

# Saul Centers



## *2006* Annual Report

## CORPORATE PROFILE

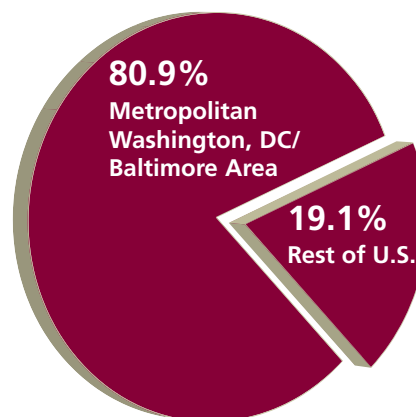
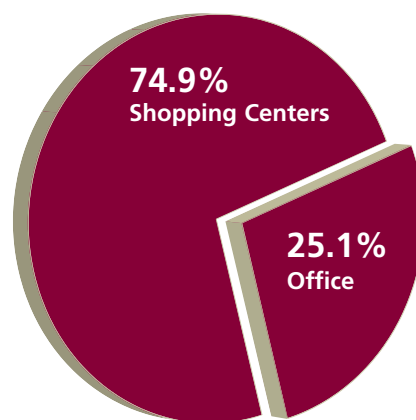
### *Saul Centers, Inc.*

is a self-managed, self-administered equity real estate investment trust headquartered in Bethesda, Maryland. Saul Centers operates and manages a real estate portfolio of 47 community and neighborhood shopping centers and office properties totaling approximately 7.9 million square feet of leasable area. Over 80% of the property operating income 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 retail, office and mixed-use properties, and acquisitions of operating properties as appropriate opportunities arise.

