

Saul Centers



2005
Annual Report

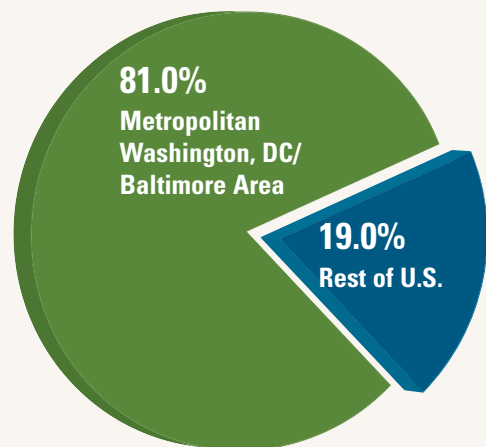
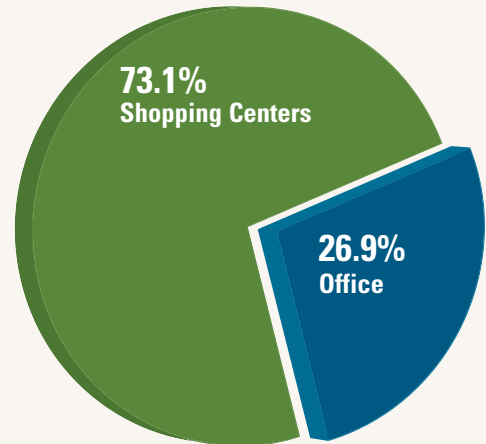
Company Profile

Saul Centers, Inc. is a self-managed, self-administered equity real estate investment trust headquartered in Bethesda, Maryland. After the January 2006 acquisition of Smallwood Village Center, Saul Centers operates and manages a real estate portfolio of 45 community and neighborhood shopping centers and office properties totaling approximately 7.6 million square feet of leasable area. Over 80% of the cash flow is generated from properties in the metropolitan Washington, DC/Baltimore area.

Saul Centers' primary operating strategy is to focus on continuing its program of internal growth, renovations, and expansions of community and neighborhood shopping centers that primarily serve the day-to-day necessities and services sub-sector of the overall retail market. The Company plans to supplement its growth through effective development of new office and retail properties and acquisitions of operating properties as appropriate opportunities arise.

Portfolio Composition

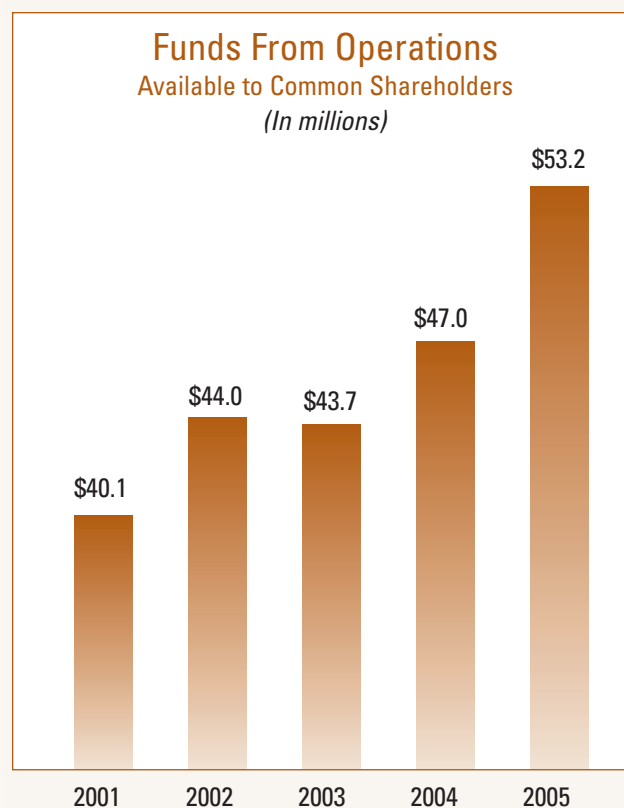
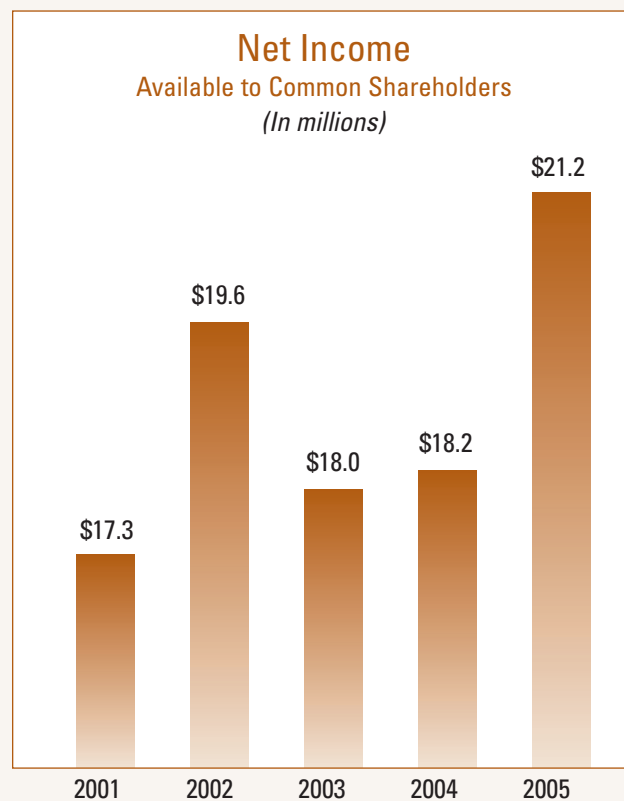
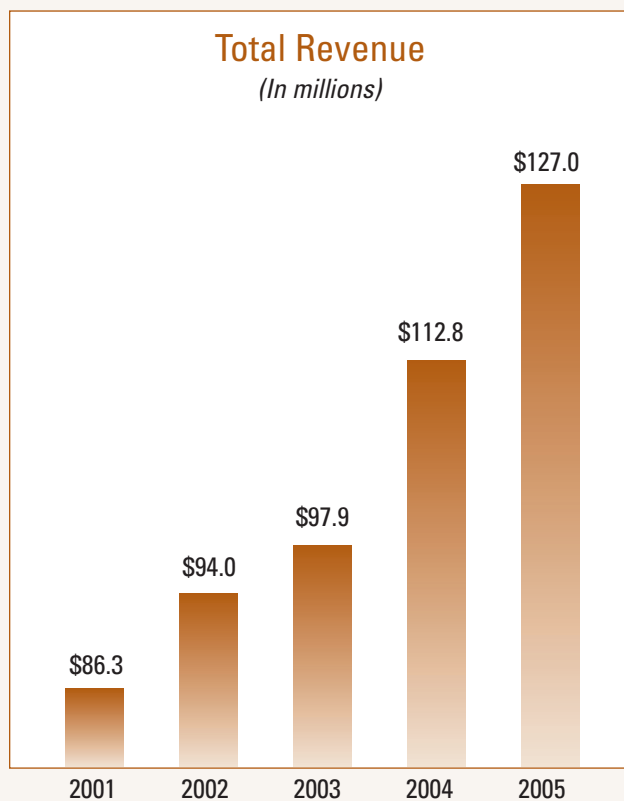
Based on 2005 Property Operating Income



Shares of Saul Centers are traded on the New York Stock Exchange under the symbol "BFS."



Historic Operating Performance



* Funds From Operations (FFO) is a non-GAAP financial measure.
See page 52 for a definition of FFO and reconciliation to Net Income.

Financial Highlights

		Year ended December 31,			
	2005	2004	2003	2002	2001
Summary Financial Data					
Total Revenue	\$127,015,000	\$112,842,000	\$97,884,000	\$93,963,000	\$86,308,000
Net Income Available to Common Stockholders	\$ 21,227,000	\$ 18,174,000	\$ 17,998,000	\$19,566,000	\$17,314,000
FFO Available to Common Shareholders	\$ 53,222,000	\$ 47,031,000	\$ 43,740,000	\$44,031,000	\$40,141,000
Average Common Stock Outstanding	16,770,554	16,210,736	15,607,890	14,886,505	14,210,470
Average Shares and Units Outstanding	22,002,922	21,404,976	20,790,216	20,059,264	19,382,720
FFO Available to Common Shareholders Per Share (Diluted)	\$ 2.42	\$ 2.20	\$ 2.10	\$ 2.20	\$ 2.07
Net Income Available to Common Stockholders Per Share (Diluted)	\$ 1.27	\$ 1.12	\$ 1.15	\$ 1.31	\$ 1.22
Common Dividend as a Percentage of FFO (Per Share)	66%	71%	74%	71%	75%
Interest Expense Coverage ^a	3.15	3.14	2.78	2.78	2.63
Property Data					
Number of Properties ^b	44	40	36	34	33
Total Portfolio Square Feet	7,376,000	7,217,000	6,532,000	6,272,000	6,159,000
Shopping Center Square Feet	6,170,000 ^c	6,012,000	5,328,000	5,069,000	4,956,000
Office Square Feet	1,206,000	1,205,000	1,204,000	1,203,000	1,203,000
Average Percentage Leased ^d	95%	94%	93%	94%	93%

(a) Interest expense coverage is defined as operating income before the sum of interest expense and amortization of deferred debt, and depreciation and amortization, divided by interest expense.

(b) Excludes development land parcels (Lansdowne Town Center, Broadlands Village III, Clarendon Center, Ashland Square, Lexington and New Market).

(c) During 2005, approximately 301,000 square feet of space was taken out of service at Lexington for the planned redevelopment of the center.

(d) Average percentage leased would have been 96% for both 2005 and 2004 if the Lexington redevelopment space was excluded from the calculation for the entire year.

Elizabeth Arden's Red Door Spa anchors the recently completed Kentlands Place development in Gaithersburg, Maryland.



Message to Our Shareholders

During 2005, Saul Centers achieved new leasing percentage highs, completed several grocery-anchored neighborhood shopping center acquisitions, and commenced a very significant town center development which, together, position us well for 2006 and beyond. Our portfolio-wide leasing levels averaged 95% during 2005, our highest since inception as a public company in 1993. We acquired three quality grocery-anchored shopping centers in Florida, totaling 370,000 square feet of space, a 6% increase in our retail square footage. We commenced one of our most significant new developments with ground-breaking of the 191,000 square foot Lansdowne Town Center in Loudoun County, Virginia. Our dividend payout ratio was reduced to its historically lowest level of 66%, while the common dividend was increased from \$0.39 per share in the fourth quarter of 2004 to the current level of \$0.42 per share, a 7.7% annualized increase. Total debt and equity capitalization exceeded \$1.3 billion at year end 2005. Our outlook remains very positive in the areas where we have focused our growth – the grocery-anchored retail property sector located in the Washington, DC metropolitan area and in other strong southeastern regions of the country.



2005 marked the acquisition of three retail properties (clockwise from left) Seabreeze Plaza, Jamestown Place and Palm Springs Center.

ACQUISITIONS & DEVELOPMENTS

Operating Property Acquisitions

The year 2005 marked the acquisition of three more retail operating properties. In March 2005, we acquired the 126,400 square foot Albertson's-anchored Palm Springs Center in Altamonte Springs, Florida, a suburb of metropolitan Orlando. In November 2005, we added the 96,400 square foot Jamestown Place located within five miles of Palm Springs Center. Jamestown Place is anchored by a 55,000 square foot Publix supermarket. An average of over 87,000 people, with annual household incomes averaging greater than \$75,000, live within a 3-mile radius of these centers.

Also in November 2005, we acquired Seabreeze Plaza, a Publix-anchored shopping center in Palm Harbor, Florida, near Tampa. Seabreeze Plaza is a 146,700

square foot neighborhood shopping center with a 44,800 square foot supermarket. This property is located within a community of over 102,000 people within a 3-mile radius whose household incomes average approximately \$70,000.

Subsequent to year end, in January 2006, we acquired the 198,000 square foot Smallwood Village Center, located on 25 acres within the St. Charles planned community in Waldorf, Maryland, a suburb of metropolitan Washington, DC. This center is 89% leased and is anchored by a recently remodeled and expanded 55,000 square foot Safeway supermarket and a 10,000 square foot CVS drugstore. The St. Charles residential development is 60% complete and is expected to total approximately 25,000 dwelling units. Over 43,000 people with annual household incomes averaging greater than \$71,000 are located within a 3-mile radius of the center.

Message to Our Shareholders

2005 Developments & Redevelopments

During 2005, we completed the construction and lease-up of four development projects which commenced between late 2003 and 2005. These developments are the 109,100 square foot Giant-anchored Shops at Monocacy in Frederick, Maryland, the 40,600 square foot Kentlands Place retail/office property adjacent to our Kentlands Square center anchored by Lowes home improvement store in Gaithersburg, Maryland, and expansions to Thruway in Winston-Salem, North Carolina, and The Glen in Prince William County, Virginia. All four of these projects were 100% leased at year end 2005.

Our redevelopment of Olde Forte Village, a Safeway-anchored neighborhood shopping center in Fort Washington, Maryland, is nearing completion. Construction of a new 33,000 square feet of small shop space has been completed. Fifteen of the 19 new stores, representing over 75% of the new leasable area, have been leased. The redeveloped center totals 143,100 square feet, and is 91% leased.

2006 Developments

We expect the value added potential of ongoing and planned development projects will continue to be a significant driver of Saul Centers' growth in future years. In November 2005, we commenced construction of the Harris Teeter-anchored 191,000 square foot Lansdowne Town Center in Loudoun County, Virginia. This development will be the town center within a planned community of over 5,500 residences, approximately 2,500 of which are constructed and currently occupied. Three-mile average household incomes surrounding the planned development are approximately \$120,000. Substantial completion of construction is scheduled in the fourth quarter of 2006, with project costs expected to total approximately \$42 million.

In late 2005, we commenced construction of the third phase of the Broadlands Village shopping center, also located in Loudoun County, Virginia. This phase will total 22,000 square feet of in-line shops, and over 80% of the space is pre-leased. Substantial completion of construction is scheduled for the third quarter of 2006.

In January 2006, we began building a 7,400 square foot expansion to our Ravenwood shopping center in Towson, Maryland. Over 70% of this space is pre-leased and construction is projected to be substantially complete in the summer of 2006.

Construction of four development projects was completed in 2005, including (clockwise from top left) Thruway, Shops at Monocacy, Kentlands Place and The Glen.

Rendering of the recently commenced Lansdowne Town Center.



2005 FINANCIAL RESULTS

Acquisitions and developments completed during 2004 and 2005 produced the significant portion of increased operating income in 2005. During 2004 and 2005, we invested over \$185 million in seven operating property acquisitions and five retail developments and redevelopments totaling over 1.1 million square feet of new space.

In 2005, total revenue increased 12.6% to \$127,015,000 compared to \$112,842,000 in 2004. Operating income increased 9.8% to \$37,025,000 compared to \$33,707,000 in 2004. Net income available to common stockholders was \$21,227,000, or \$1.27 per diluted share in 2005, resulting in a per share increase of 13.4% compared to \$18,174,000 or \$1.12 per diluted share in 2004.

Funds From Operations (FFO) available to common shareholders (after deducting preferred stock dividends) increased 13.2% to \$53,222,000 in 2005. Diluted per share FFO available to common shareholders increased 10.0% to \$2.42 per share in 2005 compared to \$2.20 per share in 2004. The \$6,191,000 increase in FFO was primarily due to increased operating income from retail acquisition and development properties and, to a lesser extent, the receipt of a payment related to the resolution of a land use dispute with a landowner adjacent to Lexington Mall.

Message to Our Shareholders



RETAIL HIGHLIGHTS

Our retail portfolio consisted of 39 community and neighborhood shopping center properties totaling 6.2 million square feet of space at the end of 2005. These shopping centers comprised 73.1% of Saul Centers' 2005 property operating income.

The 2004 and 2005 acquisitions, developments and redevelopments increased the leasable area of our retail portfolio by over 20%. Substantially all of the development and redevelopment activity was in the Washington, DC metropolitan area, while acquisitions were spread between the Washington, DC area, Florida and Georgia. One of the key criteria we use to locate these additional properties is the demographic characteristics of the surrounding neighborhoods. Population density within a 3-mile radius of these new assets averaged over 73,000 people. Average household incomes within a 3-mile radius were over \$92,000 comparing favorably to the national average of \$68,700. While acquiring 5 shopping centers in the southeastern United States over the past 2 years, our operating income generated from properties in the metropolitan Washington, DC/Baltimore area continues to exceed 79% of our total property operating income.

During 2005, our same property operating income in the retail portfolio increased 2.6%. Leasing increases contributed to this improvement. At year end 2005,

96.9% of the retail portfolio was leased compared to the prior year level of 95.7%. Also a factor in this growth, new or renewal leases were signed at average initial cash rental rates of approximately 9.6% over rents paid on expiring leases for the 695,000 square feet of lease renewals and rollovers.

We renewed a total of 74% of the expiring leases in 2005, as measured by annualized base rents at expiration. This renewal rate was slightly higher than our 5-year average renewal rate of 71%. Real estate taxes and property operating expenses for the core properties increased 8.0%, largely due to increases in utility expenses and insurance costs. Despite these increases, property operating income was only minimally impacted, as overall retail expenses were 75% recoverable from tenants.

Overall retail sales, based upon data supplied by tenants required to report sales, totaled \$311 per square foot in 2005. On a same store basis, sales remained the same as 2004 levels, compared to the preceeding 5-year average increase of 1.0% per year. Although the sales of many of our grocery anchors have been impacted by competitive forces, the overall average sales volume reported by our grocery stores totaled \$470 per square foot, an indication that these stores attract healthy customer traffic to the retail centers.

Message to Our Shareholders



In late 2005, construction commenced on a 22,000 square foot expansion to Broadlands Village [left]. Over 80% of the new space is pre-leased. Newly acquired Seabreeze Plaza (top) is over 98% leased.

During 2005, we signed 198 new or renewal retail leases totaling 907,000 square feet of space. In the first two months of 2006, leasing activity continues to be strong. A total of approximately 665,000 square feet of retail space is scheduled to expire during 2006 and, as of March 1, 2006, 40% of this space has already been leased.

As of year end 2005, 19 of our 27 grocery-anchored properties were occupied by market share leaders Giant Food, Safeway and Publix. These three grocers typically hold the top two market share positions in the areas where our properties are located. This dominant anchor profile is a key parameter of our core leasing strategy and acquisition selection. The addition of our first four Publix-anchored shopping centers has added to the diversification of our grocery tenants. Tenant diversity continues to be the other primary focus of our leasing strategy, as we maintain that such diversity is essential to long term cash flow stability. Overall, only two retail tenants in 2005 paid annual rent in excess of 2.5% of total revenue – Giant Food at 5.3% and Safeway at 3.1%.

OFFICE HIGHLIGHTS

Our five office/industrial properties, totaling over 1.2 million square feet of leasable area, contributed 26.9% of the 2005 property operating income. Our premier asset, the 226,000 square foot 601 Pennsylvania

Avenue office building, located between the U.S. Capitol and The White House, is 100% leased and accounts for approximately 9.4% of our total property operating income. The building contains 12 tenants, the largest totaling 55,000 square feet. A few of the building's significant tenants include the National Gallery of Art, the American Association of Health Plans and the Credit Union National Association.

During 2005, same property operating income in the office portfolio increased 1.6%. The office portfolio was 96.6% leased at year end 2005, compared to 95.9% a year earlier.

Over 90% of the office leases have fixed annual escalations averaging over 2.5% per year. Only 125,000 square feet of the office portfolio's leases are scheduled to expire in 2006, and as of March 1, 2006, over 40% of this space has already been leased. Our diverse office tenant base minimizes credit risk, with only one office tenant, the U.S. Government at 3.1%, representing more than 2.5% of total 2005 revenue. Over 97% of the property operating income in the office portfolio is generated from properties in the Washington, DC metropolitan area. This market area has consistently experienced above average job growth and below average vacancy rates compared to the nation's other major metropolitan areas. The federal government and related private sector contractors continue to be the primary drivers behind

Message to Our Shareholders



❖ *601 Pennsylvania Avenue (above), Saul Centers' premier office asset, is 100% leased and accounts for 9.4% of total property operating income.*

the job growth in this region. Office market vacancy rates in the District of Columbia are approximately 8% and surrounding Maryland and Northern Virginia submarket vacancy rates are 10% and 12%, respectively, continuing to be well below national averages of approximately 15%.

FUTURE DEVELOPMENT PIPELINE

We have future opportunities in four well located land parcels totaling approximately 80 acres and zoned to accommodate over 880,000 square feet of retail and mixed-use development. In September 2005, we resolved a land dispute at Lexington Mall, allowing increased flexibility in future development rights for this 26 acre site in Lexington, Kentucky. We also reached agreement with Dillard's, the previous anchor at Lexington Mall, to terminate its lease during October 2005. During the fourth quarter of 2005, concurrent with the closing of Dillard's, this Lexington Mall property was removed from operations and placed in development. We have engaged land planners and assembled a team to proceed with conceptual designs. The site is zoned to accommodate over 300,000 square feet of retail space.

