did not use the market price to value its bonds. Ms. Roll responded that the trading market was thin and not representative of where willing buyers and sellers would discover value. Based on its own analysis of Loewen's situation, Allied had concluded that its internally estimated premium valuation was appropriate. Ultimately, Allied's valuation was too optimistic, as the subsequent write-down demonstrated.

- Point 5—Companies with Discounted Bank Debt

Allied has invested in several companies where bank debt that is senior to Allied appears to be indicated to have lost value. If the senior debt is impaired, one would expect the subordinated debt and warrants to be even worse off. According to Loan Pricing Corporation Data, Kirkland, Inc.'s Term Loan tranche B was quoted 90%-92% at the end of 2001. Nonetheless, Allied at year-end carried its \$8 million investment in debt securities, preferred stock and warrants at cost.

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<sup>17</sup> We are using the bond price to compare to Allied's holding of unsecured debt on the belief that the two are pari passu. We understand that when Allied agreed to advance more money to the troubled Startec, it was able to make a portion of its investment structurally senior to the notes and wrote down its remaining investment that was pari passu with the bonds.

Wilmar Industries's Term Loan tranche B was quoted 86%-90%, according to Loan Pricing Data Corporation. The Franklin Floating Rate Trust Fund valued its investment in Wilmar term debt at a 10% discount on January 31, 2002. Allied at year-end carried its \$36 million investment in subordinated debt securities and warrants at cost.

- Point 6—Purchases of Additional Debt at a Discount

According to Allied's April 23, 2002 earnings press release,

“The company did find interesting opportunities to invest within its own portfolio by providing senior and subordinated capital to existing portfolio companies. The availability of senior debt capital from traditional sources, such as banks, continues to be scarce, and the company had several opportunities to purchase senior or subordinated notes at a discount from lending institutions looking to liquidate or reduce middle market portfolios.”

It appears that Allied bought senior debt of MVL Group and subordinated debt in United Pet Group and Polaris Pool Systems at a discount. In all of these cases, it appears that Allied continued to hold its existing investments at cost. Greenlight reasons that if the senior debt is available at a discount, then the subordinated debt is impaired to a greater extent. Greenlight thinks that when the subordinated debt can be purchased at a discount, then the remaining subordinated debt should be marked to the same level and the equity impaired. Separately, Greenlight has heard from private equity industry sources that United Pet Group and Polaris Pool Systems are problem credits.

After Mr. Einhorn criticized this practice, Mr. Walton on the May 16<sup>th</sup> conference call replied,

“There's been a couple of portfolios where people have chosen to go out of the business and as we've said repeatedly, our business is that of mezzanine investments with a long term illiquid asset class and when people need to engage in a fire sale of assets, those are typically traded at a discount and last quarter we purchased some sub-debt at a discount. And that was simply because of the fire sale phenomenon. It had nothing to do with the credit quality of the companies whose debt we were buying. In fact, it was a huge opportunity for us and very good for the shareholders. Now in cases where we were buying down senior debt where we have a subordinated debt investment, we recapitalize the business and write down the subordinated debt appropriately to reflect the overall value of the business. So it's not a question of us buying down senior debt at a discount and leaving the sub-debt in place at its previous structure and value. That simply does not happen.”



Greenlight cannot reconcile Mr. Walton's statement with the purchase of the senior MVL debt. Greenlight sees no sign of a recapitalization at MVL. Further, it seems that this management team is very quick to determine that markets are thin, quotations are not available and prices are fire sale.

- Point 7—Cooper Natural Resources

In the third quarter of 2001 Allied did a recapitalization of Cooper Natural Resources. \$3,724,000 of debt securities carried at cost became \$1,686,000 of debt securities, \$1,427,000 of preferred stock and \$832,000 of warrants. As the total cost basis and carrying value both increased by \$222,100, it appears that Allied either accrued non-cash interest or advanced additional funds to Cooper Natural Resources. According to Ms. Roll, this was done to make the capital structure make more sense to the senior lender, as the company was performing below plan.