### PORTFOLIO COMPOSITION

Based on 2006 Property Operating Income

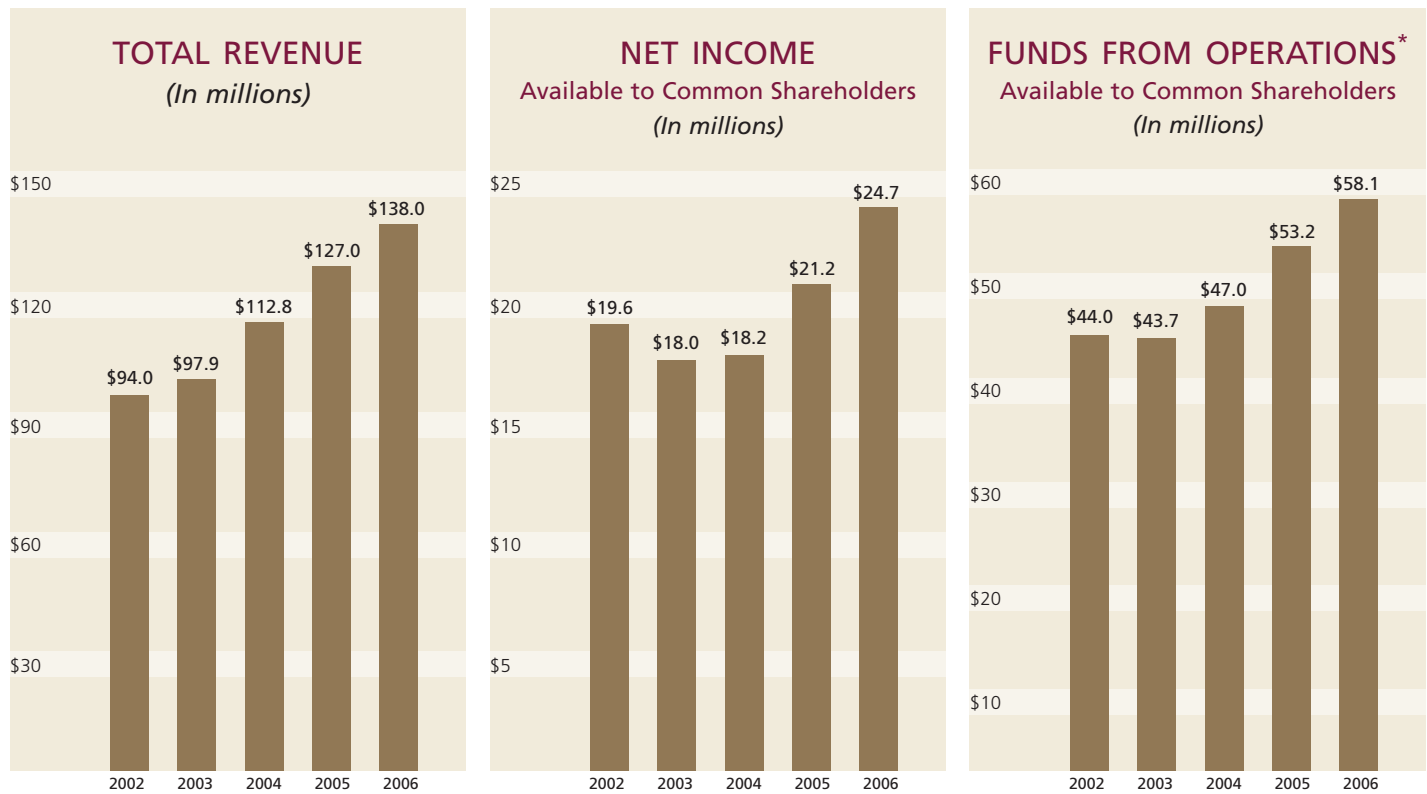


*Shares of Saul Centers are traded on the New York Stock Exchange under the symbol "BFS."*

*Broadlands Village*



## HISTORIC OPERATING PERFORMANCE



\* Funds From Operations (FFO) is a non-GAAP financial measure. See page 29 for a definition of FFO and reconciliation to Net Income.

Beacon Center





## FINANCIAL HIGHLIGHTS

Year ended December 31,

2006

2005

2004

2003

2002

### Summary Financial Data

|   |               |               |               |              |              |
|---|---------------|---------------|---------------|--------------|--------------|
| Total Revenue   | \$137,978,000 | \$127,015,000 | \$112,842,000 | \$97,884,000 | \$93,963,000 |
| Net Income Available to Common Stockholders                     | \$24,680,000  | \$21,227,000  | \$18,174,000  | \$17,998,000 | \$19,566,000 |
| FFO Available to Common Shareholders                            | \$58,121,000  | \$53,222,000  | \$47,031,000  | \$43,740,000 | \$44,031,000 |
| Weighted Average Common Stock Outstanding                       | 17,233,000    | 16,770,000    | 16,211,000    | 15,608,000   | 14,887,000   |
| Weighted Average Shares and Units Outstanding                   | 22,628,000    | 22,003,000    | 21,405,000    | 20,790,000   | 20,059,000   |
| Net Income Available to Common Stockholders Per Share (Diluted) | \$1.43        | \$1.27        | \$1.12        | \$1.15       | \$1.31       |
| FFO Available to Common Shareholders Per Share (Diluted)        | \$2.57        | \$2.42        | \$2.20        | \$2.10       | \$2.20       |
| Common Dividend as a Percentage of FFO (Per Share)              | 65%           | 66%           | 71%           | 74%          | 71%          |
| Interest Expense Coverage <sup>a</sup>                          | 3.14          | 3.15          | 3.14          | 2.78         | 2.78         |

### Property Data

|  |           |                        |           |           |           |
|--|-----------|------------------------|-----------|-----------|-----------|
| Number of Properties <sup>b</sup>      | 47        | 44                     | 40        | 36        | 34        |
| Total Portfolio Square Feet            | 7,914,000 | 7,376,000              | 7,217,000 | 6,532,000 | 6,272,000 |
| Shopping Center Square Feet            | 6,708,000 | 6,170,000 <sup>c</sup> | 6,012,000 | 5,328,000 | 5,069,000 |
| Office Square Feet                     | 1,206,000 | 1,206,000              | 1,205,000 | 1,204,000 | 1,203,000 |
| Average Percentage Leased <sup>d</sup> | 97%       | 95%                    | 94%       | 93%       | 94%       |

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

(b) Excludes development land parcels (Clarendon Center, Ashland Square, Lexington Center 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.



Jamestown Place



## *Message* TO OUR SHAREHOLDERS

*T*hrough the efforts of our professionals, Saul Centers achieved several operating milestones in 2006, and our shareholders experienced strong investment returns. Portfolio leasing levels continued to outperform previous years, with leasing for the year averaging over 97%. Rental rate growth in the retail portfolio was the strongest in the past 5 years, with spaces relet at average initial cash rental rates of 9.8% over rents paid on expiring leases. A total of over 230 new leases or lease renewals for 985,000 square feet of retail and office space were executed, making 2006 our largest lease volume year. These factors contributed to our overall retail and office portfolio same property operating increase of 4.5% over 2005 levels.