In December 2004, we acquired a 19.3 acre parcel of land in Prince William County, Virginia. The site is zoned for development of a grocery-anchored neighborhood shopping center of approximately 160,000 square feet, to be known as Ashland Square.

Final site plan approval is expected during 2006. In March 2005, we closed on the acquisition of a 7.1 acre parcel of land in New Market, Maryland, a growing area of Frederick County. We added a contiguous 28.4 acre tract in September 2005 which, together, will accommodate a neighborhood shopping center development in excess of 120,000 square feet.

Finally, we continue to pursue zoning and site plan approvals for a significant mixed-use development on an assemblage of land totaling 1.5 acres adjacent to the Clarendon Metro Station in Arlington, Virginia. The site is zoned for over 300,000 square feet of commercial development.

CAPITAL STRUCTURE

Our balance sheet provides us both availability of capital with which to execute our business plan, and comfortable interest expense and dividend coverage to provide our investors a stable income stream. At the end of 2005, we had borrowing availability of \$139 million on our revolving credit line for general corporate use and for funding future acquisition and development opportunities. Our interest expense coverage was 3.2 times for the year, and we maintained prudent leverage of approximately 35% debt to total capitalization at December 31, 2005. Our weighted average interest rate was 6.9%, with 98% of our debt being fixed-rate non-recourse mortgages with an average maturity of 9.3 years.

Message to Our Shareholders



We remain confident that we are well positioned to continue to achieve long-term property operating income growth in our core portfolio.

A 66% dividend payout ratio, the ratio of common stock dividends to FFO, provides both strong dividend security as well as retained earnings for continued redevelopment and acquisition opportunities.

MARKET PERFORMANCE

Shares of "BFS" common stock are listed and traded on the New York Stock Exchange and closed the 2005 year at a price of \$36.10 per share. After paying out \$0.39 per share in common dividends during the first two quarters, the dividend was increased to \$0.40 per share and \$0.42 per share in the third and final calendar quarters, respectively. The current annualized dividend of \$1.68 per share represents a 7.7% increase over the annualized dividend a year ago. Although the total return (the combination of the common stock's dividend yield and its share price appreciation) in 2005 was a negative 1.1%, our 5-year total return was 21.8% per year. The 10-year total return was 19.9% per year, which ranked Saul Centers in the top third of the stocks comprising the NAREIT Equity Index. Since our 1993 initial public offering, investors that have been with us from inception have realized a compounded annual total return of over 14.1%.

Our Series A Preferred Stock, issued in November 2003 and a catalyst for the accelerated growth in acquisitions and developments over the past 2 years, closed the 2005 year at a price of \$25.63 per depositary share, yielding 7.8%. The Series A Preferred Stock shares are listed and traded on the New York Stock Exchange as "BFS.PrA".

Investors in great numbers continue to seek real estate properties, thus acquisition competition is intense and returns remain thin. We will continue to be diligent in our analysis of opportunities and be patient in our approach. We remain confident that we are well positioned to continue to achieve long-term property operating income growth in our core portfolio, as well as add to this growth as our team implements our development plans. Our development pipeline should create unique opportunities and attractive returns over the coming years. Our business model has always emphasized cash flow stability and long-term value creation, and we look forward to continuing to deliver results in 2006 and beyond.

For the Board

B. Francis Saul II
March 9, 2006

Portfolio Properties



As of December 31, 2005, Saul Centers' portfolio properties were located in Virginia, Maryland, Washington, DC, North Carolina, Oklahoma, New Jersey, Georgia, Kentucky and Florida. Properties in the metropolitan Washington, DC/Baltimore area represent 70% of the portfolio's gross leasable area.

Property/Location	Gross Leasable Square Feet	Property/Location	Gross Leasable Square Feet
Shopping Centers			
Ashburn Village, Ashburn, VA	211,327	Lumberton Plaza, Lumberton, NJ	193,044
Beacon Center, Alexandria, VA	352,365	Shops at Monocacy, Frederick, MD	109,144
Belvedere, Baltimore, MD	54,941	Olde Forte Village, Ft. Washington, MD	143,062
Boca Valley Plaza, Boca Raton, FL	121,269	Olney, Olney, MD	53,765
Boulevard, Fairfax, VA	56,350	Palm Springs Center, Altamonte Springs, FL	126,446
Briggs Chaney MarketPlace, Silver Spring, MD	197,486	Ravenwood, Baltimore, MD	85,958
Broadlands Village, Loudoun County, VA	107,286	Seabreeze Plaza, Palm Harbor, FL	146,673
Broadlands Village II, Loudoun County, VA	30,193	Seven Corners, Falls Church, VA	560,998
Clarendon/Clarendon Station, Arlington, VA	11,808	Shops at Fairfax, Fairfax, VA	68,743
Countryside, Loudoun County, VA	141,696	Southdale, Glen Burnie, MD	484,115
Cruse MarketPlace, Forsyth County, GA	78,686	Southside Plaza, Richmond, VA	373,651
Flagship Center, Rockville, MD	21,500	South Dekalb Plaza, Atlanta, GA	163,418
French Market, Oklahoma City, OK	244,724	Thruway, Winston-Salem, NC	352,355
Germantown, Germantown, MD	26,241	Village Center, Centreville, VA	143,109
Giant, Baltimore, MD	70,040	West Park, Oklahoma City, OK	76,610
The Glen, Lake Ridge, VA	134,317	White Oak, Silver Spring, MD	480,156
Great Eastern, District Heights, MD	254,448	Total Shopping Centers	6,170,423
Hampshire Langley, Takoma Park, MD	131,700		
Jamestown Place, Altamonte Springs, FL	96,372	Office Properties	
Kentlands Square, Gaithersburg, MD	114,381	Avenel Business Park, Gaithersburg, MD	390,579
Kentlands Place, Gaithersburg, MD	40,648	Crosstown Business Center, Tulsa, OK	197,135
Leesburg Pike, Baileys Crossroads, VA	97,752	601 Pennsylvania Ave, Washington, DC	226,604
Lexington Mall, Lexington, KY	13,646	Van Ness Square, Washington, DC	156,493
		Washington Square, Alexandria, VA	235,042
		Total Office Properties	1,205,853
		Total Portfolio	7,376,276

Additional development parcels include Broadlands Village III (5.5 acres), Clarendon Center (1.3 acres), Lansdowne Town Center (23.4 acres), Ashland Square (19.3 acres), Lexington (26.0 acres) and New Market (35.5 acres.)



Management's Report

on Internal Control Over Financial Reporting

Assessment of Effectiveness of Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control - Integrated Framework to assess the effectiveness of the Company's internal control over financial reporting. Based upon the assessment, the Company's management has concluded that, as of December 31, 2005, the Company's internal control over financial reporting was effective. The Company's independent registered public accounting firm has issued an attestation report on management's assessment of the Company's internal control over financial reporting, which appears on page 14 of this Annual Report.



Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting

Board of Directors and Stockholders Saul Centers, Inc.

We have audited management's Assessment of Effectiveness of Internal Control Over Financial Reporting included on page 13 of this Annual Report, that Saul Centers, Inc. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Saul Centers, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the

assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Saul Centers, Inc. maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Saul Centers, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Saul Centers, Inc. as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2005 of Saul Centers, Inc. and our report dated March 8, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP
McLean, Virginia
March 8, 2006

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders Saul Centers, Inc.

We have audited the accompanying consolidated balance sheets of Saul Centers, Inc. as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Saul Centers, Inc. at December 31, 2005 and 2004, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Saul Centers, Inc.'s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 8, 2006 expressed an unqualified opinion thereon.

Ernst & Young LLP
McLean, Virginia
March 8, 2006

Consolidated Balance Sheets

(In thousands, except per share amounts)

December 31, 2005

December 31, 2004

Assets

Real estate investments

Land	\$ 139,421	\$ 119,029
Buildings and equipment	575,504	521,161
Construction in progress	47,868	42,618

762,793 682,808

Accumulated depreciation (195,376) (181,420)

567,417 501,388

Cash and cash equivalents 8,007 33,561

Accounts receivable and accrued income, net 23,410 20,654

Leasing costs, net 19,834 17,745

Prepaid expenses, net 2,540 2,421

Deferred debt costs, net 5,875 5,011

Other assets 4,386 2,616

Total assets \$ 631,469 \$ 583,396

Liabilities

Mortgage notes payable \$ 471,931 \$ 453,646

Revolving credit facility outstanding 10,500 —

Dividends and distributions payable 11,319 10,424

Accounts payable, accrued expenses and other liabilities 13,679 12,318

Deferred income 9,558 6,044

Total liabilities 516,987 482,432

Minority interests

3,068 —

Stockholders' equity

Series A Cumulative Redeemable Preferred stock, 1,000,000 shares authorized and 40,000 shares issued and outstanding 100,000 100,000

Common stock, \$0.01 par value, 30,000,000 shares authorized, 16,877,244 and 16,399,442 shares issued and outstanding, respectively 169 164

Additional paid-in capital 123,339 106,886

Accumulated deficit (112,094) (106,086)

Total stockholders' equity 111,414 100,964

Total liabilities and stockholders' equity \$ 631,469 \$ 583,396

The accompanying notes are an integral part of these statements.

Consolidated Statements of Operations

	For the Year Ended December 31,		
	2005	2004	2003
<i>(Dollars in thousands, except per share amounts)</i>			
Revenue			
Base rent	\$ 99,448	\$ 91,125	\$ 78,167
Expense recoveries	20,027	16,712	14,438
Percentage rent	2,057	1,635	1,695
Other	5,483	3,370	3,584
Total revenue	127,015	112,842	97,884
Operating expenses			
Property operating expenses	14,724	12,070	11,363
Provision for credit losses	237	488	171
Real estate taxes	11,040	9,789	8,580
Interest expense and amortization of deferred debt	30,207	27,022	26,573
Depreciation and amortization of leasing costs	24,197	21,324	17,838
General and administrative	9,585	8,442	6,213
Total operating expenses	89,990	79,135	70,738
Operating income before minority interests and gain on sale of property	37,025	33,707	27,146
Non-operating item: Gain on sale of property	—	572	182
Net operating income before minority interests	37,025	34,279	27,328
Minority interests			
Minority share of income	(6,937)	(6,386)	(6,495)
Distributions in excess of earnings	(861)	(1,719)	(1,591)
Total minority interests	(7,798)	(8,105)	(8,086)
Net income	29,227	26,174	19,242
Preferred dividends	(8,000)	(8,000)	(1,244)
Net income available to common stockholders	\$ 21,227	\$ 18,174	\$ 17,998
Per share net income available to common stockholders			
Basic	\$ 1.27	\$ 1.13	\$ 1.15
Diluted	\$ 1.27	\$ 1.12	\$ 1.15
Distributions declared per common share outstanding	\$ 1.63	\$ 1.56	\$ 1.56

The accompanying notes are an integral part of these statements.

Consolidated Statements of Stockholder's Equity (Deficit)

<i>(Dollars in thousands, except per share amounts)</i>	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Total
Stockholders' equity (deficit):					
Balance, December 31, 2002	\$ —	\$ 152	\$ 79,131	\$ (92,550)	\$ (13,267)
Issuance of 664,651 shares of common stock:					
552,170 shares due to dividend reinvestment plan	—	6	13,697	—	13,703
112,481 shares due to employee stock options, directors' deferred stock plan and stock option awards	—	1	2,314	—	2,315
Issuance of 40,000 shares of preferred stock	100,000	—	(3,673)	—	96,327
Net income	—	—	—	19,242	19,242
Distributions payable preferred stock (\$31.00 per share)	—	—	—	(1,244)	(1,244)
Common stock distributions	—	—	—	(18,247)	(18,247)
Distributions payable common stock (\$.39 per share)	—	—	—	(6,186)	(6,186)
Balance, December 31, 2003	100,000	159	91,469	(98,985)	92,643
Issuance of 538,208 shares of common stock:					
497,282 shares due to dividend reinvestment plan	—	5	14,077	—	14,082
40,928 shares due to employee stock options, directors' deferred stock plan and stock option awards	—	—	1,340	—	1,340
Net income	—	—	—	26,174	26,174
Preferred stock distributions	—	—	—	(6,000)	(6,000)
Distributions payable preferred stock (\$50.00 per share)	—	—	—	(2,000)	(2,000)
Common stock distributions	—	—	—	(18,879)	(18,879)
Distributions payable common stock (\$.39 per share)	—	—	—	(6,396)	(6,396)
Balance, December 31, 2004	100,000	164	106,886	(106,086)	100,964
Issuance of 477,802 shares of common stock:					
455,494 shares due to dividend reinvestment plan	—	5	15,402	—	15,407
22,308 shares due to employee stock options, directors' deferred stock plan and stock option awards	—	—	1,051	—	1,051
Net income	—	—	—	29,227	29,227
Preferred stock distributions	—	—	—	(6,000)	(6,000)
Distributions payable preferred stock (\$50.00 per share)	—	—	—	(2,000)	(2,000)
Common stock distributions	—	—	—	(20,146)	(20,146)
Distributions payable common stock (\$.42 per share)	—	—	—	(7,089)	(7,089)
Balance, December 31, 2005	\$ 100,000	\$ 169	\$ 123,339	\$ (112,094)	\$ 111,414

The accompanying notes are an integral part of these statements.

Consolidated Statements of Cash Flows

(Dollars in thousands)	For the Year Ended December 31,		
	2005	2004	2003
Cash flows from operating activities:			
Net income	\$ 29,227	\$ 26,174	\$ 19,242
Adjustments to reconcile net income to net cash provided by operating activities:			
Gain on sale of property	—	(572)	(182)
Minority interests	7,798	8,105	8,086
Depreciation and amortization of leasing costs	24,197	21,324	17,838
Amortization of deferred debt costs	1,161	929	801
Non-cash compensation costs from stock grants and options	718	571	353
Provision for credit losses	237	488	171
Increase in accounts receivable and accrued income	(2,843)	(6,003)	(2,308)
Increase in leasing costs	(2,940)	(2,266)	(2,303)
(Increase) decrease in prepaid expenses	(119)	188	(3,250)
(Increase) decrease in other assets	(1,770)	(355)	171
Increase (decrease) in accounts payable, accrued expenses and other liabilities	1,425	1,630	(897)
Increase (decrease) in deferred income	1,310	473	(6)
Net cash provided by operating activities	58,401	50,686	37,716
Cash flows from investing activities:			
Acquisitions of real estate investments, net*	(47,745)	(78,509)	(26,375)
Additions to real estate investments	(9,175)	(6,425)	(7,709)
Additions to development and redevelopment activities	(16,885)	(29,366)	(15,317)
Proceeds from sale of asset	—	833	280
Net cash used in investing activities	(73,805)	(113,467)	(49,121)
Cash flows from financing activities:			
Proceeds from notes payable	25,500	94,800	93,134
Repayments on notes payable	(20,794)	(16,427)	(69,879)
Proceeds from revolving credit facility	10,500	33,000	35,000
Repayments on revolving credit facility	—	(33,000)	(81,750)
Additions to deferred debt costs	(2,025)	(1,716)	(900)
Proceeds from the issuance of preferred stock, net of issuance costs	—	—	96,327
Proceeds from the issuance of common stock and convertible limited partnership units in the Operating Partnership	19,556	14,851	15,665
Distributions to preferred stockholders	(8,000)	(7,244)	—
Distributions to common stockholders and holders of convertible limited partnership units in the Operating Partnership	(34,887)	(33,166)	(32,257)
Net cash (used) provided by financing activities	(10,150)	51,098	55,340
Net decrease in cash and cash equivalents	(25,554)	(11,683)	43,935
Cash and cash equivalents, beginning of year	33,561	45,244	1,309
Cash and cash equivalents, end of year	\$ 8,007	\$ 33,561	\$ 45,244
Supplemental disclosure of cash flow information:			
Cash paid for interest	\$ 32,112	\$ 28,682	\$ 26,878

* Supplemental discussion of non-cash investing and financing activities: The \$47,745,000 shown as 2005 real estate acquisitions does not include any mortgage assumed as this represents a non-cash acquisition cost. On November 30, 2005, the Company purchased Seabreeze Plaza at an acquisition cost of \$25,912,000 and assumed a mortgage of \$13,579,000 with the balance being paid in cash. The \$78,509,000 shown as 2004 real estate acquisitions does not include \$18,025,000 in total assumed mortgages for 2 of the properties acquired during the year. On February 13, 2004, the Company purchased Boca Valley Plaza for an acquisition cost of \$17,678,000 and assumed a mortgage in an amount of \$9,200,000 with the balance being paid in cash. On March 25, 2004, the Company purchased Cruse MarketPlace for an acquisition cost of \$12,897,000 and assumed a mortgage of \$8,825,000 with the balance being paid in cash.

The accompanying notes are an integral part of these statements.

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1. ORGANIZATION, FORMATION, AND BASIS OF PRESENTATION

Organization

Saul Centers, Inc. ("Saul Centers") was incorporated under the Maryland General Corporation Law on June 10, 1993. Saul Centers operates as a real estate investment trust (a "REIT") under the Internal Revenue Code of 1986, as amended (the "Code"). Saul Centers generally will not be subject to federal income tax, provided it annually distributes at least 90% of its REIT taxable income to its stockholders and meets certain organizational and other requirements. Saul Centers has made and intends to continue to make regular quarterly distributions to its stockholders. Saul Centers, together with its wholly owned subsidiaries and the limited partnerships of which Saul Centers or one of its subsidiaries is the sole general partner, are referred to collectively as the "Company". B. Francis Saul II serves as Chairman of the Board of Directors and Chief Executive Officer of Saul Centers.

Formation and Structure of Company

Saul Centers was formed to continue and expand the shopping center business previously owned and conducted by the B.F. Saul Real Estate Investment Trust, the B.F. Saul Company, Chevy Chase Bank, F.S.B. and certain other affiliated entities, each of which is controlled by B. Francis Saul II and his family members (collectively, "The Saul Organization"). On August 26, 1993, members of The Saul Organization transferred to Saul Holdings Limited Partnership, a newly formed Maryland limited partnership (the "Operating Partnership"), and two newly formed subsidiary limited partnerships (the "Subsidiary Partnerships", and collectively with the Operating Partnership, the "Partnerships"), shopping center and office properties, and the management functions related to the transferred properties. Since its formation, the Company has developed and purchased additional properties. The Company has developed and purchased several properties since mid year 2003. In July 2003, the Company purchased Olde Forte Village, a grocery anchored shopping center located in Fort Washington, Maryland. In November 2004, the Company completed construction of Shops at Monocacy, a grocery anchored shopping center in Frederick, Maryland, the land of which was acquired in November 2003. During

the fourth quarter of 2003, the Company completed construction of Broadlands Village Phase I, an in-line retail and retail pad, grocery anchored shopping center. Phase II, a 30,000 square foot addition to the center was completed in November 2004. In January 2004, the Company purchased a land parcel adjacent to its Kentlands Square shopping center, and constructed a 41,000 square foot retail/office property known as Kentlands Place. During 2004 and 2005 the Company acquired seven grocery anchored shopping centers; (1) Boca Valley Plaza, 121,000 square feet, located in Boca Raton, Florida, (2) Countryside, 142,000 square feet located in Loudoun County, Virginia, (3) Cruse MarketPlace, 79,000 square feet, located in Forsyth County, Georgia, (4) Briggs Chaney MarketPlace, 197,000 square feet, located in Silver Spring, Maryland, (5) Palm Springs Center, 126,000 square feet, located in Altamonte Springs, Florida, (6) Jamestown Place, 96,000 square feet, located in Altamonte Springs, Florida and (7) Seabreeze Plaza, 147,000 square feet, located in Palm Harbor, Florida. As of December 31, 2005, the Company's properties (the "Current Portfolio Properties") consisted of 39 operating shopping center properties (the "Shopping Centers"), five predominantly office operating properties (the "Office Properties") and six (non-operating) development properties.

The Company established Saul QRS, Inc., a wholly owned subsidiary of Saul Centers, to facilitate the placement of collateralized mortgage debt. Saul QRS, Inc. was created to succeed to the interest of Saul Centers as the sole general partner of Saul Subsidiary I Limited Partnership. The remaining limited partnership interests in Saul Subsidiary I Limited Partnership and Saul Subsidiary II Limited Partnership are held by the Operating Partnership as the sole limited partner. Through this structure, the Company owns 100% of the Current Portfolio Properties.

Basis of Presentation

The accompanying financial statements of the Company have been presented on the historical cost basis of The Saul Organization because of affiliated ownership and common management and because the assets and liabilities were the subject of a business combination with the Operating Partnership, the Subsidiary Partnerships and Saul Centers, all newly formed entities with no prior operations.