Greenlight does not understand how debt securities that have to be partially equitized due to below plan operating performance can have a fair value of cost.

- Point 8—The CMBS portfolio

Allied owns around \$700 million in commercial mortgage backed securities (CMBS). According to the financial statements, Allied holds the CMBS at fair value. However, on the May 29<sup>th</sup> conference call, Ms. Sweeney said that Allied carries the CMBS at "amortized cost." Greenlight questions whether amortized cost is the same as fair value.

Greenlight has spoken with industry participants. One participant questioned Allied's use of a single loss assumption. Allied assumes that all CMBS will suffer loss of 1% spread evenly between years 3,6 and 9. According to him, it is more appropriate to make loss assumptions on a loan-by-loan basis. The industry participant estimated that portfolios held by Allied would more likely suffer losses in the 2-3% range. If so, this would have an enormous impact on Allied's CMBS portfolio value.

Greenlight thinks these examples speak loudly. Allied is required under the Investment Company Act of 1940 to mark its portfolio to "fair value." For Velocita, Startec and Loewen it appears that Allied violated its own policy as stated in its 10-K: "The value of investments in public securities is determined using quoted market prices, discounted for illiquidity or restrictions on resale."<sup>18</sup>

Greenlight questions whether it is appropriate to carry investments above market value. Management has responded on the conference call that it should not have to carry its investments at "fire sale" prices. However, in some cases, Allied appears to have carried investments above the market price for several quarters in a row. This suggests

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<sup>18</sup> Allied Capital Corporation 2001 Annual Report, p.18.

that the market prices with which Allied disagreed were not fire sale levels. To Greenlight, the market price is the market price. If the market price is too low, it will eventually improve, and then the investment can be written back up.

One sell side analyst from one of Allied's underwriters defending Allied has written, that "The nuance here is that Allied is required to mark to long term value, not mark to market."<sup>19</sup> Greenlight believes that this is inconsistent with Allied's stated policy quoted above and the Investment Company Act of 1940.

If Allied believes its portfolio markings in these instances were justifiable at the time, Greenlight invites them to publicly disclose the contemporaneous analysis they performed. Inasmuch as Velocita, Startec and Loewen are public companies with fully disclosed public data and NetTel is defunct, it is hard to see how disclosure of Allied's analysis could harm its investees. In Greenlight's estimation, disclosure is required to restore management's credibility.

Greenlight wonders whether the examples identified are isolated or part of a broader problem. Unfortunately for investors, little information is available on many of Allied's private investments. Greenlight has identified 35% of Allied's specialty finance portfolio that Greenlight believes may be carried above fair value.

Greenlight believes the burden is now on Allied's management to disclose enough information about its entire portfolio to demonstrate affirmatively that the anecdotes described above are isolated. As Mr. Walton said during the May 16<sup>th</sup> conference call, "We're committed to transparency and full disclosure." Greenlight awaits further disclosure.

#### *Systematic Valuation Concerns:*

Greenlight is also critical of certain valuation methodologies that appear to permeate entire sections of Allied's portfolio.

#### **The Whole Portfolio**

The entire market for middle market loans has deteriorated. Allied has not taken adjustment to its portfolio value to reflect the changed market. According to Mr. Walton on the May 29<sup>th</sup> conference call,

"In today's senior loan environment we are seeing sales as well as discounts that are clearly in the money. What we believe is that some banks have changed their policies about things like acceptable senior leverage ratios. Three years ago, banks were generally willing to lend up to 3.5, sometimes 4.5 times EBITDA. Now EBITDA as we all know is not a measure of cash flow, but is

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<sup>19</sup> "Allied Capital Corp. – The Song Remains the Same", Merrill Lynch Equity Research, May 16, 2002, p.2.

a standard metric use in the industry so we'll use that for today's discussion purposes. In any event, banks now want loans in most cases no more than 2 to 2.5 times EBITDA, at most 3. Some banks are selling loans that are above these ratios and because there's no liquid market, which we've talked about in the past, they're forced to take a discount."