We ended the year with a 12 month total return of 59% for our shareholders, as real estate investment trusts were generally rewarded in the capital markets throughout the year. At year end, our total debt and equity market capitalization exceeded \$1.8 billion.

### *Development Performance*

In November, the Harris Teeter grocery store opened for business in Lansdowne Town Center, our new 188,000 square foot shopping center in Loudoun County, Virginia. The development will also include a CVS Pharmacy, over 80,000 square feet of retail establishments, and over 38,000 square feet of professional office suites. Since ground was broken in late 2005, the three mile population surrounding this development has grown by over 10% to over 55,000 people and household incomes average over \$128,000. At year end, Lansdowne Town Center was 45% occupied and is currently over 88% leased.

We received zoning approval for our mixed-use Clarendon Center project. The Clarendon Center development will encompass nearly two city blocks adjacent to the Clarendon Metro Station in Arlington County, Virginia, one of the better residential and commercial submarkets in the Washington, DC area. The proposed development, located in the heart of an



## MESSAGE TO OUR SHAREHOLDERS

urban live/work environment, will contain two office buildings totaling 170,000 square feet, one residential tower with 244 luxury apartment units, and 42,000 square feet of street-level retail. We expect the project will also be certified "green" by the U.S. Green Building Council.

We plan to further enhance internal growth by continuing to develop additional retail properties.

### *Ashland Square*

During 2006, we received site plan approval from Prince William County to develop 125,000 square feet of retail space at Ashland Square in Dumfries, Virginia, with zoning available for an additional 35,000 square feet.

### *Lexington Center*

Conceptual designs have been prepared for the redevelopment of our 26 acre Lexington, Kentucky property. The site is zoned for over 325,000 square feet of retail space. We are marketing the Lexington Center to anchor tenants.

### *Rendering of the proposed Clarendon Center*

### *New Market*

Over the past few years, we have acquired 35.5 acres of contiguous land in New Market, just east of Frederick, Maryland. This parcel will accommodate a neighborhood shopping center development in excess of 120,000 square feet.

Development timetables for these three projects have yet to be determined.

### *Westview Village*

We plan to develop 105,000 square feet of retail shop, professional office, and pad site space at Westview Village on Buckeystown Pike (MD Route 85) in Frederick, Maryland. Our purchase of this 10.4 acre site in the Westview development is expected to close in the summer of 2007, with building construction anticipated soon thereafter.



## MESSAGE TO OUR SHAREHOLDERS

### *Redevelopments and Expansions*

During 2006, we completed several shopping center renovations and expansions. We developed the initial phase of the Safeway anchored Broadlands Village shopping center in 2003, located in Loudoun County, Virginia. Construction of a 22,000 square foot small shop expansion was completed in the summer of 2006, increasing the center to 160,000 square feet. The center is 100% leased and all of the new space was occupied at year end. Acreage remains on the site for approximately 15,000 square feet of additional small shop or pad buildings.

Also in Loudoun County, we constructed a 10,000 square foot in-line shop space addition to our Giant anchored Ashburn Village shopping center. We initially developed Ashburn Village in 1994, and have expanded the center in four phases to its current 222,000 square feet. The center is 99% leased and all of the new space is leased to tenants expected to commence operations during early 2007. This property has only one pad site location remaining to develop, and contains over 60 retail and professional office businesses including 15 eating establishments. Ashburn Village is now our third largest shopping center asset as measured by property operating income.

In the third quarter of 2006, we completed construction of a 7,400 square foot expansion to the Giant anchored Ravenwood shopping center in Towson, Maryland. The overall center now totals 93,000 square feet and is 100% leased. Four of the five new spaces were occupied at year end.

*During 2006, several shopping center renovations and expansions were completed including Broadlands Village, Ashburn Village, Ravenwood and Beacon Center.*



**Broadlands Village**



**Ashburn Village**



**Ravenwood**



## MESSAGE TO OUR SHAREHOLDERS

Our Lowe's home improvement and Giant anchored Beacon Center, located fronting U.S. Route 1 in Alexandria, Virginia, consists of 356,000 square feet of retail space. During 2005, we were able to recapture four of the pad buildings with prime street frontage. Three of these leases dated back to the 1970's. The architecture of the improvements was very dated and the rents being paid by the tenants were well below current market rates. During 2006, we obtained final Fairfax County approvals to demolish these buildings and redevelop the streetscape with new retail uses and upgraded landscaping.