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2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

The Company, which conducts all of its activities through its subsidiaries, the Operating Partnership and Subsidiary Partnerships, engages in the ownership, operation, management, leasing, acquisition, renovation, expansion, development and financing of community and neighborhood shopping centers and office properties, primarily in the Washington, DC/Baltimore metropolitan area. Because the properties are located primarily in the Washington, DC/Baltimore metropolitan area, the Company is subject to a concentration of credit risk related to these properties. A majority of the Shopping Centers are anchored by several major tenants. As of December 31, 2005, twenty-seven of the Shopping Centers were anchored by a grocery store and offer primarily day-to-day necessities and services. No single property accounted for more than 7.6% of the total gross leasable area. Only two retail tenants, Giant Food (5.3%), a tenant at nine Shopping Centers and Safeway (3.1%), a tenant at six Shopping Centers and one office tenant, the United States Government (3.1%), a tenant at six properties, individually accounted for more than 2.5% of the Company's total revenue for the year ended December 31, 2005.

Principles of Consolidation

The accompanying consolidated financial statements of the Company include the accounts of Saul Centers, its subsidiaries, and the Operating Partnership and Subsidiary Partnerships which are majority owned by Saul Centers. All significant intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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 revenues and expenses during the reporting period. Actual results could differ from those estimates.

Real Estate Investment Properties

The Company purchases real estate investment properties from time to time and allocates the purchase price to various components, such as land, buildings, and intangibles related

to in-place leases and customer relationships in accordance with Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") 141, "Business Combinations." The purchase price is allocated based on the relative fair value of each component. The fair value of buildings is determined as if the buildings were vacant upon acquisition and subsequently leased at market rental rates. As such, the determination of fair value considers the present value of all cash flows expected to be generated from the property including an initial lease-up period. The Company determines the fair value of above and below market intangibles associated with in-place leases by assessing the net effective rent and remaining term of the lease relative to market terms for similar leases at acquisition. In the case of below market leases, the Company considers the remaining contractual lease period and renewal periods, taking into consideration the likelihood of the tenant exercising its renewal options. The fair value of a below market lease component is recorded as deferred income and amortized as additional lease revenue over the remaining contractual lease period and any renewal option periods included in the valuation analysis. The fair value of above market lease intangibles is recorded as a deferred asset and is amortized as a reduction of lease revenue over the remaining contractual lease term. The Company determines the fair value of at-market in-place leases considering the cost of acquiring similar leases, the foregone rents associated with the lease-up period and carrying costs associated with the lease-up period. Intangible assets associated with at-market in-place leases are amortized as additional expense over the remaining contractual lease term. To the extent customer relationship intangibles are present in an acquisition, the fair value of the intangibles are amortized over the life of the customer relationship.

Real estate investment properties are reviewed for potential impairment losses quarterly or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If there is an event or change in circumstance indicating the potential for an impairment in the value of a real estate investment property, the Company's policy is to assess potential impairment in value by making a comparison of the current and projected operating cash flows of the property over its remaining useful life, on an undiscounted basis, to the carrying amount of that property. If such carrying amount is in excess of the estimated projected operating cash flows of the property, the Company would recognize an impairment loss equivalent to an amount required to adjust the carrying amount to its estimated fair market value. The Company has not recognized an impairment loss in 2005, 2004 or 2003 on any of its real estate.

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Interest, real estate taxes and other carrying costs are capitalized on projects under development and construction. Once construction is substantially completed and the assets are placed in service, their rental income, real estate tax expense, property operating expenses (consisting of payroll, repairs and maintenance, utilities, insurance and other property related expenses) and depreciation are included in current operations. Property operating expenses are charged to operations as incurred. Interest expense capitalized totaled \$3,258,000, \$3,227,000 and \$1,382,000, for 2005, 2004 and 2003, respectively. In the initial rental operations of development projects, a project is considered substantially complete and available for occupancy upon completion of tenant improvements, but no later than one year from the cessation of major construction activity. Substantially completed portions of a project are accounted for as separate projects.

Depreciation is calculated using the straight-line method and estimated useful lives of 35 to 50 years for base buildings and up to 20 years for certain other improvements that extend the useful lives. In addition, we capitalize leasehold improvements when certain criteria are met, including when we supervise construction and will own the improvement. Leasehold improvements are amortized, over the shorter of the lives of the related leases or the useful life of the improvement, using the straight-line method. Depreciation expense and amortization of leasehold improvements for the years ended December 31, 2005, 2004 and 2003 was \$19,824,000, \$17,061,000 and \$14,649,000, respectively. Repairs and maintenance expense totaled \$6,329,000, \$4,927,000 and \$4,943,000, for 2005, 2004 and 2003, respectively, and is included in operating expenses in the accompanying consolidated financial statements.

Lease Acquisition Costs

Certain initial direct costs incurred by the Company in negotiating and consummating a successful lease are capitalized and amortized over the initial base term of the lease. These costs total \$19,834,000 and \$17,745,000, net of accumulated amortization of \$11,392,000 and \$9,461,000 as of December 31, 2005 and 2004, respectively. Amortization expense, included in depreciation and amortization in the consolidated statements of operations, totaled \$4,373,000, \$4,263,000 and \$3,189,000, for the years ended December 31, 2005, 2004 and 2003, respectively. Capitalized leasing costs consist of commissions paid to third party leasing agents as well as internal direct costs such as employee compensation and payroll related fringe benefits directly related to time

spent performing leasing related activities. Such activities include evaluating the prospective tenant's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating lease terms, preparing lease documents and closing the transaction. The carrying amount of costs are written-off to expense if the applicable lease is terminated prior to expiration of the initial lease term.

Construction in Progress

Construction in progress includes preconstruction costs and development costs of active projects. Preconstruction costs associated with these active projects include legal, zoning and permitting costs and other project carrying costs incurred prior to the commencement of construction. Development costs include direct construction costs and indirect costs incurred subsequent to the start of construction such as architectural, engineering, construction management and carrying costs consisting of interest, real estate taxes and insurance. Construction in progress balances as of December 31, 2005 and 2004 are as follows:

Construction in Progress

(In thousands)	December 31,	
	2005	2004
Clarendon Center	\$ 16,629	\$ 14,976
Lansdowne Town Center	10,348	6,872
Ashland Square	7,262	6,411
Kentlands Place	--	5,905
Olde Forte Village	5,667	4,755
Broadlands Village III	3,638	1,660
Lexington	1,972	--
Ravenwood	607	--
Other	1,745	2,039
Total	\$ 47,868	\$ 42,618

Accounts Receivable and Accrued Income

Accounts receivable primarily represent amounts currently due from tenants in accordance with the terms of the respective leases. Receivables are reviewed monthly and reserves are established with a charge to current period operations when, in the opinion of management, collection of the receivable is doubtful. Accounts receivable in the accompanying consolidated financial statements are shown net of an allowance for doubtful accounts of \$430,000 and \$1,125,000, at December 31, 2005 and 2004, respectively.

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Allowance for Doubtful Accounts

(In thousands)	For the Year Ended December 31,	
	2005	2004
Beginning Balance	\$ 1,125	\$ 881
Provision for Credit Losses	237	488
Charge-offs	(932)	(244)
Ending Balance	\$ 430	\$ 1,125

In addition to rents due currently, accounts receivable include \$14,701,000 and \$12,101,000, at December 31, 2005 and 2004, respectively, representing minimum rental income accrued on a straight-line basis to be paid by tenants over the remaining term of their respective leases. These amounts are presented after netting allowances of \$64,000 and \$237,000, respectively, for tenants whose rent payment history or financial condition cast doubt upon the tenant's ability to perform under its lease obligations.

Cash and Cash Equivalents

Cash and cash equivalents include short-term investments. Short-term investments are highly liquid investments that are both readily convertible to cash and so near their maturity that they present insignificant risk of changes in value arising from interest rate fluctuations. Short-term investments include money market accounts and other investments which generally mature within three months, measured from the acquisition date.

Deferred Debt Costs

Deferred debt costs consist of fees and costs incurred to obtain long-term financing, construction financing and the revolving line of credit. These fees and costs are being amortized over the terms of the respective loans or agreements, which approximates the effective interest method. Deferred debt costs totaled \$5,875,000 and \$5,011,000, net of accumulated amortization of \$3,155,000 and \$4,229,000, at December 31, 2005 and 2004, respectively. During 2005, \$2,235,000 of fully amortized deferred debt costs was written-off.

Deferred Income

Deferred income consists of payments received from tenants prior to the time they are earned and recognized by the Company as revenue. These payments include prepayment of the following month's rent, prepayment of real estate taxes when the taxing jurisdiction has a fiscal year differing from the calendar year reimbursements specified in the lease agreement and advance payments by tenants for tenant construction work provided by the Company. In addition, deferred income includes the fair value of a below market lease component associated with acquisition properties as determined pursuant to the application of SFAS 141 "Business Combinations".

Revenue Recognition

Rental and interest income is accrued as earned except when doubt exists as to collectibility, in which case the accrual is discontinued. Recognition of rental income commences when control of the space has been given to the tenant. When rental payments due under leases vary from a straight-line basis because of free rent periods or stepped increases, income is recognized on a straight-line basis in accordance with accounting principles generally accepted in the United States. Expense recoveries represent a portion of property operating expenses billed to the tenants, including common area maintenance, real estate taxes and other recoverable costs. Expense recoveries are recognized in the period when the expenses are incurred. Rental income based on a tenant's revenues ("percentage rent") is accrued when a tenant reports sales that exceed a specified breakpoint.

Income Taxes

The Company made an election to be treated, and intends to continue operating so as to qualify as a REIT under sections 856 through 860 of the Internal Revenue Code of 1986, as amended, commencing with its taxable year ending December 31, 1993. A REIT generally will not be subject to federal income taxation on that portion of its income that qualifies as REIT taxable income to the extent that it distributes at least 90% of its REIT taxable income to stockholders and complies with certain other requirements. Therefore, no provision has been made for federal income taxes in the accompanying consolidated financial statements.

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Stock Based Employee Compensation, Deferred Compensation and Stock Plan for Directors

Effective January 2003, the Company adopted the fair value method to value and account for employee stock options using the prospective transition method specified under SFAS 148, "Accounting for Stock-Based Compensation-Transition and Disclosure" and accounts for stock based compensation according to SFAS 123, "Accounting for Stock-Based Compensation". The Company had no options eligible for valuation prior to the grant of options in 2003. The fair value of options granted in 2003, 2004 and 2005 was determined at the time of each award using the Black-Scholes model, a widely used method for valuing stock based employee compensation, and the following assumptions: (1) Expected Volatility. Because Saul Centers common stock is thinly traded, with average daily trading volume averaging less than 50,000 shares (since the Company's inception), expected volatility is determined using the entire trading history of the Company's common stock (month-end closing prices since its inception), (2) Average Expected Term. The options are assumed to be outstanding for a term calculated as the period of time from grant until the midpoint between the full vesting date and expiration date, (3) Expected Dividend Yield. This rate is a value management determines after considering the Company's current and historic dividend yield rates, the Company's yield in relation to other retail REITs and the Company's market yield at the grant date, and (4) Risk-free Interest Rate. This rate is based upon the market yields of US Treasury obligations with maturities corresponding to the average expected term of the options at the grant date. The Company amortizes the value of options granted, ratably over the vesting period, and includes the amounts as compensation in general and administrative expenses.

The Company established a stock option plan in 1993 (the "1993 Plan") for the purpose of attracting and retaining executive officers and other key personnel. The 1993 Plan provides for grants of options to purchase a specified number of shares of common stock. A total of 400,000 shares were made available under the 1993 Plan. The 1993 Plan authorizes the Compensation Committee of the Board of Directors to grant options at an exercise price which may not be less than the market value of the common stock on the date the option is granted. On May 23, 2003, the Compensation Committee granted options to purchase a total of 220,000 shares (80,000 shares from incentive stock options and 140,000 shares from nonqualified stock options) to six Company officers (the "2003 Options"). Following the grant of the 2003 Options, no additional shares remained for issuance under the 1993 Plan. The 2003 Options vest 25%

per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment. The exercise price of \$24.91 was the closing market price of the Company's common stock on the date of the award.

At the annual meeting of the Company's stockholders in 2004, the stockholders approved the adoption of the 2004 stock plan (the "2004 Plan") for the purpose of attracting and retaining executive officers, directors and other key personnel. The 2004 Plan provides for grants of options to purchase up to 500,000 shares of common stock as well as grants of up to 100,000 shares of common stock to directors. The 2004 Plan authorizes the Compensation Committee of the Board of Directors to grant options at an exercise price which may not be less than the market value of the common stock on the date the option is granted.

Effective April 26, 2004, the Compensation Committee granted options to purchase a total of 152,500 shares (27,500 shares from incentive stock options and 125,000 shares from nonqualified stock options) to eleven Company officers and to the twelve Company directors (the "2004 Options"). The officers' 2004 Options vest 25% per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment. The directors' options were immediately exercisable. The exercise price of \$25.78 was the closing market price of the Company's common stock on the date of the award. Using the Black-Scholes model, the Company determined the total fair value of the 2004 Options to be \$360,000, of which \$293,000 and \$67,000 were the values assigned to the officer options and director options respectively. Because the directors' options vest immediately, the entire \$67,000 was expensed as of the date of grant. The expense of the officers' options is being recognized as compensation expense monthly during the four years the options vest. The 2004 Options are due to expire April 25, 2014.

Effective May 6, 2005, the Compensation Committee granted options to purchase a total of 162,500 shares (35,500 shares from incentive stock options and 127,000 shares from nonqualified stock options) to twelve Company officers and to the twelve Company directors (the "2005 Options"). The officers' 2005 Options vest 25% per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment. The directors' options were immediately exercisable. The exercise price of \$33.22 was the closing market price of the Company's common stock on the date of the award. Using the Black-Scholes model, the Company determined the total fair value of the 2005 Options to be \$484,500, of which \$413,400 and \$71,100 were the values assigned to the officer options and director options respectively. Because the directors' options vest

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immediately, the entire \$71,100 was expensed as of the date of grant. The expense of the officers' options is being recognized as compensation expense monthly during the four years the options vest. The 2005 Options are due to expire May 5, 2015. (See Note 10. Stock Option Plan)

Pursuant to the 2004 Plan, the Compensation Committee established a Deferred Compensation Plan for Directors for the benefit of its directors and their beneficiaries. This replaces the Company's previous Deferred Compensation and Stock Plan for Directors. A director may elect to defer all or part of his or her director's fees and has the option to have the fees paid in cash, in shares of common stock or in a combination of cash and shares of common stock upon termination from the Board. If the director elects to have fees paid in stock, fees earned during a calendar quarter are aggregated and divided by the common stock's closing market price on the first trading day of the following quarter to determine the number of shares to be allocated to the director. As of December 31, 2005, 186,000 shares had been credited to the directors' deferred fee accounts.

The Compensation Committee has also approved an annual award of shares of the Company's common stock as additional compensation to each director serving on the Board of Directors as of the record date for the Annual Meeting of Stockholders. The shares are awarded as of each Annual Meeting of Shareholders, and their issuance may not be deferred. Each director was issued 200, 200 and 100 shares, for the years ended December 31, 2005, 2004 and 2003, respectively. The shares were valued at the closing stock price on the dates the shares were awarded and included in general and administrative expenses in the total amounts of \$80,000, \$71,000 and \$29,000, for the years ended December 31, 2005, 2004 and 2003, respectively.

Minority Interests

Saul Centers is the sole general partner of the Operating Partnership, owning a 76.1% common interest as of December 31, 2005. Minority Interests in the Operating Partnership are comprised of limited partnership units owned by The Saul Organization. Minority Interests as reflected on the Balance Sheets are increased for earnings allocated to limited partnership interests, distributions reinvested in additional units and distributions to minority interests in excess of earnings allocated, and are decreased for limited partner distributions. Minority Interests as reflected on the Statements of Operations represent earnings allocated to limited partnership interests. Amounts distributed in excess of the limited partners' share of earnings, net of limited partner reinvestments of distributions, also increase minority interests expense in the respective period and are classified on the Statements of Operations as Distributions in excess of

earnings to the extent such distributions in excess of earnings exceed the carrying amount of minority interests.

Per Share Data

Per share data is calculated in accordance with SFAS 128, "Earnings Per Share." Per share data for net income (basic and diluted) is computed using weighted average shares of common stock. Convertible limited partnership units and employee stock options are the Company's potentially dilutive securities. For all periods presented, the convertible limited partnership units are anti-dilutive. For the years ended December 31, 2005, 2004 and 2003 the options are dilutive because the average share price of the Company's common stock exceeded the exercise prices. The treasury share method was used to measure the effect of the dilution.

Basic and Diluted Shares Outstanding

	December 31,		
(In thousands)	2005	2004	2003
Weighted average common shares outstanding – Basic	16,663	16,154	15,591
Effect of dilutive options	107	57	17
Weighted average common shares outstanding – Diluted	16,770	16,211	15,608
Average Share Price	\$ 35.20	\$ 30.66	\$ 25.77

Reclassifications

Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation. The reclassifications have no impact on operating results previously reported.

Legal Contingencies

The Company is subject to various legal proceedings and claims that arise in the ordinary course of business. These matters are generally covered by insurance. While the resolution of these matters cannot be predicted with certainty, the Company believes the final outcome of such matters will not have a material adverse effect on the financial position or the results of operations. Once it has been determined that a loss is probable to occur, the estimated amount of the loss is recorded in the financial statements. Both the amount of the loss and the point at which its occurrence is considered probable can be difficult to determine.

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Recent Accounting Pronouncements

The Emerging Issues Task Force ("EITF") issued EITF 04-5, last updated on July 15, 2005, "Investors Accounting for an Investment in a Limited Partnership when the Investor is the General Partner and the Limited Partners have Certain Rights" ("EITF 04-5"), which addresses the General Partner in a limited partnership who is presumed to control the partnership unless the Limited Partners have the ability, through a majority vote, to remove the General Partner without cause or the ability to effectively participate in significant decisions that would be expected to be made in the ordinary course of business. EITF 04-5 is effective as of June 29, 2005 for new limited partnerships and existing limited partnerships where the partnership agreement has been modified after that date or for fiscal periods beginning after December 15, 2005. The Company has not entered into any new agreements or made any amendments to existing agreements that are covered by EITF 04-5. The Company is evaluating the potential impact of EITF 04-5 with respect to existing agreements and does not anticipate that the adoption of EITF 04-5, if applicable, will have material impact on its financial condition or results of operations.

In December 2004, the FASB issued FAS No. 123 (revised 2004), "Share-Based Payment" ("FAS No. 123R"), which is a revision of FAS No. 123, "Accounting for Stock-Based Compensation." FAS No. 123R supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and amends FAS No. 95, "Statement of Cash Flows." On April 14, 2005, the Securities and Exchange Commission announced its decision to delay compliance with FAS No. 123R until the first fiscal year following December 15, 2005. Saul Centers therefore will adopt FAS No. 123R as required, effective January 1, 2006. FAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recorded as an expense based on their fair values. The grant-date fair value of employee share options and similar instruments will be estimated using an option-pricing model adjusted for any unique characteristics of a particular instrument. If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification. The Company already values stock option awards using the fair value method and expenses the option value over the vesting period of the options, in accordance with FAS No. 123. The Company plans to adopt FAS No. 123R using the modified prospective transition method. The Company anticipates that the adoption of FAS No. 123R will not have a material impact upon its financial statements.

3. REAL ESTATE ACQUIRED

Boca Valley Plaza

On February 13, 2004, the Company acquired Boca Valley Plaza in Boca Raton, Florida. Boca Valley Plaza is a 121,000 square foot neighborhood shopping center on U.S. Highway 1 in South Florida. The center, constructed in 1988, is 91% leased and anchored by a 42,000 square foot Publix supermarket. The property was acquired for a purchase price of \$17.5 million, subject to the assumption of a \$9.2 million mortgage. The mortgage assumption was treated as a non-cash acquisition in the Statement of Cash Flows.

Countryside

On February 17, 2004, the Company completed the acquisition of the 142,000 square foot Safeway-anchored Countryside shopping center, its fourth neighborhood shopping center investment in Loudoun County, Virginia. The center is 96% leased and was acquired for a purchase price of \$29.7 million.

Cruse MarketPlace

On March 25, 2004, the Company completed the acquisition of the 79,000 square foot Publix-anchored, Cruse MarketPlace located in Forsyth County, Georgia. Cruse MarketPlace was constructed in 2002 and is 97% leased. The center was purchased for \$12.6 million subject to the assumption of an \$8.8 million mortgage loan. The mortgage assumption was treated as a non-cash acquisition in the Statement of Cash Flows.

Briggs Chaney MarketPlace

On April 23, 2004, the Company completed the acquisition of the 197,000 square foot Safeway-anchored Briggs Chaney MarketPlace shopping center located in Silver Spring, Maryland. The center is 98% leased and was acquired for a purchase price of \$27.3 million.

Ashland Square

On December 15, 2004, the Company acquired a 19.3 acre parcel of land in Dumfries, Prince William County, Virginia, for a purchase price of \$6.3 million. The Company has preliminary plans to develop the parcel into a grocery-anchored neighborhood shopping center. The Company submitted a site plan to Prince William County during the second quarter of 2005 in order to obtain approvals for developing a shopping center totaling approximately 160,000 square feet, and is marketing the project to grocers and other retail businesses.

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Palm Springs Center

On March 3, 2005, the Company completed the acquisition of the 126,000 square foot Albertson's-anchored Palm Springs Center located in Altamonte Springs, Florida. The center is 100% leased and was acquired for a purchase price of \$17.5 million.