It seems that Allied recognizes the market has changed, but believes that every sale is a "fire sale."

According to the JP Morgan 2001 High-Yield Annual Review, spreads on high yield bonds have widened over the past few years. Within high yield, lower grade bond spreads have widened more than higher grade bond spreads and non-cash paying bond spreads have widened versus cash paying bond spreads.<sup>20</sup> This suggest that the values of investments in Allied's portfolio have probably fallen.

Greenlight believes that Allied's entire portfolio should be marked to reflect the deterioration in the current value of middle market investments in the current environment.

### **Monitored Loans**

Loans rated 3 are on Allied's monitor list. According to Allied, companies on the monitor list are probably performing below plan and may have tripped financial or other covenants. They may have even stopped paying interest temporarily. However, no permanent loss of interest or principal is expected. Allied carries such monitor list loans at cost.

Greenlight asked the company why Grade 3 loans were not written down. Greenlight asked why a loan is not worth less than it was worth on the day it was underwritten, given the deterioration.

According to Ms. Sparrow, "Investments are marked down only when we believe that there has been a permanent impairment of the value. Once we mark it down we don't believe we will recover the investment."<sup>21</sup>

Greenlight understands the definitions, and cannot change the company's beliefs. However, Greenlight does not believe permanent impairment of value is an appropriate standard for measuring fair value. The company's accounting treatment seems inconsistent with the notion of fair value as defined by the SEC.

In Greenlight's experience, when a credit underperforms, even if Greenlight thinks it will pay all its interest and principal, spreads widen and debt instruments issued

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<sup>20</sup> J.P. Morgan "2001 Annual High-Yield Review," p. 19.

<sup>21</sup> Greenlight Capital spoke to Ms. Sparrow on April 24, 2002 to discuss Allied Capital, its investments and its valuation methodology.

at par become worth 95% or 90% of par or less. This does not seem to happen at Allied, where monitor list loans continue to be marked at cost.

### **Impaired Loans**

Loans rated 4 mean that Allied expects to lose some contractual interest but no principal. These loans are considered non-accrual. As for the carrying value of these loans, according to the May 29<sup>th</sup> conference call, “It depends on the asset, but most of those would be carried at original cost.” Greenlight does not believe that it is appropriate to carry non-accruing loans at a fair value of original cost.

Loans rated 5 mean that the principal is impaired. These loans appear to get written down to the value Allied expects to eventually recover. According to Mr. Walton on the May 29<sup>th</sup> call, “We write loans down to the amount that we believe we will collect. We record unrealized depreciation to show shareholders what we think has been lost.”

According to Ms. Sparrow, “There is no time limit on our investments...we could keep them at some level of value as long as something is being done to try and recover the investment.”<sup>22</sup>

Allied makes a big deal that its realized gains exceed its realized losses. Greenlight wonders whether the no time limit policy is appropriate for charge-offs. This leads to an enormous selection bias in this line item. If they can try collecting for a long time, charge-offs are unreasonably delayed. Perhaps, when a loan is permanently impaired the amount of the impairment should be recognized as a charge-off or a realized loss. Greenlight believes that Allied may be using the tax definition rather than the GAAP definition of realized losses. Greenlight estimates that Allied has deferred over \$65 million in charge-offs by not following this method.

Allied cites this as a positive benefit of their structure compared to a bank that has to recognize charge-offs to satisfy regulators. During conversations with Allied’s management, Greenlight asked for an example of an investment where the company’s patience paid off. Neither Ms. Sparrow nor Ms. Roll could cite a single loan in the last three years where Allied had carried the loan at a discount, were patient, and eventually got an improved recovery.

Greenlight believes that when a mezzanine loan to a middle market company becomes impaired, its fair value should be discounted from the eventual recovery value at a relatively high rate to compensate for both the time value of money and the inherent risk of achieving a recovery in such a difficult situation. Allied appears not to perform its valuation analysis in this fashion. Instead, Allied apparently carries the loan at the amount it expects to ultimately recover in the future.

Greenlight has evaluated Allied’s impaired loans. Greenlight observes that initial impairments are often followed by additional impairments. Greenlight finds very little

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<sup>22</sup> Ibid.

evidence to suggest Allied recaptures an appropriate risk-adjusted, net present value discount on impaired loans, let alone an actual improved recovery.

### Problems With Allied's Earnings' Quality:

Greenlight criticizes Allied's quality of earnings with respect to two additional areas: (1) controlled investment fees and interest and (2) non-cash interest and dividends.

#### *Controlled Investments*

In ordinary GAAP accounting, as applied to operating businesses, when one owns the majority of a company, results must be consolidated. Transactions between parent companies and controlled subsidiaries are called "intra-company" and are eliminated in the consolidation.

In Allied's RIC accounting, controlled investments are not consolidated, and intra-company transactions are not eliminated from consolidated results. The creation of these wholly controlled investments is a relatively recent practice for Allied. Allied provides services and charges fees (for investment banking and the like) to its controlled investments. In 1999, when Allied had no controlled investments, it recorded fee income of \$6 million, flat with 1998's fee income. In 2000, fee income grew to \$13 million. Last year, fee income on the income statement was \$46 million. According to Ms. Roll, \$29 million of the fees came from controlled investments. As non-controlled companies seem much less willing to hire Allied to perform services on similar terms, Greenlight wonders whether these fees are arms-length transactions for competitive services at competitive prices.

#### **Business Loan Express**

Business Loan Express (BLX) is the second largest small business lending company in the United States. It is Allied's largest investment. Thirteen percent of Allied's specialty finance portfolio is invested in BLX. Allied acquired the predecessor entity to BLX in an all-stock transaction at a 3.6 times multiple of book value in December 2000. The transaction was accomplished at a 60-80% premium to the trading value of Business Loan Financial (the predecessor entity). SBA lenders typically are sold at modest premiums to book value. The premiums paid are typically for the value of the license. Allied already owned an SBA license through its own small business lending entity called Allied Capital Express.

Subsequent to the acquisition, Allied contributed its 100% ownership interest in Allied Capital Express for preferred stock of the newly formed BLX. The valuation of Allied Capital Express is not disclosed. At the end of the transaction, BLX is owned 94% by Allied with Allied holding subordinate debt, preferred stock and common stock. Allied also guarantees 50% of BLX's third party debt.

Greenlight believes there is little economic substance to the various tranches of securities owned by Allied in BLX because Allied effectively owns nearly 100% of the upside and 100% of the downside. By carving out their economic interest in mezzanine debt and preferred stock, Allied is able to generate a "return" on its investment that likely substantially exceeds the economic earnings the business generates. At a price of 3.5 times book, Greenlight doubts an SBA lender could generate even a 10% return on investment, let alone the 25% BLX is "paying" to Allied for an \$80 million loan. This amounts to \$20 million of intra-company interest income.

In addition, Allied reduced its general and administrative expense by "transferring" 37 employees to BLX which further increased Allied's reported profitability.

In effect, Allied has turned a potential modest generator of earnings, BLX, into a huge generator of reported earnings. If one is a little more circumspect, one could conclude that the motivation to the transaction was to get Allied Capital Express off balance sheet because of growing losses in its loan portfolio which many SBAs have experienced in the last few years. BLX's most recent securitization document suggests that credit quality has deteriorated. Total delinquencies grew from 3.5% on June 30, 1999 to 14.5% on December 31, 2001.<sup>23</sup>

Greenlight has had discussions with industry insiders who are familiar with BLX's securitizations. Greenlight has been told that approximately 15% of the portfolio is in the liquidation phase, meaning that BLX is in the process of trying to recover value through a workout and/or asset sales. Further, BLX's recent loan pools have performed very poorly. Greenlight has been told that 7% of the original balance of loans originated in FY1999 has already been written-off. The same statistic for FY2000 was approximately 1.4% with over 10% of the 2000 loan pool in liquidation. Given that the average life of SBA loans are 20 years or more, things can only get worse for these particular pools.