New Market

On March 3, 2005, the Company acquired a 7.1 acre parcel of land located in New Market, Maryland for a purchase price of \$500,000. On September 8, 2005, the Company acquired a 28.4 acre contiguous parcel for a purchase price of \$1,500,000. The Company has contracted to purchase one additional parcel with the intent to assemble acreage for retail development near a major interstate highway interchange.

Lansdowne Town Center

During the first quarter of 2005, the Company received approval of a zoning submission to Loudoun County which will allow the development of a neighborhood shopping center to be known as Lansdowne Town Center, within the Lansdowne Community in northern Virginia. On March 29, 2005, the Company finalized the acquisition of an additional 4.5 acres of land to bring the total acreage of the development parcel to 23.4 acres (including the 18.9 acres acquired in 2002). The additional purchase price was approximately \$1.0 million. The Company has received final site plan approval from the County, and has commenced construction of the 191,000 square foot retail center during late 2005. A lease was executed with Harris Teeter for a 55,000 square foot grocery store to anchor this development.

Jamestown Place

On November 17, 2005, the Company completed the acquisition of the 96,000 square foot Publix-anchored Jamestown Place located in Altamonte Springs, Florida. The center is 99% leased and was acquired for a purchase price of \$14.8 million.

Seabreeze Plaza

On November 30, 2005, the Company completed the acquisition of the 147,000 square foot Publix-anchored Seabreeze Plaza located in Palm Harbor, Florida. The center is 99% leased and was acquired for a purchase price of \$25.9 million subject to the assumption of a \$13.6 million mortgage loan (See Note 5. Mortgage Notes Payable). The mortgage assumption was treated as a non-cash acquisition in the Statement of Cash Flows.

Application of SFAS 141, "Business Combinations", for Real Estate Acquired

The Company accounts for the acquisition of operating properties using the purchase method of accounting in accordance with SFAS 141, "Business Combinations." The Company allocates the purchase price to various components, such as land, buildings and intangibles related to in-place leases and customer relationships, if applicable, as described in Note 2. Significant Accounting Policies-Real Estate Investment Properties. Of the combined \$58,464,000 total cost of the operating property acquisitions in 2005 and \$89,299,000 in 2004, of which both amounts include the properties' purchase price and closing costs, a total of \$3,523,000 and \$4,403,000, was allocated as lease intangible assets and included in lease acquisition costs at December 31, 2005 and December 31, 2004, respectively. Each year's lease intangible assets are being amortized over the remaining periods of the leases acquired, a weighted average term of 13 and 9 years, for 2005 and 2004, respectively. The value of below market leases totaled \$2,203,000 and \$1,094,000, are being amortized over a weighted average term of 19 and 14 years, for 2005 and 2004, respectively, and are included in deferred income. The value of above market leases totaled \$151,000 and \$497,000, are being amortized over a weighted average term of 5 years, for both periods, and are included as a deferred asset in accounts receivable.

As of December 31, 2005 and 2004, the gross carrying amount of lease intangible assets included in lease acquisition costs was \$9,121,000 and \$5,598,000, respectively, and accumulated amortization was \$3,088,000 and \$1,584,000, respectively. Total amortization of these assets was \$1,504,000, \$1,456,000 and \$128,000, for the years ended December 31, 2005, 2004 and 2003, respectively. As of December 31, 2005 and 2004, the gross carrying amount of below market lease intangible assets included in deferred income was \$3,362,000 and \$1,159,000, respectively, and accumulated amortization was \$415,000 and \$148,000, respectively. Total amortization of these assets was \$267,000, \$136,000 and \$12,000, for the years ended December 31, 2005, 2004 and 2003, respectively. As of December 31, 2005 and 2004, the gross carrying amount of above market lease intangible assets included in accounts receivable was \$689,000 and \$538,000, respectively, and accumulated amortization was \$299,000 and \$142,000 respectively. Total amortization of these assets was \$157,000, \$137,000 and \$5,000, for the years ended December 31, 2005, 2004 and 2003, respectively.

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As of December 31, 2005, the scheduled amortization of intangible assets and deferred income related to in place leases are as follows:

Amortization of Intangible Assets and Deferred Income Related to In-place Leases

<i>(In thousands)</i>	Lease acquisition costs	Above market leases	Below market leases	Total
2006	\$ (2,051)	\$ (130)	\$ 445	\$ (1,736)
2007	(1,257)	(98)	274	(1,081)
2008	(764)	(82)	205	(641)
2009	(478)	(45)	181	(342)
2010	(352)	(33)	167	(218)
Thereafter	(1,131)	(2)	1,675	542
Total	\$ (6,033)	\$ (390)	\$ 2,947	\$ (3,476)

The results of operations of the acquired properties are included in the consolidated statements of operations as of the acquisition date. The following unaudited pro-forma combined condensed statements of operations set forth the consolidated results of operations for the years ended December 31, 2005 and 2004, respectively, as if the above described operating property acquisitions had occurred on January 1, 2005 and 2004, respectively. The unaudited pro-forma information does not purport to be indicative of the results that actually would have occurred if the combinations had been in effect for the years ended December 31, 2005 and 2004, respectively.

Pro-Forma Consolidated Condensed Statements of Operations

(unaudited)

<i>(In thousands, except per share data)</i>	Year ended December 31,	
	2005	2004
Total revenue	\$130,461	\$117,583
Net income available to common shareholders	\$ 21,695	\$ 19,027
Net income per common share – basic	\$ 1.30	\$ 1.18
Net income per common share – diluted	\$ 1.29	\$ 1.17

4. MINORITY INTERESTS - HOLDERS OF CONVERTIBLE LIMITED PARTNERSHIP UNITS IN THE OPERATING PARTNERSHIP

The Saul Organization has a 23.9% limited partnership interest, represented by 5,310,000 convertible limited partnership units, in the Operating Partnership, as of December 31, 2005. These convertible limited partnership units are convertible into shares of Saul Centers' common stock, at the option of the unitholders, on a one-for-one basis, provided the rights may not be exercised at any time that The Saul Organization beneficially owns, directly or indirectly, in the aggregate more than 24.9% of the value of the outstanding common stock and preferred stock of Saul Centers (the "Equity Securities"). The limited partnership units were not convertible as of December 31, 2005 because the Saul Organization owned in excess of 24.9% of the Company's Equity Securities.

The Operating Partnership issued 110,910 and 11,557 limited partnership units pursuant to the Dividend Reinvestment and Stock Purchase Plan at a weighted average discounted price of \$35.15 and \$27.66 per share during the years ended December 31, 2005 and 2004, respectively.

The impact of The Saul Organization's 23.9% limited partnership interest in the Operating Partnership is reflected as minority interests in the accompanying consolidated financial statements. Fully converted partnership units and diluted weighted average shares outstanding for the years ended December 31, 2005, 2004 and 2003, were 22,003,000, 21,405,000 and 20,790,000, respectively.

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5. MORTGAGE NOTES PAYABLE, REVOLVING CREDIT FACILITY, INTEREST EXPENSE AND AMORTIZATION OF DEFERRED DEBT COSTS

The Company's outstanding debt, including amounts owed under the Company's revolving credit facility, totaled \$482,431,000 at December 31, 2005, of which \$471,931,000 was fixed rate debt and \$10,500,000 was variable rate debt. At the prior year's end, notes payable totaled \$453,646,000, all of which was fixed rate debt. At December 31, 2005, the Company had a \$150 million unsecured revolving credit facility with \$10,500,000 outstanding borrowings. The facility is due to mature January 2008 and requires monthly interest payments, if applicable, at a rate of LIBOR plus a spread of 1.40% to 1.625% (determined by certain debt service coverage and leverage tests) or upon the bank's reference rate at the Company's option. Loan availability is determined by operating income from the Company's unencumbered properties, which, as of December 31, 2005 supported line availability of \$83,000,000 leaving \$72,500,000 available for working capital uses. An additional \$67,000,000 was available for funding working capital and operating property acquisitions supported by the unencumbered properties' internal cash flow growth and operating income of future acquisitions.

Saul Centers has guaranteed a portion of a mortgage note payable totaling \$4,500,000, the amount of which is considered a recourse obligation to Saul Centers as of December 31, 2005. The guarantee is expected to be released upon the achievement of specified leasing thresholds at a recently redeveloped property. Saul Centers is also a guarantor of the revolving credit facility. The balance of the mortgage notes payable totaling \$467,431,000 are non-recourse.

During 2005 the Company refinanced its revolving credit facility, refinanced an existing mortgage loan, completed a new mortgage financing and assumed an existing mortgage loan upon the acquisition of a shopping center. On January 28, 2005 the Company executed a \$150 million unsecured revolving credit facility, an expansion of the \$125 million agreement in place as of December 31, 2004. The facility is intended to provide working capital and funds for

acquisitions, certain developments and redevelopments. The line has a three-year term and provides for an additional one-year extension at the Company's option, subject to the Company's satisfaction of certain conditions. Until January 27, 2007, certain or all of the lenders may, upon request by the Company and payment of certain fees, increase the revolving credit facility line by up to \$50,000,000. Letters of credit may be issued under the revolving credit facility. The Company closed on two new fixed-rate, non-recourse financings during the second quarter of 2005. The first loan is a refinancing of the \$9,200,000, 6.82% interest rate mortgage loan assumed during the February 2004 acquisition of Boca Valley Plaza. The new loan is a 15-year, \$13,000,000 fixed-rate mortgage loan collateralized by Boca Valley Plaza. The loan requires monthly principal and interest payments based upon a fixed interest rate of 5.60% and a 30-year amortization schedule. A final payment of \$9,149,000 will be due at loan maturity, May 2020. The second loan is a permanent financing of Palm Springs Center, acquired in March 2005. The loan is a 15-year, \$12,500,000 fixed-rate mortgage loan collateralized by Palm Springs Center. The loan requires monthly principal and interest payments based upon a fixed interest rate of 5.30% and a 25-year amortization schedule. A final payment of \$7,075,000 will be due at loan maturity, June 2020. On November 30, 2005 the Company assumed an existing \$13,600,000 loan upon the acquisition of Seabreeze Plaza. The loan requires fixed monthly principal and interest payments based upon a 5.28% interest rate and 25-year amortization. A final payment of \$10,531,000 will be due at loan maturity, May 2014.

In December 2005, the Company entered into a rate lock agreement and made application for a 15-year, \$40,000,000 fixed-rate mortgage loan to be collateralized by Lansdowne Town Center. The rate lock agreement set the interest rate at 5.62%, contingent upon meeting certain construction and leasing criteria prior to loan funding, projected to occur in February 2007. The Company paid a loan deposit fee of \$850,000 which is refundable, less expenses, if the parties are unable to close on the financing.

The following is a summary of notes payable as of December 31, 2005 and 2004:

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Notes Payable

(Dollars in thousands)	December 31,		Interest Rate *	Scheduled Maturity *
	2005	2004		
Fixed rate mortgages:	\$ 91,203 (a)	\$ 94,794	8.00%	Dec-2011
	126,637 (b)	129,883	7.67%	Oct-2012
	32,185 (c)	33,138	7.88%	Jan-2013
	8,520 (d)	8,699	5.77%	Jul-2013
	13,554 (e)	—	5.28%	May-2014
	12,712 (f)	13,057	8.33%	Jun-2015
	40,627 (g)	41,324	6.01%	Feb-2018
	46,479 (h)	47,375	5.88%	Jan-2019
	15,040 (i)	15,335	5.76%	May-2019
	20,774 (j)	21,185	5.62%	Jul-2019
	20,514 (k)	20,906	5.79%	Sep-2019
	18,407 (l)	18,750	5.22%	Jan-2020
	12,901 (m)	9,200	5.60%	May-2020
	12,378 (n)	—	5.30%	Jun-2020
Total fixed rate	471,931	453,646	6.90%	9.3 Years
Variable rate loan:				
Revolving credit facility	10,500 (o)	—	LIBOR + 1.5 %	Jan-2008
Total variable rate	10,500	—	5.82%	2.1 Years
Total notes payable	\$ 482,431	\$ 453,646	6.87%	9.2 Years

* Interest rate and scheduled maturity data presented as of December 31, 2005. Totals computed using weighted averages.

- (a) The loan is collateralized by Avenel Business Park, Van Ness Square, Ashburn Village, Leesburg Pike, Lumberton Plaza and Village Center. The loan has been increased on four occasions since its inception in 1997. The 8.00% blended interest rate is the weighted average of the initial loan rate and additional borrowing rates. The loan requires equal monthly principal and interest payments of \$920,000 based upon a weighted average 23-year amortization schedule and a final payment of \$63,153,000 at loan maturity. Principal of \$3,591,000 was amortized during 2005.
- (b) The loan is collateralized by nine shopping centers (Seven Corners, Thruway, White Oak, Hampshire Langley, Great Eastern, Southside Plaza, Belvedere, Giant and Ravenwood) and requires equal monthly principal and interest payments of \$1,103,000 based upon a 25-year amortization schedule and a final payment of \$97,403,000 at loan maturity. Principal of \$3,246,000 was amortized during 2005.
- (c) The loan is collateralized by 601 Pennsylvania Avenue and requires equal monthly principal and interest payments of \$294,000 based upon a 25-year amortization schedule and a final payment of \$22,961,000 at loan maturity. Principal of \$953,000 was amortized during 2005.
- (d) The loan is collateralized by Cruse MarketPlace and requires equal monthly principal and interest payments of \$56,000 based upon an amortization schedule of approximately 24 years and a final payment of \$6,830,000 at loan maturity. Principal of \$179,000 was amortized during 2005.
- (e) The loan is collateralized by Seabreeze Plaza and requires equal monthly principal and interest payments of \$84,000 based upon a 25-year amortization schedule and a final payment of \$10,531,000 at loan maturity. Principal of \$25,000 was amortized during 2005.
- (f) The loan is collateralized by Shops at Fairfax and Boulevard shopping centers and requires monthly principal and interest payments of \$118,000 based upon a 22-year amortization schedule and a final payment of \$7,630,000 at loan maturity. Principal of \$345,000 was amortized during 2005.

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- (g) The loan is collateralized by Washington Square and requires equal monthly principal and interest payments of \$264,000 based upon a 27.5-year amortization schedule and a final payment of \$28,012,000 at loan maturity. Principal of \$697,000 was amortized during 2005.
- (h) The loan, consisting of two notes dated December 2003 and two notes dated February and December 2004, is currently collateralized by four shopping centers, Broadlands Village (Phases I & II), The Glen and Kentlands Square, and requires equal monthly principal and interest payments of \$306,000 (beginning February 1, 2005; prior to that date, payments totaled \$256,000 per month) based upon a 25-year amortization schedule and a final payment of \$28,393,000 at loan maturity. Principal of \$896,000 was amortized during 2005.
- (i) The loan is collateralized by Olde Forte Village and requires equal monthly principal and interest payments of \$98,000 based upon a 25-year amortization schedule and a final payment of \$8,985,000 at loan maturity. Principal of \$295,000 was amortized during 2005.
- (j) The loan is collateralized by Countryside and requires equal monthly principal and interest payments of \$133,000 based upon a 25-year amortization schedule and a final payment of \$12,288,000 at loan maturity. Principal of \$411,000 was amortized during 2005.
- (k) The loan is collateralized by Briggs Chaney MarketPlace and requires equal monthly principal and interest payments of \$133,000 based upon a 25-year amortization schedule and a final payment of \$12,192,000 at loan maturity. Principal of \$392,000 was amortized during 2005.
- (l) The loan is collateralized by Shops at Monocacy and requires equal monthly principal and interest payments of \$112,000 based upon a 25-year amortization schedule and a final payment of \$10,568,000 at loan maturity. Principal of \$343,000 was amortized during 2005.
- (m) The loan is collateralized by Boca Valley Plaza and requires equal monthly principal and interest payments of \$75,000 based upon a 30-year amortization schedule and a final payment of \$9,149,000 at loan maturity. Principal of \$99,000 was amortized during 2005. The previous loan was repaid in 2005 with proceeds from this financing.
- (n) The loan is collateralized by Palm Springs Center and requires equal monthly principal and interest payments of \$75,000 based upon a 25-year amortization schedule and a final payment of \$7,075,000 at loan maturity. Principal of \$122,000 was amortized during 2005.
- (o) The loan is an unsecured revolving credit facility totaling \$150,000,000. Loan availability for working capital and general corporate uses is determined by operating income from the Company's unencumbered properties, with a portion available only for funding qualified operating property acquisitions. Interest expense is calculated based upon the 1,2,3 or 6 month LIBOR rate plus a spread of 1.40% to 1.625% (determined by certain debt service coverage and leverage tests) or upon the bank's reference rate at the Company's option. The line may be extended one year with payment of a fee of 1/4% at the Company's option. Monthly payments, if applicable, are interest only and will vary depending upon the amount outstanding and the applicable interest rate for any given month.

The December 31, 2005 and 2004 depreciation adjusted cost of properties collateralizing the mortgage notes payable totaled \$467,015,000 and \$420,320,000, respectively. The Company's credit facility requires the Company and its subsidiaries to maintain certain financial covenants. As of December 31, 2005, the material covenants required the Company, on a consolidated basis, to:

- limit the amount of debt so as to maintain a gross asset value in excess of liabilities of at least \$400 million;
- limit the amount of debt as a percentage of gross asset value (leverage ratio) to less than 60%;
- limit the amount of debt so that interest coverage will exceed 2.1 to 1 on a trailing four quarter basis; and
- limit the amount of debt so that interest, scheduled principal amortization and preferred dividend coverage exceeds 1.55 to 1.

As of December 31, 2005, the Company was in compliance with all such covenants.

Notes payable at December 31, 2005 and 2004, totaling \$169,322,000 and \$163,022,000, respectively, are guaranteed by members of The Saul Organization. As of December 31, 2005, the scheduled maturities of all debt including scheduled principal amortization for years ended December 31, are as follows:

Debt Maturity Schedule

(In thousands)

2006	\$ 12,991
2007	13,967
2008	25,491
2009	16,149
2010	17,369
Thereafter	396,464
Total	\$482,431

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Interest Expense and Amortization
of Deferred Debt Costs

<i>(In thousands)</i>	Year ended December 31,		
	2005	2004	2003
Interest incurred	\$ 32,304	\$ 29,320	\$ 27,154
Amortization of deferred debt costs	1,161	929	801
Capitalized interest	(3,258)	(3,227)	(1,382)
Total	\$ 30,207	\$ 27,022	\$ 26,573

6. LEASE AGREEMENTS

Lease income includes primarily base rent arising from noncancelable commercial leases. Base rent (including straight-lined rent) for the years ended December 31, 2005, 2004 and 2003, amounted to \$99,448,000, \$91,125,000 and \$78,167,000, respectively. Future contractual payments under noncancelable leases for years ended December 31, are as follows:

Future Contractual Payments

<i>(In thousands)</i>	
2006	\$102,138
2007	94,545
2008	83,683
2009	71,256
2010	59,713
Thereafter	283,396
Total	\$694,731

The majority of the leases also provide for rental increases and expense recoveries based on fixed annual increases or increases in the Consumer Price Index and increases in operating expenses. The expense recoveries generally are payable in equal installments throughout the year based on estimates, with adjustments made in the succeeding year. Expense recoveries for the years ended December 31, 2005, 2004 and 2003 amounted to \$20,027,000, \$16,712,000 and \$14,438,000, respectively. In addition, certain retail leases provide for percentage rent based on sales in excess of the minimum specified in the tenant's lease. Percentage rent amounted to \$2,057,000, \$1,635,000 and \$1,695,000, for the years ended December 31, 2005, 2004 and 2003, respectively.

7. LONG-TERM LEASE OBLIGATIONS

Certain properties are subject to noncancelable long-term leases which apply to land underlying the Shopping Centers. Certain of the leases provide for periodic adjustments of the

base annual rent and require the payment of real estate taxes on the underlying land. The leases will expire between 2058 and 2068. Reflected in the accompanying consolidated financial statements is minimum ground rent expense of \$164,000 for each of the years ended December 31, 2005, 2004 and 2003, respectively. The future minimum rental commitments under these ground leases are as follows:

Ground Lease Rental Commitments

<i>(In thousands)</i>	Annually 2006-2008	2009	2010	Total Thereafter
Beacon Center	\$ 53	\$ 53	\$ 53	\$ 3,077
Olney	51	52	56	4,265
Southdale	60	60	60	3,425
Total	\$ 164	\$ 165	\$ 169	\$ 10,767

In addition to the above, Flagship Center consists of two developed out parcels that are part of a larger adjacent community shopping center formerly owned by The Saul Organization and sold to an affiliate of a tenant in 1991. The Company has a 90-year ground leasehold interest which commenced in September 1991 with a minimum rent of one dollar per year. Countryside Shopping Center was acquired in February, 2004. Because of certain land use considerations, approximately 0.54 of the 16 acres acquired is held under a 99-year ground lease. The lease requires the Company to pay minimum rent of one dollar per year as well as its pro-rata share of the real estate taxes.