There is no disclosure of BLX's actual financial statements. It is the ideal on-balance sheet/off-balance sheet structure. Greenlight believe BLX is analogous to Enron's Raptor. (i.e., Allied controls BLX through common share ownership. Allied books income for dividends and interest income which BLX finances through cash investments and third party loans guaranteed by Allied. Yet because of the peculiar rules of RIC's, Allied does not have to provide any data on the actual economics of BLX).

In Greenlight's opinion, however, this type of activity, left pocket to right pocket, explains why intra-company transactions are eliminated under most accounting systems. Moreover, Greenlight does not know of any finance companies like BLX that are able to make consistent profits when forced to borrow money at 25%. On the May 16<sup>th</sup> conference call, Mr. Walton was not able to cite any other third-party companies to which Allied charges 25% interest.

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<sup>23</sup> Business Loan Express SBA Loan-Backed Notes Series 2002-1 Preliminary Private Placement Memorandum, April 26, 2002, p. 49.

Mr. Walton attempted to comfort investors on the May 16<sup>th</sup> conference call by highlighting that BLX is performing “above plan.” Since, in addition to having no financial information at all regarding BLX, the public markets do not know what “plan” is, it is difficult to assess how much comfort this provides.

On the May 29<sup>th</sup> conference call management added, “For the nine months ended March 31, 2002, BLX made a profit after all expenses, including interest and fees to Allied Capital.” Greenlight has heard that Allied believes that BLX has \$50 million of EBITDA and is undervalued on Allied’s balance sheet.

Greenlight questions the quality of these earnings, particularly in the absence of full financial disclosure. As BLX is a securitizer of its loans, Greenlight wonders how much of its earnings come from low quality gain on sale accounting. Given Allied’s questionable practices for recognizing deterioration in credit, Greenlight wonders whether BLX has sufficiently provided for losses in its income statement. Further, Greenlight wonders whether there may be residuals from earlier securitizations that may be impaired because BLX probably did not assume delinquencies would reach 14.5% at December 31.

Moreover, Greenlight doubts that BLX has improved in value, as its recent credit facility could only be obtained through a 50% guarantee of principal from Allied. In Greenlight’s opinion, when an equity sponsor has to guarantee the bank debt the investment is a troubled situation.

Business Loan Express’s largest competitor is CIT. Tyco purchased CIT about six months after Allied purchased Business Loan Financial. Tyco paid a much lower multiple of book value that Allied paid. As the economy has deteriorated, the SEC recently forced Tyco to recognize an impairment in the value of CIT. Greenlight wonders whether Business Loan Express has suffered a similar impairment in value that has not been recognized by Allied.

### **Hillman**

Another Allied controlled investment, Hillman, has a \$40 million loan outstanding for which Allied charges a rate at 18%. This charge is in addition to the fees Allied charges Hillman. Since Hillman has some publicly traded preferred securities, Hillman has publicly available financial information. While Hillman appears to generate enough cash to support its interest expense, Hillman reports net losses. Greenlight concludes, therefore, that Hillman is, in effect, drawing down its equity in order to pay Allied fees and interest. Allied does not appear to be reducing its carrying value of Hillman’s equity to reflect such drawdowns.

According to the Hillman 2001 form 10-K, in the description of the term loans and credit facility, the term loans have a face value of \$54.1 million and were estimated to have a “fair value” of \$41.3 million.<sup>24</sup> This means that Allied’s \$40 million of

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<sup>24</sup> The Hillman Companies, Inc. Form 10-K, December 31, 2001, p. 48.

unsecured subordinated notes and \$57 million equity probably do not have a fair value of cost, though they are valued at cost on Allied's books.

In 2001 Allied earned \$29 million in fees and at least \$27 million in interest from controlled companies. These low quality earnings streams represented almost one-third of the \$180 million that Allied paid in dividends last year.