The Company's corporate headquarters lease, which commenced in March 2002, is leased by a member of The Saul Organization. The 10-year lease provides for base rent escalated at 3% per year, with payment of a pro-rata share of operating expenses over a base year amount. The Company and The Saul Organization entered into a Shared Services Agreement whereby each party pays an allocation of total rental payments on a percentage proportionate to the number of employees employed by each party. The Company's rent payments for the years ended December 31, 2005, 2004 and 2003 were \$661,000, \$621,000 and \$569,000, respectively. Expenses arising from the lease are included in general and administrative expense (see Note 9 – Related Party Transactions).

8. STOCKHOLDERS' EQUITY (DEFICIT) AND
MINORITY INTERESTS

The consolidated statement of operations for the year ended December 31, 2005 includes a charge for minority interests of \$7,798,000, consisting of \$6,937,000 related to The Saul

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Organization's share of the net income for the year and \$861,000 related to distributions to minority interests in excess of allocated net income for the year. The charge for the year ended December 31, 2004 was \$8,105,000, consisting of \$6,386,000 related to The Saul Organization's share of the net income for the year and \$1,719,000 related to distributions to minority interests in excess of allocated net income for the year. The charge for the year ended December 31, 2003 was \$8,086,000, consisting of \$6,495,000 related to The Saul Organization's share of the net income for the year and \$1,591,000 related to distributions to minority interests in excess of allocated net income for the year.

On July 16, 2003, the Company filed a shelf registration statement (the "Shelf Registration Statement") with the SEC relating to the future offering of up to an aggregate of \$100 million of preferred stock and depositary shares. On November 5, 2003 the Company sold 3,500,000 depositary shares, each representing 1/100th of a share of 8% Series A Cumulative Redeemable Preferred Stock. The underwriters exercised an over-allotment option, purchasing an additional 500,000 depositary shares on November 26, 2003.

The depositary shares may be redeemed, in whole or in part, at the \$25.00 liquidation preference at the Company's option on or after November 5, 2008. The depositary shares will pay an annual dividend of \$2.00 per share, equivalent to 8% of the \$25.00 liquidation preference. The first dividend, paid on January 15, 2004 was for less than a full quarter and covered the period from November 5 through December 31, 2003. The Series A preferred stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and is not convertible into any other securities of the Company. Investors in the depositary shares generally have no voting rights, but will have limited voting rights if the Company fails to pay dividends for six or more quarters (whether or not declared or consecutive) and in certain other events.

9. RELATED PARTY TRANSACTIONS

Chevy Chase Bank, an affiliate of The Saul Organization, leases space in 15 of the Company's properties. Total rental income from Chevy Chase Bank amounted to \$1,768,000, \$1,733,000 and \$1,495,000, for the years ended December 31, 2005, 2004 and 2003, respectively. As of December 31, 2005 and 2004, accounts receivable and accrued income, net included \$8,000 and \$4,000, respectively, from various Chevy Chase Bank leases.

The Company utilizes Chevy Chase Bank for its various checking accounts and as of December 31, 2005 had \$7,723,000 deposited in cash and short-term investment accounts.

The Chairman and Chief Executive Officer, the President, the Senior Vice President- General Counsel and the Vice President-Chief Accounting Officer of the Company are also officers of various members of The Saul Organization and their management time is shared with The Saul Organization. Their annual compensation is fixed by the Compensation Committee of the Board of Directors, with the exception of the Vice President-Chief Accounting Officer whose share of annual compensation allocated to the Company is determined by the shared services agreement (described below).

The Company participates in a multiemployer profit sharing retirement plan with other entities within The Saul Organization which covers those full-time employees who meet the requirements as specified in the plan. Beginning January 1, 2002, only employer contributions are made to the plan. Each participant who is entitled to be credited with at least one hour of service on or after January 1, 2002, shall be 100% vested in his or her employer contribution account and no portion of such account shall be forfeitable. Employer contributions, included in general and administrative expense or property operating expenses in the consolidated statements of operations, at the discretionary amount of up to six percent of the employee's cash compensation, subject to certain limits, were \$266,000, \$269,000 and \$199,000 for 2005, 2004 and 2003, respectively. There are no past service costs associated with the plan since it is of the defined-contribution type.

The Company also participates in a multiemployer nonqualified deferred plan with entities in The Saul Organization which covers those full-time employees who meet the requirements as specified in the plan. The plan, which can be modified or discontinued at any time, requires participating employees to defer 2% of their compensation over a specified amount. For the years ended December 31, 2005, 2004 and 2003, the Company was required to contribute three times the amount deferred by employees. The Company's expense, included in general and administrative expense, totaled \$118,000, \$650,000 and \$31,000, for the years ended December 31, 2005, 2004 and 2003, respectively. All amounts deferred by employees and the Company are fully vested. The cumulative unfunded liability under this plan was \$570,000 and \$452,000 at December 31, 2005 and 2004, respectively, and is included in accounts payable, accrued expenses and other liabilities in the consolidated balance sheets.

The Company has entered into a shared services agreement (the "Agreement") with The Saul Organization that provides for the sharing of certain personnel and ancillary functions such as computer hardware, software, and support services and certain direct and indirect administrative personnel. The method for determining the cost of the shared services is

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provided for in the Agreement and is based upon head count estimates of usage or estimates of time incurred, as applicable. Senior management has determined that the final allocations of shared costs are reasonable. The terms of the Agreement and the payments made thereunder are reviewed annually by the Audit Committee of the Board of Directors, which consists entirely of independent directors. Billings by The Saul Organization for the Company's share of these ancillary costs and expenses for the years ended December 31, 2005, 2004 and 2003, which included rental payments for the Company's headquarters lease (see Note 7. Long Term Lease Obligations), totaled \$3,462,000, \$3,139,000 and \$2,628,000, respectively. The amounts are expensed when incurred and are primarily reported as general and administrative expenses in these consolidated financial statements. As of December 31, 2005 and 2004, accounts payable, accrued expenses and other liabilities included \$305,000 and \$259,000, respectively, represent billings due to The Saul Organization for the Company's share of these ancillary costs and expenses.

On January 23, 2004, the Company purchased a 3.4 acre site, adjacent to the Company's Kentlands Square property, from a subsidiary of Chevy Chase Bank for \$1,425,000. The Company developed this property into a 41,000 square foot retail/office property known as Kentlands Place. The purchase price of the property was determined by the average of two independent third party appraisals which were contracted, one on behalf of the Company and one on behalf of Chevy Chase Bank.

10. STOCK OPTION PLAN

The Company established a stock option plan in 1993 (the "1993 Plan") for the purpose of attracting and retaining executive officers and other key personnel. The 1993 Plan provided for grants of options to purchase a specified number of shares of common stock. A total of 400,000 shares were made available under the 1993 Plan. The 1993 Plan authorizes the Compensation Committee of the Board of Directors to grant options at an exercise price which may not be less than the market value of the common stock on the date the option is granted.

During 1993 and 1994, the Compensation Committee granted options to purchase a total of 180,000 shares (90,000 shares from incentive stock options and 90,000 shares from nonqualified stock options) to five Company officers. The options vested 25% per year over four years, had an exercise price of \$20 per share and a term of ten years, subject to earlier expiration upon termination of employment. No compensation expense was recognized as a result of these grants. As of December 31, 2004, no 1993 and 1994 options remained unexercised.

On May 23, 2003, the Compensation Committee granted options to purchase a total of 220,000 shares (80,000 shares from incentive stock options and 140,000 shares from nonqualified stock options) to six Company officers (the "2003 Options"). The 2003 Options vest 25% per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment. The exercise price of \$24.91 was the market trading price of the Company's common stock at the time of the award. As a result of the 2003 Options grant, no further shares were available under the 1993 Plan.

At the annual meeting of the Company's stockholders in 2004, the stockholders approved the adoption of the 2004 stock plan (the "2004 Plan") for the purpose of attracting and retaining executive officers, directors and other key personnel. The 2004 Plan provides for grants of options to purchase up to 500,000 shares of common stock as well as grants of up to 100,000 shares of common stock to directors. The 2004 Plan authorizes the Compensation Committee of the Board of Directors to grant options at an exercise price which may not be less than the market value of the common stock on the date the option is granted.

Effective April 26, 2004, the Compensation Committee granted options to purchase a total of 152,500 shares (27,500 shares of incentive stock options and 125,000 shares of nonqualified stock options) to eleven Company officers and to the twelve Company directors (the "2004 Options"). The officers' 2004 Options vest 25% per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment. The directors' options are exercisable immediately. The exercise price of \$25.78 was the market trading price of the Company's common stock at the time of the award.

Effective May 6, 2005, the Compensation Committee granted options to purchase a total of 162,500 shares (35,500 shares of incentive stock options and 127,000 shares of nonqualified stock options) to twelve Company officers and to the twelve Company directors (the "2005 Options"). The officers' 2005 Options vest 25% per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment. The directors' options are exercisable immediately. The exercise price of \$33.22 was the market trading price of the Company's common stock at the time of the award.

The following table summarizes the status of the 2005, 2004 and 2003 Option grants and the value of the options expensed and included in general and administrative expense in the Consolidated Statements of Operations:

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Stock Options

	Officers			Directors		Total
Grant date	05/23/2003	04/26/2004	05/06/2005	04/26/2004	05/06/2005	
Total grant	220,000	122,500	132,500	30,000	30,000	535,000
Vested	110,000	30,625	—	30,000	30,000	200,625
Exercised	20,000	1,875	—	—	—	21,875
Remaining unexercised	200,000	120,625	132,500	30,000	30,000	513,125
Exercise price	\$ 24.91	\$ 25.78	\$ 33.22	\$ 25.78	\$ 33.22	
Volatility	0.175	0.183	0.207	0.183	0.198	
Expected life (years)	7.0	7.0	8.0	5.0	10.0	
Assumed yield	7.00%	5.75%	6.37%	5.75%	6.91%	
Risk-free rate	4.00%	4.05%	4.15%	3.57%	4.28%	
Total value	\$ 332,200	\$ 292,775	\$ 413,400	\$ 66,600	\$ 71,100	\$ 1,176,075
Expensed in 2003	50,000	—	—	—	—	50,000
Expensed in 2004	83,000	50,000	—	66,600	—	199,600
Expensed in 2005	83,000	73,000	69,000	—	71,100	296,100

The table below summarizes the option activity for the years 2005, 2004 and 2003:

	2005		2004		2003	
	Shares	Wtd Avg Exercise Price	Shares	Wtd Avg Exercise Price	Shares	Wtd Avg Exercise Price
Outstanding at January 1	352,500	\$ 25.29	220,000	\$ 24.91	93,210	\$ 20.00
Granted	162,500	33.22	152,500	25.78	220,000	24.91
Exercised	(1,875)	25.78	(20,000)	24.91	(93,210)	20.00
Expired/Forfeited	—	—	—	—	—	—
Outstanding December 31	513,125	27.80	352,500	25.29	220,000	24.91
Exercisable at December 31	178,750	26.59	65,000	25.31	—	—

The weighted average remaining contractual life of the Company's options is 8.3 years at December 31, 2005.

11. NON-OPERATING ITEMS

Gain on Sale of Property

The gain on sale of property of \$572,000 in 2004 represents the Company's share of the gain recognized as a result of a condemnation of a portion of land at the Company's White Oak shopping center for road improvements. The gain on sale of property of \$182,000 in 2003 represents the gain recognized as a result of a condemnation of a portion of land at the Company's Avenel Business Park property for improvement of an interchange on I-270, adjacent to the property. There were no property dispositions in 2005.

12. FAIR VALUE OF FINANCIAL INSTRUMENTS

Statement of Financial Accounting Standards No. 107, "Disclosure about Fair Value of Financial Instruments," requires disclosure about the fair value of financial instruments. The carrying values of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses are reasonable estimates of their fair value. Based upon management's estimate of borrowing rates and loan terms currently available to the Company for fixed rate financing, the fair value of the fixed rate notes payable is in excess of the \$471,931,000 and \$453,646,000 carrying value at December 31, 2005 and 2004, respectively. Management estimates that the fair value of these fixed rate notes payable, assuming long term interest rates of approximately 5.65% and 5.50%, would be approximately \$501,550,000 and \$474,993,000, as of December 31, 2005 and 2004, respectively.

13. COMMITMENTS AND CONTINGENCIES

Neither the Company nor the Current Portfolio Properties are subject to any material litigation, nor, to management's knowledge, is any material litigation currently threatened against the Company, other than routine litigation and administrative proceedings arising in the ordinary course of business. Management believes that these items, individually or in the aggregate, will not have a material adverse impact on the Company or the Current Portfolio Properties.

14. DISTRIBUTIONS

In December 1995, the Company established a Dividend Reinvestment and Stock Purchase Plan (the "Plan"), to allow its stockholders and holders of limited partnership interests an opportunity to buy additional shares of common stock by reinvesting all or a portion of their dividends or distributions. The Plan provides for investing in newly issued shares of common stock at a 3% discount from market price without payment of any brokerage commissions, service charges or

other expenses. All expenses of the Plan are paid by the Company. The Operating Partnership also maintains a similar dividend reinvestment plan that mirrors the Plan, which allows limited partnership interests the opportunity to buy additional limited partnership units.

The Company paid common stock distributions of \$1.60 per share during 2005 and \$1.56 per share during 2004 and 2003 and paid preferred stock dividends of \$2.00 and \$1.811 per depositary share during 2005 and 2004. No preferred stock dividends were paid during 2003. For the common stock dividends paid, \$1.520, \$1.248 and \$1.284 per share, represented ordinary dividend income and \$0.080, \$0.312 and \$0.276 per share, represented return of capital to the shareholders for the years 2005, 2004 and 2003, respectively. All of the preferred stock dividends paid were considered ordinary dividend income.

The following summarizes distributions paid during the years ended December 31, 2005, 2004 and 2003, and includes activity in the Plan as well as limited partnership units issued from the reinvestment of unit distributions:

	Total Distributions to (Dollars in thousands)			Dividend Reinvestments		
	Preferred Stockholders	Common Stockholders	Limited Partnership Unitholders	Common Stock Shs Issued	Units Issued	Discounted Share Price
Distributions during 2005						
October 31	\$ 2,000	\$ 7,042	\$ 2,207	108,133	57,875	\$ 33.95
July 29	2,000	6,668	2,081	91,353	50,483	36.67
April 29	2,000	6,436	2,029	158,607	—	32.50
January 31	2,000	6,396	2,028	97,401	2,552	32.40
Total 2005	\$ 8,000	\$ 26,542	\$ 8,345	455,494	110,910	
Distributions during 2004						
October 29	\$ 2,000	\$ 6,342	\$ 2,028	116,006	2,590	\$ 31.53
July 30	2,000	6,296	2,027	117,334	2,769	29.10
April 30	2,000	6,236	2,026	140,253	3,270	24.25
January 30	1,244	6,187	2,024	123,689	2,928	26.69
Total 2004	\$ 7,244	\$ 25,061	\$ 8,105	497,282	11,557	
Distributions during 2003						
October 31	\$ —	\$ 6,135	\$ 2,023	129,319	2,919	\$ 26.38
July 31	—	6,088	2,023	126,862	2,847	26.67
April 30	—	6,021	2,020	139,576	3,262	22.88
January 31	—	5,927	2,020	156,413	3,412	21.49
Total 2003	\$ —	\$ 24,171	\$ 8,086	552,170	12,440	

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In December 2005, 2004 and 2003, the Board of Directors of the Company authorized a distribution of \$0.42, \$0.39 and \$0.39 per common share payable in January 2006, 2005 and 2004, to holders of record on January 17, 2006, January 17, 2005 and January 16, 2004, respectively. As a result, \$7,089,000, \$6,396,000 and \$6,187,000, were paid to common shareholders on January 31, 2006, January 31, 2005 and January 30, 2004, respectively. Also, \$2,230,000, \$2,028,000 and \$2,024,000, were paid to limited partnership unitholders on January 31, 2006, January 31, 2005 and January 30, 2004 (\$0.42, \$0.39 and \$0.39 per Operating Partnership unit), respectively. The Board of Directors authorized preferred

stock dividends of \$0.50, \$0.50 and \$0.31 per depositary share, to holders of record on January 3, 2006, January 3, 2005 and January 2, 2004, respectively. As a result, \$2,000,000, \$2,000,000 and \$1,244,000, were paid to preferred shareholders on January 13, 2006, January 14, 2005 and January 15, 2004, respectively. These amounts are reflected as a reduction of stockholders' equity in the case of common stock and preferred stock dividends and minority interests deductions in the case of limited partner distributions and are included in dividends and distributions payable in the accompanying consolidated financial statements.

15. INTERIM RESULTS (UNAUDITED)

The following summary presents the results of operations of the Company for the quarterly periods of calendar years 2005 and 2004.

(In thousands, except per share amounts)

	2005			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Revenue	\$ 30,307	\$ 30,752	\$ 33,182	\$ 32,774
Operating income before minority interests and gain on sale of property	8,639	8,952	9,694	9,740
Net income	6,610	6,871	7,856	7,890
Net income available to common stockholders	4,610	4,871	5,856	5,890
Net income available to common stockholders per share (basic & diluted)	0.28	0.29	0.35	0.35

	2004			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Revenue	\$ 26,341	\$ 27,888	\$ 29,044	\$ 29,569
Operating income before minority interests and gain on sale of property	8,329	8,329	8,793	8,256
Net income	6,305	6,286	7,355 (a)	6,228
Net income available to common stockholders	4,305	4,286	5,355	4,228
Net income available to common stockholders per share (basic & diluted) (b)	0.27	0.27	0.33	0.26

(a) Includes \$572 gain on land condemnation at White Oak.

(b) The sum of the quarterly net income per common share-diluted, \$1.13, differs from the annual net income per common share-diluted, \$1.12, due to rounding.

16. BUSINESS SEGMENTS

The Company has two reportable business segments: Shopping Centers and Office Properties. The accounting policies of the segments are the same as those described in the summary of significant accounting policies (see Note 2). The Company evaluates performance based upon income from real estate for the combined properties in each segment.

<i>(In thousands)</i>	Shopping Centers	Office Properties	Corporate and Other	Consolidated Totals
2005				
Real estate rental operations:				
Revenue	\$ 90,592	\$ 35,762	\$ 661	\$ 127,015
Expenses	(17,221)	(8,780)	—	(26,001)
Income from real estate	73,371	26,982	661	101,014
Interest expense & amortization of debt costs	—	—	(30,207)	(30,207)
General and administrative	—	—	(9,585)	(9,585)
Subtotal	73,371	26,982	(39,131)	61,222
Depreciation and amortization	(16,283)	(7,914)	—	(24,197)
Minority interests	—	—	(7,798)	(7,798)
Net income	\$ 57,088	\$ 19,068	\$ (46,929)	\$ 29,227
Capital investment	\$ 70,652	\$ 3,153	\$ —	\$ 73,805
Total assets	\$ 453,817	\$ 131,402	\$ 46,250	\$ 631,469
2004				
Real estate rental operations:				
Revenue	\$ 77,906	\$ 34,679	\$ 257	\$ 112,842
Expenses	(14,226)	(8,121)	—	(22,347)
Income from real estate	63,680	26,558	257	90,495
Interest expense & amortization of debt costs	—	—	(27,022)	(27,022)
General and administrative	—	—	(8,442)	(8,442)
Subtotal	63,680	26,558	(35,207)	55,031
Depreciation and amortization	(13,758)	(7,566)	—	(21,324)
Gain on property sale	572	—	—	572
Minority interests	—	—	(8,105)	(8,105)
Net income	\$ 50,494	\$ 18,992	\$ (43,312)	\$ 26,174
Capital investment	\$ 109,874	\$ 4,426	\$ —	\$ 114,300
Total assets	\$ 394,674	\$ 138,273	\$ 50,449	\$ 583,396
2003				
Real estate rental operations:				
Revenue	\$ 66,070	\$ 31,722	\$ 92	\$ 97,884
Expenses	(12,274)	(7,840)	—	(20,114)
Income from real estate	53,796	23,882	92	77,770
Interest expense & amortization of debt costs	—	—	(26,573)	(26,573)
General and administrative	—	—	(6,213)	(6,213)
Subtotal	53,796	23,882	(32,694)	44,984
Depreciation and amortization	(10,429)	(7,409)	—	(17,838)
Gain on property sale	—	182	—	182
Minority interests	—	—	(8,086)	(8,086)
Net income	\$ 43,367	\$ 16,655	\$ (40,780)	\$ 19,242
Capital investment	\$ 43,279	\$ 6,122	\$ —	\$ 49,401
Total assets	\$ 271,565	\$ 138,862	\$ 61,189	\$ 471,616

17. SUBSEQUENT EVENTS

On January 10, 2006, the Company closed on a new fixed-rate mortgage financing in the amount of \$10,500,000, secured by Jamestown Place, acquired in November 2005. The loan matures February 2021, requires equal monthly principal and interest payments of \$66,000, based upon a 5.81% interest rate and 25-year principal amortization, and requires a final payment of \$6,102,000 at maturity.

On January 12, 2006, the Company agreed to final terms of a contract to purchase a 10.4 acre site in Frederick, Maryland, from a subsidiary of Chevy Chase Bank, a related party, for \$5,000,000. The Company plans to develop this property into a retail center. The purchase price of the property was determined by the average of two independent third party appraisals which were contracted, one on behalf of the Company and one on behalf of Chevy Chase Bank.

On January 27, 2006, the Company acquired the 198,000 square foot Smallwood Village Center, located on 25 acres within the St. Charles planned community of Waldorf, Maryland, a suburb of metropolitan Washington, DC, through a wholly-owned subsidiary of its operating partnership. The purchase price was \$17,500,000 and was paid with cash and by the assumption of a mortgage loan. The outstanding balance on the loan was \$11,333,000 at settlement. The loan matures January 2013, requires equal monthly principal and interest payments of \$71,000, based upon a 6.12% interest rate and 30-year principal amortization, and requires a final payment of \$10,071,000 at maturity. The property was approximately 89% leased at the date of acquisition.

Management's Discussion & Analysis

of Financial Condition & Results of Operations

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) begins with the Company's primary business strategy to give the reader an overview of the goals of the Company's business. This is followed by a discussion of the critical accounting policies that the Company believes are important to understanding the assumptions and judgments incorporated in the Company's reported financial results. The next section, beginning on page 42, discusses the Company's results of operations for the past two years. Beginning on page 46, the Company provides an analysis of its liquidity and capital resources, including discussions of its cash flows, debt arrangements, sources of capital and financial commitments. Finally, on page 51, the Company discusses funds from operations, or FFO, which is a relative non-GAAP financial measure of performance of an equity REIT used by the REIT industry.

The MD&A should be read in conjunction with the other sections of this Annual Report, including the consolidated financial statements and notes thereto. Historical results set forth in Summary Financial Information, the Financial Statements and this section should not be taken as indicative of the Company's future operations.

OVERVIEW

The Company's principal business activity is the ownership, management and development of income-producing properties. The Company's long-term objectives are to increase cash flow from operations and to maximize capital appreciation of its real estate.

The Company's primary operating strategy is to focus on its community and neighborhood shopping center business and to operate its properties to achieve both cash flow growth and capital appreciation. Management believes there is potential for growth in cash flow as existing leases for space in the Shopping Centers expire and are renewed, or newly available or vacant space is leased. The Company intends to renegotiate leases where possible and seek new tenants for available space in order to maximize this potential for increased cash flow. As leases expire, management expects to revise rental rates, lease terms and conditions, relocate existing tenants, reconfigure tenant spaces and introduce new tenants with the goal of increasing cash flow. In those circumstances in which leases are not otherwise expiring, management selectively attempts to increase cash flow through a variety of means, or in connection with renovations or relocations, recapturing leases with below market rents

and re-leasing at market rates, as well as replacing financially troubled tenants. When possible, management also will seek to include scheduled increases in base rent, as well as percentage rental provisions, in its leases.

The Company's redevelopment and renovation objective is to selectively and opportunistically redevelop and renovate its properties, by replacing leases with below market rents with strong, traffic-generating anchor stores such as supermarkets and drug stores, as well as other desirable local, regional and national tenants. The Company's strategy remains focused on continuing the operating performance and internal growth of its existing Shopping Centers, while enhancing this growth with selective retail redevelopments and renovations.

Management believes that attractive acquisition and development opportunities for investment in existing and new shopping center properties will continue to be available from time to time. Management believes that the Company's capital structure will enable it to take advantage of these opportunities as they arise. In addition, management believes its shopping center expertise should permit it to optimize the performance of shopping centers once they have been acquired.

Management also believes that opportunities may arise for investment in new office properties. It is management's view that several of the office sub-markets in which the Company operates have attractive supply/demand characteristics. The Company will continue to evaluate new office development and redevelopment as an integral part of its overall business plan.

Although it is management's present intention to concentrate future acquisition and development activities on community and neighborhood shopping centers and office properties in the Washington, DC/Baltimore metropolitan area and the southeastern region of the United States, the Company may, in the future, also acquire other types of real estate in other areas of the country as opportunities present themselves. While the Company may diversify in terms of property locations, size and market, the Company does not set any limit on the amount or percentage of Company assets that may be invested in any one property or any one geographic area. In addition to investing in properties in the Washington, DC/Baltimore metropolitan area, during 2004 and 2005, the Company also acquired four grocery-anchored neighborhood shopping centers in Florida, totaling 491,000 square feet and another grocery-anchored neighborhood shopping center in Georgia totaling 79,000 square feet.

Management's Discussion & Analysis

of Financial Condition & Results of Operations

CRITICAL ACCOUNTING POLICIES

The Company's accounting policies are in conformity with accounting principles generally accepted in the United States ("GAAP"). The preparation of financial statements in conformity with GAAP requires management to use judgment in the application of accounting policies, including making estimates and assumptions. These judgments affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the Company's financial statements and the reported amounts of revenue and expenses during the reporting periods. If judgment or interpretation of the facts and circumstances relating to various transactions had been different, it is possible that different accounting policies would have been applied resulting in a different presentation of the financial statements. Below is a discussion of accounting policies which the Company considers critical in that they may require judgment in their application or require estimates about matters which are inherently uncertain. Additional discussion of accounting policies which the Company considers significant, including further discussion of the critical accounting policies described below, can be found in the Notes to the Consolidated Financial Statements.

Real Estate Investments

Real estate investment properties are stated at historic cost basis less depreciation. Management believes that these assets have generally appreciated in value and, accordingly, the aggregate current value exceeds their aggregate net book value and also exceeds the value of the Company's liabilities as reported in these financial statements. Because these financial statements are prepared in conformity with GAAP, they do not report the current value of the Company's real estate assets. The purchase price of real estate assets acquired is allocated between land, building and in-place acquired leases based on the relative fair values of the components at the date of acquisition. Buildings are depreciated on a straight-line basis over their estimated useful lives of 35 to 50 years. Intangibles associated with acquired in-place leases are amortized over the remaining base lease terms.

If there is an event or change in circumstance that indicates an impairment in the value of a real estate investment property, the Company assesses an impairment in value by making a comparison of the current and projected operating cash flows of the property over its remaining useful life, on an undiscounted basis, to the carrying amount of that property. If such carrying amount is greater than the estimated projected cash flows, the Company would recognize an impairment loss equivalent to an amount

required to adjust the carrying amount to its estimated fair market value.

When incurred, the Company capitalizes the cost of improvements that extend the useful life of property and equipment and all repair and maintenance expenditures are expensed. In addition, we capitalize leasehold improvements when certain criteria are met, including when we supervise construction and will own the improvement.

Interest, real estate taxes and other carrying costs are capitalized on projects under construction. Once construction is substantially complete and the assets are placed in service, rental income, direct operating expenses, and depreciation associated with such properties are included in current operations.

In the initial rental operations of development projects, a project is considered substantially complete and available for occupancy upon completion of tenant improvements, but no later than one year from the cessation of major construction activity. Substantially completed portions of a project are accounted for as separate projects. Depreciation is calculated using the straight-line method and estimated useful lives of 35 to 50 years for base buildings and up to 20 years for certain other improvements. Leasehold improvements are amortized over the lives of the related leases using the straight-line method.

Lease Acquisition Costs

Certain initial direct costs incurred by the Company in negotiating and consummating successful leases are capitalized and amortized over the initial base term of the leases. Capitalized leasing costs consist of commissions paid to third party leasing agents as well as internal direct costs such as employee compensation and payroll related fringe benefits directly related to time spent performing leasing related activities. Such activities include evaluating prospective tenants' financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating lease terms, preparing lease documents and closing transactions.

Revenue Recognition

Rental and interest income is accrued as earned except when doubt exists as to collectibility, in which case the accrual is discontinued. Recognition of rental income commences when control of the space has been given to the tenant. When rental payments due under leases vary from a straight-line basis because of free rent periods or scheduled rent increases, income is recognized on a straight-line basis throughout the initial term of the lease. Expense recoveries

Management's Discussion & Analysis

of Financial Condition & Results of Operations

represent a portion of property operating expenses billed to tenants, including common area maintenance, real estate taxes and other recoverable costs. Expense recoveries are recognized in the period when the expenses are incurred. Rental income based on a tenant's revenues, known as percentage rent, is accrued when a tenant reports sales that exceed a specified breakpoint.

Allowance for Doubtful Accounts - Current and Deferred Receivables

Accounts receivable primarily represent amounts accrued and unpaid from tenants in accordance with the terms of the respective leases, subject to the Company's revenue recognition policy. Receivables are reviewed monthly and reserves are established with a charge to current period operations when, in the opinion of management, collection of the receivable is doubtful. In addition to rents due currently, accounts receivable include amounts representing minimum rental income accrued on a straight-line basis to be paid by

tenants over the remaining term of their respective leases. Reserves are established with a charge to income for tenants whose rent payment history or financial condition casts doubt upon the tenant's ability to perform under its lease obligations.

Legal Contingencies

The Company is subject to various legal proceedings and claims that arise in the ordinary course of business. These matters are generally covered by insurance. While the resolution of these matters cannot be predicted with certainty, the Company believes the final outcome of such matters will not have a material adverse effect on the financial position or the results of operations. Once it has been determined that a loss is probable to occur, the estimated amount of the loss is recorded in the financial statements. Both the amount of the loss and the point at which its occurrence is considered probable can be difficult to determine.

RESULTS OF OPERATIONS

Revenue

(Dollars in thousands)	For the year ended December 31,			Percentage Change	
	2005	2004	2003	2005 to 2004	2004 to 2003
Base rent	\$ 99,448	\$ 91,125	\$ 78,167	9.1%	16.6%
Expense recoveries	20,027	16,712	14,438	19.8%	15.8%
Percentage rent	2,057	1,635	1,695	25.8%	(3.5%)
Other	5,483	3,370	3,584	62.7%	(6.0%)
Total	\$ 127,015	\$ 112,842	\$ 97,884	12.6%	15.3%

Total revenue increased 12.6% for the 2005 year compared to 2004 primarily due to (1) the contribution of operating revenue from three development properties (Shops at Monocacy, Kentlands Place and Broadlands Village II) and three acquisition properties (Palm Springs, Jamestown Place and Seabreeze Plaza) placed in service during 2005 and four operating properties acquired during the first half of 2004, (Boca Valley Plaza, Countryside, Cruse MarketPlace and Briggs Chaney MarketPlace) together defined as the "2005/2004 Development and Acquisition Properties", whose operating results are included in 2005's operating income but not fully in the previous year's results and (2) the payment related to resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall. The 2005/2004 Development and Acquisition Properties

contributed \$8,414,000 or 59.4% of the increase in revenues. The net payment related to the resolution of the Lexington Mall land use dispute contributed \$1,801,000 or 12.7% of the increase in revenues. 601 Pennsylvania Avenue also contributed \$768,000 or 5.4% of the increase due to both a collection of a lease termination fee and increased rental income because all of its rentable area was producing rent during 2005 while a portion of the area was being prepared for occupancy during the 2004. Also contributing to the 2005 revenue increase were rents earned at the Company's Thruway (resulting from a 15,725 square foot expansion completed in April 2004), The Glen (impacted by a 22,000 square foot expansion completed November 2005) and Southdale shopping centers, which provided increased revenues of \$533,000 or 3.8%, \$392,000 or 2.8% and \$376,000 or 2.7%, respectively.

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Total revenue increased 15.3% for the 2004 year compared to 2003 primarily due to the contribution of operating revenue from three development properties and five acquisition properties placed in service during 2004 or 2003. The developments Broadlands Village II and Shops at Monocacy were placed in service in 2004 and Broadlands Village in 2003. The acquisition properties Boca Valley Plaza, Countryside, Cruse MarketPlace and Briggs Chaney Plaza were acquired in 2004 and Olde Forte Village was acquired in 2003 (the "2004/2003 Development and Acquisition Properties"). The 2004/2003 Development and Acquisition Properties contributed \$10,888,000 or 72.8% of the increase in revenues. The Company's 601 Pennsylvania Avenue office property was fully leased during 2004 and contributed \$2,267,000 or 15.2% of the year's revenue improvement. A discussion of the components of revenue follows.

Base Rent

The \$8,323,000 increase in base rent for 2005 versus 2004 was primarily attributable (76.4% or approximately \$6,362,000) to leases in effect at the 2005/2004 Development and Acquisition Properties. Thruway also contributed to the increase in base rent (5.3% or approximately \$437,000). Contractual rent increases at other properties substantially accounted for the balance of the increase.

The \$12,958,000 increase in base rent for 2004 versus 2003 was primarily attributable (69.1% or approximately \$8,958,000) to leases in effect at the 2004/2003 Development and Acquisition Properties. The lease-up of space at 601 Pennsylvania Avenue (14.6% or approximately \$1,886,000) and contractual rent increases at other Properties substantially accounted for the balance of the increase.

Expense Recoveries

Expense recoveries represent a portion of property operating expenses billable to tenants, including common area maintenance, real estate taxes and other recoverable costs. The majority of the \$3,315,000 2005 versus 2004 increase in expense recovery income was contributed by the 2005/2004 Development and Acquisition Properties (58.8% or approximately \$1,948,000). Increased operating expenses recovered from tenants in the office portfolio (19.3% or approximately \$640,000) contributed toward the 2005 increase. Increased real estate taxes, insurance, repairs and utilities expenses at several of the Company's other properties were incurred and recovered from tenants.

The 2004/2003 Development and Acquisition Properties provided the majority (81.3% or approximately \$1,849,000) of the 2004 versus 2003 increase of \$2,274,000 in expense recovery income. The office properties 601 Pennsylvania Avenue and Van Ness Square also made significant contributions toward the 2004 increase (together, 20.1% or approximately \$457,000).

Percentage Rent

Percentage rent is rental revenue calculated on the portion of a tenant's sales revenue that exceeds a specified breakpoint. The majority of the \$422,000 2005 versus 2004 increase in percentage rents resulted from improved sales reported by a restaurant tenant at 601 Pennsylvania Avenue (53.3% or approximately \$225,000). Additionally, 2005 percentage rent was positively impacted by two tenants at Southdale, one paying percentage rent for the first time and the other reporting improved sales (together, 18.7% or approximately \$79,000). Smaller percentage rent increases were recognized at several of the Company's properties due to increased sales reported by selected tenants at those properties.

Percentage rent decreased \$60,000 for 2004 versus 2003 due to a change in major tenant's sales reporting procedures. In years prior to 2004, the tenant voluntarily provided interim sales reports upon which the Company had based its calculations. The tenant has indicated that going forward, it will only provide required annual sales reports per the terms of its lease agreement. Accounting rules prohibit the accrual of percentage rent until the tenant actually reports sales. Therefore, the tenant's sales reporting change impacts only the timing of when the Company recognizes percentage rent. The Company recognized percentage rent for this tenant during the second quarter of year 2005.

Other Revenue

Other revenue consists primarily of parking revenue at three of the Office Properties, kiosk leasing, temporary leases and payments associated with early termination of leases and interest income from the investment of cash balances. Other revenue increased \$2,113,000 during 2005 versus 2004 as a result of \$1,801,000 (85.2 % of increase) related to resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall and increased interest income from short-term investments (19.1% or \$404,000). Also contributing to the other revenue increase was the collection of a lease termination fee and settlement of a rent dispute with two former tenants at 601 Pennsylvania Avenue (12.4%

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or \$262,000). The other revenue increases were offset in part by reduced parking revenue in the office portfolio (7.0% or \$147,000), primarily at 601 Pennsylvania Avenue where parking spaces were temporarily placed out of service while the parking deck was being refurbished, and lower overall lease termination fees received in 2005 compared to 2004.

The \$214,000 decrease in other income for 2004 versus 2003 resulted primarily from a \$619,000 decrease in lease termination fees from \$1,286,000 in 2003 to \$667,000 in 2004, which was partially offset by an increase in parking income at the Office Properties of \$178,000 and an increase in cash investment income of \$166,000 in 2004.

Operating Expenses

(Dollars in thousands)	For the year ended December 31,			Percentage Change	
	2005	2004	2003	2005 to 2004	2004 to 2003
Property operating expenses	\$ 14,724	\$ 12,070	\$ 11,363	22.0%	6.2%
Provision for credit losses	237	488	171	(51.4%)	185.4%
Real estate taxes	11,040	9,789	8,580	12.8%	14.1%
Interest expense and amortization of deferred debt	30,207	27,022	26,573	11.8%	1.7%
Depreciation and amortization	24,197	21,324	17,838	13.5%	19.5%
General and administrative	9,585	8,442	6,213	13.5%	35.9%
Total	\$ 89,990	\$ 79,135	\$ 70,738	13.7%	11.9%

Property Operating Expenses

Property operating expenses consist primarily of repairs and maintenance, utilities, payroll, insurance and other property related expenses. The \$2,654,000 increase in 2005 versus 2004 property operating expenses was caused primarily by the operation of the 2005/2004 Development and Acquisition Properties (48.4% or approximately \$1,286,000) and to a lesser extent increased operating expenses, primarily increased repairs and maintenance and utilities expenses, at the office properties (16.9% or approximately \$448,000) and increased repair and maintenance expenses in shopping centers owned more than one year (22.2% or approximately \$590,000).

Property operating expenses increased \$707,000 for 2004 versus 2003. The Development and Acquisition Properties accounted for a \$1,024,000 increase in property operating expenses during 2004 which was offset by an approximately \$591,000 decrease in snow removal expenses at the remainder of the property portfolio due to 2003's unseasonably severe winter weather primarily in the Mid-Atlantic region.

Provision for Credit Losses

The provision for credit losses represents the Company's estimation that amounts previously included in income and owed by tenants may not be collectible. The provision for

credit losses decreased \$251,000 for 2005 versus 2004 due primarily to the absence of significant credit losses experienced during 2004 at Great Eastern Plaza (\$155,000) and Leesburg Pike (\$113,000).

The provision for credit losses increased \$317,000 for 2004 versus 2003 primarily due to 2003's absence of any significant tenant bankruptcy or collection difficulties. The 2004 provision for credit loss includes a \$155,000 provision for an anchor tenant at Great Eastern Plaza, a \$113,000 provision for a former tenant at Leesburg Pike Plaza, and a \$55,000 provision for a tenant at Seven Corners Center.

Real Estate Taxes

The \$1,251,000 increase in real estate taxes for 2005 versus 2004 was primarily attributable to the commencement of operations at the 2005/2004 Development and Acquisition Properties (63.1% or approximately \$790,000). In addition, the majority of the Company's properties received increases in assessed values during 2005, especially newly acquired, developed or redeveloped properties and those properties located in the Metropolitan Washington, DC area.

The \$1,209,000 increase in real estate taxes for 2004 versus 2003 was primarily attributable to the commencement of operations at the 2004/2003 Development and Acquisition Properties (79.2% or approximately \$958,000).

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Interest and Amortization of Deferred Debt

Interest expense increased \$2,953,000 and Deferred debt cost amortization increased \$232,000 in 2005 versus 2004. Interest expense increased due to new borrowings, as the Company placed permanent 15-year fixed rate mortgages on selected 2005/2004 Development and Acquisition Properties. The increase in average outstanding borrowings of approximately \$56,000,000 resulted from financing selected 2005/2004 Development and Acquisition Properties (approximately \$4,051,000 increase in interest expense). Offsetting the increase in interest expense was an approximately 23 basis point decrease in the average interest rate for the loan portfolio as the Company financed the new borrowings at interest rates lower than the average existing mortgage debt (approximately \$1,067,000 decrease in interest expense). The Company also paid a \$92,000 prepayment premium on the refinancing of a mortgage loan during 2005 in order to obtain a new 15-year loan at a lower interest rate. Interest was capitalized as a cost of construction and development projects during the 2005 and 2004 years in the amount of \$3,258,000 and \$3,227,000, respectively (\$31,000 decrease in interest expense). Deferred debt cost amortization expense was \$1,161,000 and \$929,000, for the 2005 and 2004 periods, respectively. The increased expense (\$232,000) resulted from amortization of financing costs of new mortgage loans and the early write-off of unamortized costs incident to the refinancing of the Company's revolving credit facility during the 2005.

Of the \$449,000 increase from 2004 versus 2003, \$322,000 resulted from increased interest expense and \$127,000 resulted from increased amortization of deferred debt expense. Interest expense increased in 2004 versus 2003 due to an increase in average outstanding borrowings of approximately \$22,645,000 (\$1,608,000 interest expense increase) and an increase in the weighted average interest rate of 12 basis points (\$501,000 interest expense increase), reflecting the Company's repayment of all of its short-term line of credit borrowings with proceeds from new 15-year fixed rate mortgages. As a result of the 2004 financing activity, the allocation of the Company's average floating rate notes payable balances as a percentage of total indebtedness decreased from 12% in 2003 to 1% in 2004. The increase in interest expense resulting from the new financings was more than offset by an increase in interest capitalized on costs of construction and development work. During 2004 and 2003, \$3,227,000 and \$1,382,000, was capitalized, respectively (\$1,845,000 interest expense decrease).