### *PIK Income*

Last year, Allied recognized approximately \$65 million from non-cash or PIK interest and dividends from companies in which it invested. This figure represents another third of Allied's dividend. Greenlight does not believe there is anything wrong with non-cash interest, provided Allied eventually collects the money and marks its portfolio fairly. For the reasons described above, Greenlight does not think that is happening. However, the non-cash interest creates a cash flow shortfall that must be funded.

According to Allied's 2001 annual report, "As a provider of long-term privately negotiated investment capital, it is not atypical to defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent may vary from quarter to quarter."

Greenlight wonders whether it is appropriate to carry investments where Allied agreed to defer payment of principal or interest at cost. Greenlight also wonders whether it is appropriate to accrue non-cash interest on such loans.

### The Problem With Non-Cash Income and Growing The Dividend:

When Ms. Sweeney explained on the May 16<sup>th</sup> conference call that, as long as the cash portion of loans covers Allied's cost of debt, incremental PIK interest merely enhances returns through reinvestment, she misses Greenlight's point. Since Allied must pay out its earnings as a dividend, cash needs include both interest on Allied's debt and Allied's required dividend. Since Allied recognized \$65 million in non-cash earnings last year that it paid out in dividends, Allied had to finance that payment by shrinking the portfolio, borrowing money or selling equity.

Allied has pledged to grow its dividend by 10% per year. To accomplish such growth, Allied must increase its Net Asset Value per share at a similar rate. Since Allied cannot retain most of its earnings, its principal means of increasing Net Asset Value per share is to periodically sell new shares at a premium.

Greenlight believes this requirement could prove problematic if investors take a more critical view toward Allied's valuation methods and earnings quality. Should that happen, equity investors might stop valuing Allied based on its dividend yield and start asking themselves what the portfolio is actually worth. Should regulators take a critical eye toward Allied's practices, Allied's ability to raise equity capital could become further



impaired. At that point Allied's lenders may begin to ask themselves how comfortable they feel lending to a management that appears to have mismarked its portfolio.

The Problem with the Arthur Andersen Audit Letter:

At the conference, Mr. Einhorn pointed out that Allied's auditors, Arthur Andersen LLP, either would not, could not, or did not feel they were required to provide Allied's Board of Directors and Shareholders in 2001 the following assurance they had provided in previous years:

“We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such investments and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate.”

In response, Ms. Sweeney, Allied's COO, on a May 16<sup>th</sup> conference call addressing recent market activity said, “the AICPA in 2001 issued a new audit guide for investment companies and Allied Capital Corporation is a sub-set of an investment company, being a business development company. The audit guide simply changed the language of the standard auditor's opinion and, as a result, our audit opinion language changed.”

On May 22, Merrill Lynch, which was the lead manager of Allied's last three secondary offerings according to Bloomberg, issued a report that attempted to substantiate Ms. Sweeney's claim.

“[W]e have written that we believe these allegations are unfounded and uninformed and have attempted to produce as much factual rebuttal as possible. As outlined below, we believe we can now factually dismiss the allegation of a less thorough audit...”

“Prior to 2001, AICPA guidelines instructed auditors to include an explanatory paragraph when they found a company's valuation procedures reasonable and acceptable. Such paragraphs appear in ALD's pre-2001 auditor reports. This guideline was changed in May 2001. Auditors are now instructed to comment only when they find a company's valuation procedures unacceptable – hence the exclusion of the ‘reasonableness’ sentence from ALD's most recent report...”

“[B]y excluding a comment on the reasonableness of ALD's investment valuation procedures from its 2001 report, the company's auditor was following AICPA guidelines to the letter of the word, not tacitly expressing concern.”

Mr. Walton, Allied's CEO, stated on the May 16<sup>th</sup> conference call, "There has been no change in the scope of the audit."

Greenlight actually has no way to know whether or not the scope of the audit changed. Despite Mr. Walton's and Merrill Lynch's claims, this issue is not central to Greenlight's analysis in any way. All of Greenlight's criticisms hold, regardless of what Arthur Andersen did/did not do or said/did not say. In auditing an Investment Company, "the accountant does not function as an appraiser and is not expected to substitute his judgment for that of the company's directors."<sup>25</sup> It seems that an auditor is not responsible to bless the ultimate valuations arrived at by the Board of Directors.

Nonetheless Greenlight has researched this point. Greenlight asked its auditors to investigate the change in language in Allied's audit opinion.

According to Greenlight's auditors:

"We contacted the AICPA and consulted with their 'technical hotline' department, specifically requesting when the guidance on this matter may have changed. The 1996 audit guide included examples of audit opinions in paragraphs 9.08 (unqualified opinion). 9.09 (qualified opinion). The 1997 audit guide paragraph 9.08 was an example of a qualified opinion; there was no specific example given of an unqualified opinion.

"We were advised that the removal of the unqualified opinion example in the May 1997 guide resulted from changes set forth in SAS 79 concerning the reporting of uncertainties. In order to obtain additional clarification of this, we obtained the Accounting Standards and Financial Reporting Requirements for Small Business Investment Companies (effective date 8/3/99). SBA has modified its sample auditors' report but state that the inclusion of an explanatory paragraph is specifically permitted if the auditor considers it appropriate (i.e., the paragraph is not required but may be included at the discretion of the auditor). [Emphasis added]

"In conclusion, the changes in guidance for auditors on this particular matter occurred between 1996 and 1997 and not during 2001."

In fact, Merrill Lynch's own research report acknowledges in a tiny footnote that it was comparing the AICPA guide from 1993 to the 2001 guide.

The actual change in the audit guide occurred in 1996/1997. This cannot explain why the 2001 audit letter should be worded differently from the 2000 letter.

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<sup>25</sup> ASR 118.

Since the additional assurance is at the discretion of the auditor, Greenlight does not know why Arthur Andersen changed the language, but Ms. Sweeney's and Merrill Lynch's explanation are not factually correct.

Greenlight called this matter to the attention of Mr. Hughes, the author of Merrill's report. While he conceded, "you have more facts than I do," he suggested that rather than admitting the error, "What if we argue that Arthur Andersen changed its internal policy on this matter?" Is his job to analyze and present facts about his investment banking client, or make them up?

A week later, Merrill Lynch did publish an admission of its error. "We were mistaken. The audit guide changed in May 1997."<sup>26</sup>

Sirrom Capital was a competitor to Allied in the late 1990s. Its stock eventually collapsed under the weight of its poor loans and aggressive valuations. Greenlight was critical of Sirrom Capital at the time.

Sirrom was another client of Arthur Andersen LLP. At that time, Greenlight identified that the language in Sirrom's audit letter changed in the same way that Allied's has now changed. In Andersen's January 12, 1995, letter to Sirrom, Andersen included the assurance worded identically as described above. However, Andersen removed this assurance from subsequent Sirrom audit opinions.

On the May 29<sup>th</sup> conference call, management attempted to blame Arthur Andersen. According to Ms. Sweeney, "When our audit opinion was issued, we inquired as to why the language had changed. We understood, based upon explanation by our auditors, that they had simply conformed their opinion language to the new 2001 audit guide. We thought this meant that the guide had changed, thus requiring new opinion language."

This does not explain why Allied sent pages from the 1993 guide to Merrill Lynch to assist Merrill in its inquiry.

Now everyone is left to management's word that they have "asked Andersen if a change in opinion language in any way reflected a change at Allied Capital. Their answer is no." Greenlight does not know why management did not get Andersen to put this reassurance in writing and file it with the SEC.

From Greenlight's point of view, regardless of whether the scope of the audit has changed, whoever approved the Velocita debt and warrant valuations at cost at the end of 2001 and the other criticized investments and valuation methods did not provide appropriate critical scrutiny.

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<sup>26</sup> "A Conversation with Allied's Auditor," Merrill Lynch Equity Research, May 29, 2002.