Depreciation and Amortization

The \$2,873,000 increase in depreciation and amortization expense resulted primarily from the acceleration of depreciation expense during 2005 related to the shortened useful life of vacant buildings at Lexington Mall, exclusive of the Dillard's space, resulting from the resolution of a land use dispute with an adjacent property owner and the resulting determination by management to take the building out of service and redevelop the shopping center (52.7% or \$1,515,000). The balance of the increase in depreciation and amortization expense resulted primarily from the 2005/2004 Development and Acquisition Properties placed in service during 2005 and 2004. The remaining approximately \$1,500,000 of net book value was attributable to the Dillard's building, which was taken out of service effective October 31, 2005 upon termination of Dillard's lease. The Company is pursuing either leasing opportunities for the existing space or potentially demolishing the building in conjunction with the overall redevelopment of the rest of the property which will determine the remaining depreciable life of the building. The ultimate plan for this site and the treatment of the remaining capitalized costs is expected to be made by management in 2006.

The increase in depreciation and amortization expense from 2003 to 2004 of \$3,486,000 resulted primarily from the 2004/2003 Development and Acquisition Properties placed in service during 2004 and 2003.

General and Administrative

General and administrative expenses consists of payroll, administrative and other overhead expenses. The \$1,143,000 increase in general and administrative expenses for 2005 versus 2004 was attributable primarily to increased payroll and related expenses in part for additional construction and leasing administration (38.3% or \$438,000), the write-off of abandoned acquisition (7.3% or \$84,000) and redevelopment costs associated with pre-settlement land use requirements at Lexington Mall (21.5% or \$246,000) and increased office rent for the Company's corporate offices in Bethesda, Maryland (19.9% or \$227,000).

The \$2,229,000 increase in general and administrative expense for 2004 versus 2003 was attributable to increased payroll, retirement and employment expenses (46.7% or \$1,040,000) primarily resulting from staffing for the Company's acquisitions department and a non-recurring retirement payment to a former executive officer. In addition, accounting fees and other administrative expenses, incurred to comply with new Sarbanes-Oxley documentation and compliance requirements, increased 27.5% or \$614,000, and the expensing of officer and director stock options increased 6.7% or \$150,000.

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Gain on Sale of Property

The Company recognized a gain on the sale of real estate of \$572,000 in 2004 and \$182,000 in 2003. There were no property dispositions in 2005. The 2004 gain resulted from the State of Maryland's condemnation and taking of a small strip of unimproved land for a road widening project at White Oak shopping center. The 2003 gain resulted from the State of Maryland's condemnation and purchase of a piece of vacant land at Avenel Business Park for improvement of an interchange on I-270, adjacent to the property.

IMPACT OF INFLATION

Inflation has remained relatively low and has had a minimal impact on the operating performance of the Company's portfolio; however, substantially all of the Company's leases contain provisions designed to mitigate the adverse impact of inflation on the Company's results of operations. These provisions include upward periodic adjustments in base rent due from tenants, usually based on a stipulated increase and to a lesser extent on a factor of the change in the consumer price index, commonly referred to as the CPI.

Substantially all of the Company's properties are leased to tenants under long-term leases, which provide for reimbursement of operating expenses by tenants. These leases tend to reduce the Company's exposure to rising property expenses due to inflation. Inflation and increased costs may have an adverse impact on the Company's tenants if increases in their operating expenses exceed increases in their revenue.

LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents were \$8,007,000 and \$33,561,000 at December 31, 2005 and 2004, respectively. The changes in cash and cash equivalents during the years ended December 31, 2005 and 2004 were attributable to operating, investing and financing activities, as described below.

(Dollars in thousands)	Year Ended December 31,	
	2005	2004
Cash provided by operating activities	\$ 58,401	\$ 50,686
Cash used in investing activities	(73,805)	(113,467)
Cash (used) provided by financing activities	(10,150)	51,098
Decrease in cash	\$ (25,554)	\$ (11,683)

Operating Activities

Cash provided by operating activities increased \$7,715,000 to \$58,401,000 for the year ended December 31, 2005 compared to \$50,686,000 for the year ended December 31, 2004 primarily reflecting increased operating income of the 2005/2004 Development and Acquisition Properties. Cash provided by operating activities represents, in each year, cash received primarily from rental income, plus other income, less property operating expenses, normal recurring general and administrative expenses and interest payments on debt outstanding.

Investing Activities

Cash used in investing activities decreased \$39,662,000 to \$73,805,000 for the year ended December 31, 2005 compared to \$113,467,000 for the year ended December 31, 2004 and primarily reflects the acquisition of properties (Palm Springs Center, Jamestown Place and Seabreeze Plaza and land parcels at Lansdowne Town Center and New Market in 2005 and Boca Valley Plaza, Briggs Chaney Plaza, Countryside, Cruse MarketPlace and the Kentlands Place and Ashland Square land parcels in 2004), the construction of new shopping center properties (The Glen expansion in 2005 and Broadlands Village II, Shops at Monocacy, Kentlands Place and Olde Forte Village redevelopment in 2004), tenant improvements and construction in progress during those years.

Financing Activities

Cash used by financing activities for the year ended December 31, 2005 was \$10,150,000 and cash provided by financing activities for the year ended December 31, 2004 was \$51,098,000. Cash used by financing activities for the year ended December 31, 2005 primarily reflects:

- the repayment of borrowings on mortgage notes payable totaling \$20,794,000;
- distributions made to common stockholders and holders of convertible limited partnership units in the Operating Partnership during the year totaling \$34,887,000;
- distributions made to preferred stockholders during the year totaling \$8,000,000; and,
- payments of \$2,025,000 for financing costs of the revolving credit facility and two mortgage loans during 2005;

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which was partially offset by:

- \$25,500,000 of proceeds received from mortgage notes payable incurred during the year;
- amounts borrowed from the revolving credit facility totaling \$10,500,000; and,
- \$19,556,000 of proceeds received from the issuance of common stock under the dividend reinvestment program and from the exercise of stock options, and from the issuance of convertible limited partnership interests in the Operating Partnership;

Cash provided by financing activities for the year ended December 31, 2004 primarily reflects:

- \$94,800,000 of proceeds received from mortgage notes payable incurred during the year; and,
- \$14,851,000 of proceeds received from the issuance of common stock under the dividend reinvestment program and from the exercise of stock options, and from the issuance of convertible limited partnership interests in the Operating Partnership;

which was partially offset by:

- the repayment of borrowings on mortgage notes payable totaling \$16,427,000;
- distributions made to common stockholders and holders of convertible limited partnership units in the Operating Partnership during the year totaling \$33,166,000;
- distributions made to preferred stockholders during the year totaling \$7,244,000; and,
- payments of \$1,716,000 for financing costs of six mortgage loans during 2004.

The Company also temporarily borrowed and subsequently repaid \$33,000,000 on its revolving credit facility during 2004.

Liquidity Requirements

Short-term liquidity requirements consist primarily of normal recurring operating expenses and capital expenditures, debt service requirements (including debt service relating to additional and replacement debt), distributions to common and preferred stockholders, distributions to unit holders and amounts required for expansion and renovation of the Current Portfolio Properties and selective acquisition and development of additional properties. In order to qualify as a REIT for federal income tax purposes, the Company must distribute to its stockholders at least 90% of its "real estate investment trust taxable income," as defined in the Code. The Company expects to meet these short-term liquidity

requirements (other than amounts required for additional property acquisitions and developments) through cash provided from operations, available cash and its existing line of credit.

Long-term liquidity requirements consisted primarily of obligations under our long-term debt and dividends paid to our preferred shareholders. We anticipate that long-term liquidity requirements will also include amounts required for property acquisitions and developments. Management anticipates that during the coming year the Company may:

- redevelop certain of the Current Portfolio Properties,
- develop additional freestanding outparcels or expansions within certain of the Shopping Centers,
- acquire existing neighborhood and community shopping centers and/or office properties, and,
- develop new shopping center or office sites.

Acquisition and development of properties are undertaken only after careful analysis and review, and management's determination that such properties are expected to provide long-term earnings and cash flow growth. During the coming year, developments, expansions or acquisitions are expected to be funded with available cash, bank borrowings from the Company's credit line, construction and permanent financing, proceeds from the operation of the Company's dividend reinvestment plan or other external debt or equity capital resources available to the Company and proceeds from the sale of properties. Borrowings may be at the Saul Centers, Operating Partnership or Subsidiary Partnership level, and securities offerings may include (subject to certain limitations) the issuance of additional limited partnership interests in the Operating Partnership which can be converted into shares of Saul Centers common stock. The availability and terms of any such financing will depend upon market and other conditions.

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Contractual Payment Obligations

As of December 31, 2005, the Company had unfunded contractual payment obligations of approximately \$23.2 million, excluding operating obligations, due within the next 12 months. The table below specifies the total contractual payment obligations as of December 31, 2005.

(Dollars in thousands)	Payments Due By Period				
	Total	Less than 1 Year	1-3 Years	4-5 Years	After 5 Years
Notes Payable	\$ 482,431	\$ 12,991	\$ 39,458	\$ 33,518	\$ 396,464
Operating Leases (1)	11,593	164	328	334	10,767
Corporate Headquarters Lease (1)	4,385	658	1,376	1,460	891
Development Obligations (2)	9,345	9,345	—	—	—
Total Contractual Cash Obligations	\$ 507,754	\$ 23,158	\$ 41,162	\$ 35,312	\$ 408,122

(1) See Note 7 to Consolidated Financial Statements. Corporate Headquarters Lease amounts represent an allocation to the Company based upon employees' time dedicated to the Company's business as specified in the Shared Services Agreement. Future amounts are subject to change as the number of employees, employed by each of the parties to the lease, fluctuate.

(2) In addition to development obligations presented as of December 31, 2005, the Company executed a contract with a general contractor, dated January 4, 2006, in the amount of \$18,480,000, to construct Lansdowne Town Center. Substantially all of the amounts are expected to be paid during 2006.

Management believes that the Company's capital resources, which at December 31, 2005 included cash balances of \$8.0 million and borrowing availability of \$139.5 million on its revolving line of credit (\$72.5 million for general corporate use and \$67 million for qualified future acquisitions), will be sufficient to meet its liquidity needs for the foreseeable future.

Preferred Stock Issue

On July 16, 2003, the Company filed a shelf registration statement with the SEC relating to the future offering of up to an aggregate of \$100 million of preferred stock and depositary shares. On November 5, 2003, the Company sold 3,500,000 depositary shares, each representing 1/100th of a share of 8% Series A Cumulative Redeemable Preferred Stock. The underwriters exercised an over-allotment option, purchasing an additional 500,000 depositary shares on November 26, 2003.

The depositary shares may be redeemed, in whole or in part, at the \$25.00 liquidation preference at the Company's option on or after November 5, 2008. The depositary shares pay an annual dividend of \$2.00 per depositary share, equivalent to 8% of the \$25.00 liquidation preference. The first dividend, paid on January 15, 2004 was for less than a full quarter and covered the period from November 5 through December 31, 2003. The Series A preferred stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and

is not convertible into any other securities of the Company. Investors in the depositary shares generally have no voting rights, but will have limited voting rights if the Company fails to pay dividends for six or more quarters (whether or not declared or consecutive) and in certain other events.

Dividend Reinvestments

In December 1995, the Company established a Dividend Reinvestment Plan (the "Plan") to allow its common stockholders and holders of limited partnership interests an opportunity to buy additional shares of common stock by reinvesting all or a portion of their dividends or distributions. The Plan provides for investing in newly issued shares of common stock at a 3% discount from market price without payment of any brokerage commissions, service charges or other expenses. All expenses of the Plan are paid by the Company. The Company issued 455,494 and 497,282 shares under the Plan at a weighted average discounted price of \$33.66 and \$27.70 per share during the years ended December 31, 2005 and 2004, respectively.

Additionally, the Operating Partnership issued 110,910 and 11,557 limited partnership units under a dividend reinvestment plan mirroring the Plan at a weighted average discounted price of \$35.15 and \$27.66 per unit during the years ended December 31, 2005 and 2004, respectively.

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CAPITAL STRATEGY AND FINANCING ACTIVITY

As a general policy, the Company intends to maintain a ratio of its total debt to total asset value of 50% or less and to actively manage the Company's leverage and debt expense on an ongoing basis in order to maintain prudent coverage of fixed charges. Asset value is the aggregate fair market value of the Current Portfolio Properties and any subsequently acquired properties as reasonably determined by management by reference to the properties' aggregate cash flow. Given the Company's current debt level, it is management's belief that the ratio of the Company's debt to total asset value was below 50% as of December 31, 2005.

The organizational documents of the Company do not limit the absolute amount or percentage of indebtedness that it may incur. The Board of Directors may, from time to time,

reevaluate the Company's debt capitalization policy in light of current economic conditions, relative costs of capital, market values of the Company property portfolio, opportunities for acquisition, development or expansion, and such other factors as the Board of Directors then deems relevant. The Board of Directors may modify the Company's debt capitalization policy based on such a reevaluation without shareholder approval and consequently, may increase or decrease the Company's debt to total asset ratio above or below 50% or may waive the policy for certain periods of time. The Company selectively continues to refinance or renegotiate the terms of its outstanding debt in order to achieve longer maturities, and obtain generally more favorable loan terms, whenever management determines the financing environment is favorable.

The following is a summary of notes payable as of December 31, 2005 and 2004:

Notes Payable

(Dollars in thousands)	December 31,		Interest Rate *	Scheduled Maturity *
	2005	2004		
Fixed rate mortgages:	\$ 91,203 (a)	\$ 94,794	8.00%	Dec-2011
	126,637 (b)	129,883	7.67%	Oct-2012
	32,185 (c)	33,138	7.88%	Jan-2013
	8,520 (d)	8,699	5.77%	Jul-2013
	13,554 (e)	—	5.28%	May-2014
	12,712 (f)	13,057	8.33%	Jun-2015
	40,627 (g)	41,324	6.01%	Feb-2018
	46,479 (h)	47,375	5.88%	Jan-2019
	15,040 (i)	15,335	5.76%	May-2019
	20,774 (j)	21,185	5.62%	Jul-2019
	20,514 (k)	20,906	5.79%	Sep-2019
	18,407 (l)	18,750	5.22%	Jan-2020
	12,901 (m)	9,200	5.60%	May-2020
	12,378 (n)	—	5.30%	Jun-2020
Total fixed rate	471,931	453,646	6.90%	9.3 Years
Variable rate loan:				
Revolving credit facility	10,500 (o)	—	LIBOR + 1.5 %	Jan-2008
Total variable rate	10,500	—	5.82%	2.1 Years
Total notes payable	\$ 482,431	\$ 453,646	6.87%	9.2 Years

* Interest rate and scheduled maturity data presented as of December 31, 2005. Totals computed using weighted averages.

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- (a) The loan is collateralized by Avenel Business Park, Van Ness Square, Ashburn Village, Leesburg Pike, Lumberton Plaza and Village Center. The loan has been increased on four occasions since its inception in 1997. The 8.00% blended interest rate is the weighted average of the initial loan rate and additional borrowing rates. The loan requires equal monthly principal and interest payments of \$920,000 based upon a weighted average 23-year amortization schedule and a final payment of \$63,153,000 at loan maturity. Principal of \$3,591,000 was amortized during 2005.
- (b) The loan is collateralized by nine shopping centers (Seven Corners, Thruway, White Oak, Hampshire Langley, Great Eastern, Southside Plaza, Belvedere, Giant and Ravenwood) and requires equal monthly principal and interest payments of \$1,103,000 based upon a 25-year amortization schedule and a final payment of \$97,403,000 at loan maturity. Principal of \$3,246,000 was amortized during 2005.
- (c) The loan is collateralized by 601 Pennsylvania Avenue and requires equal monthly principal and interest payments of \$294,000 based upon a 25-year amortization schedule and a final payment of \$22,961,000 at loan maturity. Principal of \$953,000 was amortized during 2005.
- (d) The loan is collateralized by Cruse MarketPlace and requires equal monthly principal and interest payments of \$56,000 based upon an amortization schedule of approximately 24 years and a final payment of \$6,830,000 at loan maturity. Principal of \$179,000 was amortized during 2005.
- (e) The loan is collateralized by Seabreeze Plaza and requires equal monthly principal and interest payments of \$84,000 based upon a 25-year amortization schedule and a final payment of \$10,531,000 at loan maturity. Principal of \$25,000 was amortized during 2005.
- (f) The loan is collateralized by Shops at Fairfax and Boulevard shopping centers and requires monthly principal and interest payments of \$118,000 based upon a 22-year amortization schedule and a final payment of \$7,630,000 at loan maturity. Principal of \$345,000 was amortized during 2005.
- (g) The loan is collateralized by Washington Square and requires equal monthly principal and interest payments of \$264,000 based upon a 27.5-year amortization schedule and a final payment of \$28,012,000 at loan maturity. Principal of \$697,000 was amortized during 2005.
- (h) The loan, consisting of two notes dated December 2003 and two notes dated February and December 2004, is currently collateralized by four shopping centers, Broadlands Village (Phases I & II), The Glen and Kentlands Square, and requires equal monthly principal and interest payments of \$306,000 (beginning February 1, 2005; prior to that date, payments totaled \$256,000 per month) based upon a 25-year amortization schedule and a final payment of \$28,393,000 at loan maturity. Principal of \$896,000 was amortized during 2005.
- (i) The loan is collateralized by Olde Forte Village and requires equal monthly principal and interest payments of \$98,000 based upon a 25-year amortization schedule and a final payment of \$8,985,000 at loan maturity. Principal of \$295,000 was amortized during 2005.
- (j) The loan is collateralized by Countryside and requires equal monthly principal and interest payments of \$133,000 based upon a 25-year amortization schedule and a final payment of \$12,288,000 at loan maturity. Principal of \$411,000 was amortized during 2005.
- (k) The loan is collateralized by Briggs Chaney MarketPlace and requires equal monthly principal and interest payments of \$133,000 based upon a 25-year amortization schedule and a final payment of \$12,192,000 at loan maturity. Principal of \$392,000 was amortized during 2005.
- (l) The loan is collateralized by Shops at Monocacy and requires equal monthly principal and interest payments of \$112,000 based upon a 25-year amortization schedule and a final payment of \$10,568,000 at loan maturity. Principal of \$343,000 was amortized during 2005.
- (m) The loan is collateralized by Boca Valley Plaza and requires equal monthly principal and interest payments of \$75,000 based upon a 30-year amortization schedule and a final payment of \$9,149,000 at loan maturity. Principal of \$99,000 was amortized during 2005. The previous loan was repaid in 2005 with proceeds from this financing.
- (n) The loan is collateralized by Palm Springs Center and requires equal monthly principal and interest payments of \$75,000 based upon a 25-year amortization schedule and a final payment of \$7,075,000 at loan maturity. Principal of \$122,000 was amortized during 2005.
- (o) The loan is an unsecured revolving credit facility totaling \$150,000,000. Loan availability for working capital and general corporate uses is determined by operating income from the Company's unencumbered properties, with a portion available only for funding qualified operating property acquisitions. Interest expense is calculated based upon the 1,2,3 or 6 month LIBOR rate plus a spread of 1.40% to 1.625% (determined by certain debt service coverage and leverage tests) or upon the bank's reference rate at the Company's option. The line may be extended one year with payment of a fee of 1/4% at the Company's option. Monthly payments, if applicable, are interest only and will vary depending upon the amount outstanding and the applicable interest rate for any given month.

Management's Discussion & Analysis

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The December 31, 2005 and 2004 depreciation adjusted cost of properties collateralizing the mortgage notes payable totaled \$467,015,000 and \$420,320,000, respectively. Notes payable at December 31, 2005 and 2004, totaling \$169,322,000 and \$163,022,000, respectively, are guaranteed by members of The Saul Organization. The Company's credit facility requires the Company and its subsidiaries to maintain certain financial covenants. As of December 31, 2005, the material covenants required the Company, on a consolidated basis, to:

- limit the amount of debt so as to maintain a gross asset value in excess of liabilities of at least \$400 million;
- limit the amount of debt as a percentage of gross asset value (leverage ratio) to less than 60%;
- limit the amount of debt so that interest coverage will exceed 2.1 to 1 on a trailing four quarter basis; and,
- limit the amount of debt so that interest, scheduled principal amortization and preferred dividend coverage exceeds 1.55 to 1.

As of December 31, 2005, the Company was in compliance with all such covenants.

During 2005, the Company refinanced its revolving credit facility, refinanced an existing mortgage loan, completed a new mortgage financing and assumed an existing mortgage loan upon the acquisition of a shopping center. On January 28, 2005, the Company executed a \$150 million unsecured revolving credit facility, an expansion of the \$125 million agreement in place as of December 31, 2004. The facility is intended to provide working capital and funds for acquisitions, certain developments and redevelopments. The line has a three-year term and provides for an additional one-year extension at the Company's option, subject to the Company's satisfaction of certain conditions. Until January 27, 2007, certain or all of the lenders may, upon request by the Company and payment of certain fees, increase the revolving credit facility line by up to \$50,000,000. Letters of credit may be issued under the revolving credit facility.

The Company closed on two new fixed-rate, non-recourse financings during the second quarter of 2005. The first loan is a refinancing of the \$9,200,000, 6.82% interest rate mortgage loan assumed during the February 2004 acquisition

of Boca Valley Plaza. The new loan is a 15-year, \$13,000,000 fixed-rate mortgage loan collateralized by Boca Valley Plaza. The loan requires monthly principal and interest payments based upon a fixed interest rate of 5.60% and a 30-year amortization schedule. A final payment of \$9,149,000 will be due at loan maturity, May 2020. The second loan is a permanent financing of Palm Springs Center, acquired in March 2005. The loan is a 15-year, \$12,500,000 fixed-rate mortgage loan collateralized by Palm Springs Center. The loan requires monthly principal and interest payments based upon a fixed interest rate of 5.30% and a 25-year amortization schedule. A final payment of \$7,075,000 will be due at loan maturity, June 2020. On November 30, 2005 the Company assumed an existing \$13,600,000 loan upon the acquisition of Seabreeze Plaza. The loan requires fixed monthly principal and interest payments based upon a 5.28% interest rate and 25-year amortization. A final payment of \$10,531,000 will be due at loan maturity, May 2014.

In December 2005, the Company entered into a rate lock agreement and made application for a 15-year, \$40,000,000 fixed-rate mortgage loan to be collateralized by Lansdowne Town Center. The rate lock agreement set the interest rate at 5.62%, contingent upon meeting certain construction and leasing criteria prior to loan funding, projected to occur in February 2007. The Company paid a loan deposit fee of \$850,000 which is refundable, less expenses, if the parties are unable to close on the financing.

OFF-BALANCE SHEET ARRANGEMENTS

The Company has no off-balance sheet arrangements that are reasonably likely to have a current or future material effect on the Company's financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

FUNDS FROM OPERATIONS

In 2005, the Company reported Funds From Operations (FFO) available to common shareholders (common stockholders and limited partner unitholders) of \$53,222,000 representing a 13.2% increase over 2004 FFO available to common shareholders of \$47,031,000.

The following table presents a reconciliation from net income to FFO available to common shareholders for the periods indicated:

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Funds From Operations

(Dollars in thousands)		For the Year Ended December 31,			
	2005	2004	2003	2002	2001
Net income	\$ 29,227	\$ 26,174	\$ 19,242	\$ 19,566	\$ 17,314
Subtract:					
Gain on sale of property	—	(572)	(182)	(1,426)	—
Add:					
Minority interests	7,798	8,105	8,086	8,070	8,069
Depreciation and amortization of real property	24,197	21,324	17,838	17,821	14,758
FFO	61,222	55,031	44,984	44,031	40,141
Preferred dividends	(8,000)	(8,000)	(1,244)	—	—
FFO available to common shareholders	\$ 53,222	\$ 47,031	\$ 43,740	\$ 44,031	\$ 40,141
Average shares and units used to compute FFO per share	22,003	21,405	20,790	20,059	19,382

FFO is a widely accepted non-GAAP financial measure of operating performance for REITs. FFO is defined by the National Association of Real Estate Investment Trusts as net income, computed in accordance with GAAP, plus minority interests, extraordinary items and real estate depreciation and amortization, excluding gains or losses from property sales. FFO does not represent cash generated from operating activities in accordance with GAAP and is not necessarily indicative of cash available to fund cash needs, which is disclosed in the Consolidated Statements of Cash Flows for the applicable periods. There are no material legal or functional restrictions on the use of FFO. FFO should not be considered as an alternative to net income, its most directly comparable GAAP measure, as an indicator of the Company's operating performance, or as an alternative to cash flows as a measure of liquidity. Management considers FFO a supplemental measure of operating performance and along with cash flow from operating activities, financing activities and investing activities, it provides investors with an indication of the ability of the Company to incur and service debt, to make capital expenditures and to fund other cash needs. FFO may not be comparable to similarly titled measures employed by other REITs.

ACQUISITIONS, REDEVELOPMENTS AND RENOVATIONS

Management anticipates that during the coming year the Company may: i) redevelop certain of the Current Portfolio Properties, ii) develop additional freestanding outparcels or expansions within certain of the Shopping Centers, iii) acquire existing neighborhood and community shopping centers and/or office properties, and iv) develop new shopping center or office sites. Acquisition and development of properties are undertaken only after careful analysis and review, and management's determination that such properties are expected to provide long-term earnings and cash flow growth. During the coming year, any developments, expansions or acquisitions are expected to be funded with bank borrowings from the Company's credit line, construction financing, proceeds from the operation of the Company's dividend reinvestment plan or other external capital resources available to the Company.

The Company has been selectively involved in acquisition, redevelopment and renovation activities. It continues to evaluate the acquisition of land parcels for retail and office development and acquisitions of operating properties for opportunities to enhance operating income and cash flow

growth. The Company also continues to take advantage of redevelopment, renovation and expansion opportunities within the portfolio, as demonstrated by its recent activities at Olde Forte Village, Broadlands Village, Thruway, The Glen, Ravenwood and Lansdowne Town Center. The following describes the acquisitions, redevelopments and renovations which affected the Company's financial position and results of operations in 2005 and 2004.

Olde Forte Village

In July 2003, the Company acquired Olde Forte Village, a 161,000 square foot neighborhood shopping center located in Fort Washington, Maryland. The center is anchored by a newly constructed 58,000 square foot Safeway supermarket which opened in March 2003, relocating from a smaller store within the center. The center then contained approximately 50,000 square feet of vacant space, consisting primarily of the former Safeway space, which the Company is in the process of redeveloping. The reconfigured shopping center now totals 143,000 square feet of leasable space. The Company's total redevelopment costs, including the initial property acquisition cost, are expected to total approximately \$22 million. Construction at Olde Forte Village was substantially completed during the second quarter of 2005. The center was 91% leased at March 9, 2006.

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Broadlands Village

The Company purchased 24 acres of undeveloped land in the Broadlands section of the Dulles Technology Corridor of Loudoun County, Virginia in April 2002. Broadlands is a 1,500 acre planned community consisting of 3,500 residences, approximately half of which are constructed and currently occupied. In October 2003, the Company completed construction of the first phase of the Broadlands Village shopping center. The 58,000 square foot Safeway supermarket opened in October 2003 with a pad building and many in-line small shops also opening in the fourth quarter of 2003. Construction of a 30,000 square foot second phase commenced in March 2004 and was substantially completed in the fourth quarter of 2004. The Company's total development costs of both phases, including the land acquisition, were approximately \$22 million. Both the first and second phases were 100% leased at March 9, 2006. During the fourth quarter of 2005, the Company commenced construction of a third phase of this development, totaling approximately 22,000 square feet of shop space and two pad buildings. As of March 9, 2006, leases have been executed for 73% of the new shop space. The Company's development cost for construction of the third phase is expected to total approximately \$7.5 million and be completed during the third quarter of 2006.

Thruway

During 2004, the Company completed construction of a 15,725 square foot expansion of the Thruway shopping center located in Winston Salem, North Carolina. The new development replaced a former 6,100 square foot single-tenant pad building with a new multi-tenant building. As of March 9, 2006, all of the new space was leased and occupied by tenants including Ann Taylor Loft, JoS. A Banks Clothiers, Chico's and Liz Claiborne. This \$2.1 million expansion was substantially completed in April 2004.

The Glen

In February 2005, the Company commenced construction of a 22,000 square foot expansion building at The Glen shopping center in Prince William County, Virginia. The existing 120,000 square foot Safeway anchored center is 100% leased and this expansion will provide additional restaurants and small shop service space. Construction of the expansion building was substantially completed in the fall of 2005, and development costs are estimated to total \$4.1 million. As of March 9, 2006, 100% of the new space was leased. Tenants began occupying space in September 2005 and all tenants are expected to be open for business by the end of the first quarter of 2006.

Shops at Monocacy

In November 2003, the Company acquired 13 acres of undeveloped land in Frederick, Maryland at the southeast corner of Maryland Route 26 and Monocacy Boulevard. Construction commenced in early December 2003 of a 109,000 square foot shopping center anchored by a 57,000 square foot Giant grocery store. The Company's total development costs, including the land acquisition, were approximately \$22.3 million. Construction was completed and Giant opened for business during October 2004. The property was 100% leased at March 9, 2006.

Kentlands Place

In January 2004, the Company purchased 3.4 acres of undeveloped land adjacent to its 109,000 square foot Kentlands Square shopping center in Gaithersburg, Maryland. The Company substantially completed construction of a 41,300 square foot retail/office property, comprised of 24,400 square feet of in-line retail space and 16,900 square feet of professional office suites, in early 2005. Development costs, including the land acquisition, are projected to total approximately \$8.5 million. The property was 100% leased at March 9, 2006 and includes significant retail tenants Bonfish Grill and Elizabeth Arden's Red Door Salon.

Boca Valley Plaza

The Company added Publix as one of its grocery tenants with the February 2004 acquisition of Boca Valley Plaza in Boca Raton, Florida. Boca Valley Plaza is a 121,000 square foot neighborhood shopping center on U.S. Highway 1 in South Florida. The center was constructed in 1988, was 96% leased at March 9, 2006 and is anchored by a 42,000 square foot Publix supermarket. The property was acquired for a purchase price of \$17.5 million, subject to the assumption of a \$9.2 million mortgage.

Countryside

In mid-February 2004, the Company completed the acquisition of the 142,000 square foot Safeway-anchored Countryside shopping center, its fourth neighborhood shopping center investment in Loudoun County, Virginia. The center was 97% leased at March 9, 2006 and was acquired for a purchase price of \$29.7 million.

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Cruse MarketPlace

On March 25, 2004, the Company completed the acquisition of the 79,000 square foot Publix-anchored, Cruse MarketPlace located in Forsyth County, Georgia. Cruse MarketPlace was constructed in 2002 and was 97% leased at March 9, 2006. The center was purchased for \$12.6 million, subject to the assumption of an \$8.8 million mortgage.

Briggs Chaney MarketPlace

In April 2004, the Company acquired Briggs Chaney MarketPlace in Silver Spring, Maryland. Briggs Chaney MarketPlace is a 197,000 square foot neighborhood shopping center on Route 29 in Montgomery County, Maryland. The center, constructed in 1983, was 98% leased at March 9, 2006 and is anchored by a 45,000 square foot Safeway supermarket and a 28,000 square foot Ross Dress For Less. The property was acquired for \$27.3 million. The Company has completed interior construction to reconfigure a portion of the vacant space totaling approximately 11,000 square feet of leasable area. All of the eight newly created shop spaces have been leased and were in operation prior to December 31, 2005. In October 2005, the Company also completed construction of a façade renovation of the shopping center.

Ashland Square

On December 15, 2004, the Company acquired a 19.3 acre parcel of land in Dumfries, Prince William County, Virginia for a purchase price of \$6.3 million. The Company has preliminary plans to develop the parcel into a grocery-anchored neighborhood shopping center. The Company submitted a site plan to Prince William County during the second quarter of 2005 in order to obtain approvals to build an approximately 160,000 square foot center, and is marketing the project to grocers and other retail businesses.

Palm Springs Center

On March 3, 2005, the Company completed the acquisition of the 126,000 square foot Albertson's anchored Palm Springs Center located in Altamonte Springs, Florida. The center was 100% leased at March 9, 2006 and was acquired for a purchase price of \$17.5 million.

New Market

On March 3, 2005, the Company acquired a 7.1 acre parcel of land located in New Market, Maryland for a purchase price of \$500,000. On September 8, 2005, the Company acquired a 28.4 acre contiguous parcel for a purchase price of \$1,500,000. The Company has contracted to purchase one additional parcel with the intent to assemble acreage for the development of a retail space near the I-70 interchange.

Lansdowne Town Center

During the first quarter of 2005, the Company received approval of a zoning submission to Loudoun County which will allow the development of a neighborhood shopping center to be known as Lansdowne Town Center, within the Lansdowne Community in northern Virginia. On March 29, 2005, the Company finalized the acquisition of an additional 4.5 acres of land to bring the total acreage of the development parcel to 23.4 acres (including the 18.9 acres acquired in 2002). The additional purchase price was approximately \$1.0 million. The Company has commenced construction of the 191,000 square foot retail center. The Company's total development costs, including the land acquisition, are expected to total approximately \$42 million. The development will be anchored by a 55,000 square foot Harris Teeter grocery store and was 29% pre-leased as of March 9, 2006.

Ravenwood

During the fourth quarter of 2005, the Company commenced construction of a 7,380 square foot shop space expansion to the Giant anchored Ravenwood shopping center, located in Towson, Maryland. This space is 61% pre-leased and the cost to expand Ravenwood is projected to total \$2.2 million.

Lexington

On September 29, 2005, the Company announced the resolution of a land use dispute at Lexington Mall, allowing increased flexibility in future development rights for its property. The Company and the land owner of the adjacent 16 acre site, have resolved a dispute arising from a reciprocal easement agreement governing land use between the two owners. The parties have now executed a new land use agreement which grants each other the flexibility to improve its property. The Company also reached an agreement with Dillard's to terminate its lease, without consideration exchanged by either party. The Dillard's store closed during October 2005. During the past several years, the Company has not been renewing small shop leases pending settlement with the adjacent owner. The departure of Dillard's now leaves the mall vacant and combined with the new land use agreement, expands potential redevelopment options. The Company has engaged land planners and assembled a team to proceed with conceptual designs.

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Jamestown Place

On November 17, 2005, the Company acquired the 96,000 square foot Publix-anchored Jamestown Place located in Altamonte Springs, Florida. The center was 99% leased at March 9, 2006 and was acquired for a purchase price of \$14.8 million.

Seabreeze Plaza

On November 30, 2005, the Company acquired the 147,000 square foot Publix-anchored Seabreeze Plaza located in Palm Harbor, Florida. The center was 99% leased at March 9, 2006 and was acquired for a purchase price of \$25.9 million subject to the assumption of a \$13.6 million mortgage loan.

Smallwood Village Center

On January 27, 2006, the Company acquired the 198,000 square foot Smallwood Village Center, located on 25 acres within the St. Charles planned community of Waldorf, Maryland, a suburb of metropolitan Washington, DC, through a wholly-owned subsidiary of its operating partnership. The purchase price was \$17.5 million and was paid with cash and by the assumption of an \$11.3 million mortgage loan. The property was 89% leased at March 9, 2006.

Clarendon

The Company owns an assemblage of land parcels (including its Clarendon and Clarendon Station operating properties) totaling approximately 1.5 acres adjacent to the Clarendon Metro Station in Arlington, Virginia. The Company is continuing to pursue zoning approvals for a significant mixed-use development project.

PORTFOLIO LEASING STATUS

The following chart sets forth certain information regarding our properties for the periods indicated.

As of December 31,	Total Properties		Total Square Footage		Percent Leased	
	Shopping Centers	Office	Shopping Centers	Office	Shopping Centers	Office
2005	39	5	6,170,000	1,206,000	97.2%	96.6%
2004	35	5	6,012,000	1,205,000	93.5%	95.9%
2003	31	5	5,328,000	1,204,000	94.1%	95.8%

The increase in the shopping center portfolio's leasing percentage in 2005 resulted primarily from the removal from service of 133,000 square feet of vacant mall space at Lexington Mall which the Company had not leased in 2004 in anticipation of redeveloping the shopping center. The 2005 leasing of a 39,000 square foot grocery store at Southside

Plaza in suburban Richmond, Virginia also contributed to the increase over 2004. The departure of the previous grocery store tenant at Southside in 2004 was the largest contributor to the decrease in 2004 leasing percentage compared to 2003.

Saul Centers Corporate Information

DIRECTORS

B. Francis Saul II
Chairman & Chief
Executive Officer

B. Francis Saul III
President

Philip D. Caraci
Vice Chairman

**The Honorable
John E. Chapoton**
Partner, Brown Investment Advisory

Gilbert M. Grosvenor
Chairman of the
Board of Trustees,
National Geographic Society

Philip C. Jackson, Jr.
Adjunct Professor Emeritus,
Birmingham-Southern College

David B. Kay
Managing Director,
Navigant Consulting, Inc.

General Paul X. Kelley
28th Commandant of
the Marine Corps

Charles R. Longworth
Chairman Emeritus, Colonial
Williamsburg Foundation

Patrick F. Noonan
Chairman Emeritus,
The Conservation Fund

**The Honorable
James W. Symington**
Of Counsel, O'Connor & Hannan,
Attorneys at Law

John R. Whitmore
Financial Consultant

EXECUTIVE OFFICERS

B. Francis Saul II
Chairman & Chief
Executive Officer

B. Francis Saul III
President

Scott V. Schneider
Senior Vice President,
Chief Financial Officer,
Treasurer & Secretary

Kenneth D. Shoop
Vice President,
Chief Accounting Officer

Christopher H. Netter
Senior Vice President, Leasing

John F. Collich
Senior Vice President,
Retail Development

M. Laurence Millsbaugh
Senior Vice President, Acquisitions
& Development

Charles W. Sherren, Jr.
Senior Vice President, Management

Thomas H. McCormick
Senior Vice President,
General Counsel

COUNSEL

Pillsbury Winthrop
Shaw Pittman LLP
Washington, DC 20037

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Ernst & Young LLP
McLean, Virginia 22102

WEB SITE

www.saulcenters.com

EXCHANGE LISTING

New York Stock
Exchange (NYSE) Symbol:
Common Stock: BFS
Preferred Stock: BFS.PrA

TRANSFER AGENT

Continental Stock Transfer & Trust
Company
17 Battery Place
New York, NY 10004
(800) 509-5586

INVESTOR RELATIONS

A copy of the Saul Centers, Inc. annual report to the Securities and Exchange Commission on Form 10-K, which includes as exhibits the Chief Executive Officer and Chief Financial Officer Certifications required by Section 302 of the Sarbanes-Oxley Act, may be printed from the Company's web site or obtained at no cost to stockholders by writing to the address below or calling (301) 986-6016. In 2005, the Company filed with the NYSE the Certification of its Chief Executive Officer confirming that he was not aware of any violation by the Company of the NYSE's corporate governance listing standards.

HEADQUARTERS

7501 Wisconsin Ave.
Suite 1500
Bethesda, MD 20814-6522
Phone: (301) 986-6200

Dividend Reinvestment Plan and Annual Meeting of Shareholders

Saul Centers, Inc. offers a dividend reinvestment plan which enables its shareholders to automatically invest some of or all dividends in additional shares. The plan provides shareholders with a convenient and cost-free way to increase their investment in Saul Centers. Shares purchased under the dividend reinvestment plan are issued at a 3% discount from the closing price of the stock on the dividend payment date. The Plan's prospectus is available for review in the Shareholders Information section of the Company's web site.

To receive more information please call the plan administrator at (800) 509-5586 and request to speak with a service representative or write:

Continental Stock Transfer & Trust Company
Attention: Saul Centers, Inc. Dividend Reinvestment Plan
17 Battery Place
New York, NY 10004

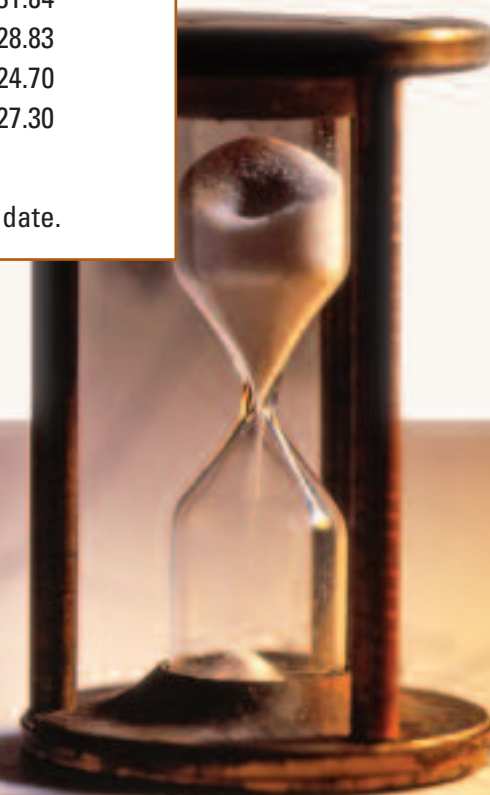
COMMON STOCK PRICES

Period	Share Price	
	High	Low
Fourth Quarter, 2005	\$38.46	\$33.82
Third Quarter, 2005	\$39.48	\$35.10
Second Quarter, 2005	\$36.41	\$31.80
First Quarter, 2005	\$37.25	\$32.00
Fourth Quarter, 2004	\$39.25	\$31.84
Third Quarter, 2004	\$33.25	\$28.83
Second Quarter, 2004	\$32.41	\$24.70
First Quarter, 2004	\$30.55	\$27.30

On March 9, 2006, the closing price was \$40.87.

There were approximately 360 holders of record as of that date.

The Annual Meeting of Shareholders will be held at 11:00 a.m., local time, on April 28, 2006, at the Hyatt Regency Bethesda, One Bethesda Metro Center, Bethesda, MD (at the southwest corner of the Wisconsin Avenue and Old Georgetown Road intersection, adjacent to the Bethesda Metro Stop on the Metro Red Line.)





7501 Wisconsin Avenue, Suite 1500

Bethesda, MD 20814-6522

Phone: (301) 986-6200

Website: www.saulcenters.com