### *Shopping Center Acquisitions*

While the overall environment for shopping center acquisitions continued to be very challenging during 2006, we completed two purchases which complement our core portfolio of neighborhood grocery anchored centers. In January 2006, we 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 Washington, DC. Smallwood Village Center was constructed in three

phases from 1978 to 1986, and is anchored by a recently remodeled and expanded 55,000 square foot Safeway supermarket and 10,000 square foot CVS drugstore. The St. Charles residential development is approximately 60% complete and is expected to total approximately 25,000 housing units. Over 42,000 people with annual household income averaging greater than \$76,000 are located within three miles. The center was 84% leased at year end. Our development team is evaluating façade renovation concepts and site access improvements in order to modernize the appearance and grow the operating income of this center.

In June 2006, we acquired the 101,000 square foot Hunt Club Corners shopping center, located in Apopka, Florida, a suburb of metropolitan Orlando, and within five miles of our Palm Springs and Jamestown Place shopping centers. Our three Orlando metropolitan area investments total over 324,000 square feet of leasable area. Hunt Club Corners was constructed in 1980, is 94% leased and is anchored by a 55,000 square foot Publix supermarket. Over 84,000 people with annual household income averaging approximately \$80,000 are located within three miles of the center.



*Smallwood Village Center*



*Hunt Club Corners*



## MESSAGE TO OUR SHAREHOLDERS

### *2006 Financial Highlights*

Successful leasing activity at several core shopping centers and operating income from recently completed developments produced the significant portion of increased operating income and Funds From Operations (FFO) in 2006.

For the 2006 year, total revenue increased 8.6% to \$137,978,000 compared to \$127,015,000 for 2005. Operating income increased 9.3% to \$40,473,000 in 2006 compared to \$37,025,000 in 2005. Net income available to common stockholders was \$24,680,000, or \$1.43 per diluted share in 2006, a 12.6% per share increase from prior year results.

FFO available to common shareholders (after deducting preferred stock dividends) increased 9.2% in 2006 to \$58,121,000, compared to \$53,222,000 in 2005. Diluted per share FFO available to common shareholders increased 6.2% to \$2.57 per share in 2006 compared to \$2.42 per share for the 2005 year. FFO increased in 2006 despite a one-time \$1,555,000 (\$0.07 per diluted share) payment received from the Lexington land use settlement included in the prior year results.

### *Shopping Center Performance*

With the completion of two shopping center acquisitions and the addition of development and expansion space, our retail portfolio totaled 42 community and neighborhood shopping centers with 6.7 million square feet of space at year end 2006. Since the beginning of 2003, we have added 15 properties, and increased the leasable square footage by over 25%. Our focus continues to be high growth, high income submarkets within our target mid-Atlantic and Southeastern regions of the country. Average household incomes within a three mile radius of our shopping centers total over \$95,000, comparing favorably to the national average of \$71,000. Tenants in our centers generally service the population of the immediate local neighborhoods, and provide convenient grocery, pharmacy, dining, medical, banking and other day-to-day service needs.

Overall retail sales reported by our tenants during 2006 averaged \$324 per square foot, a 4.2% increase from 2005. On a same store basis, retail sales increased 1.7% from 2005 levels. Twenty-eight of our centers are anchored by a grocery store, and these centers comprise



*Countryside*



*Shops at Monocacy*



*Beacon Center*

## MESSAGE TO OUR SHAREHOLDERS

85% of our total retail square footage. The traffic generated by these grocery stores remains strong, with our grocery stores generating \$455 per square foot in reported sales during 2006. The retail leasing percentage was 96.1% at year end 2006. New or renewal leases were signed at average cash rental rates of approximately 9.8% over rents paid on expiring leases for the 498,000 square feet of same space lease rollovers or renewals. During the past five years, we renewed a total of over 70% of our retail tenants, as measured by annualized base rents at lease expiration. The renewal percentage during 2006 was 71% on over 600,000 square feet of expiring retail leases.

All of the above contributed to a same property operating income increase of 6.0% for our shopping centers in 2006. Operating leverage was also achieved through efficient property management, with same center increases in total property operating expenses held to 1.1%. As of March 1, 2007, a total of approximately 49% of the 656,000 square feet of 2007 retail lease expirations have been successfully renewed or released.

## Office Highlights

Our 1.2 million square foot office portfolio contributed 25.1% of the 2006 property operating income. Sixty percent of the office property operating income is produced from the 227,000 square foot 601 Pennsylvania Avenue office building, located between the U.S. Capitol and The White House, and the 235,000 square foot Washington Square property in Old Town Alexandria, Virginia. These properties are the foundation of our office portfolio, which as a group have averaged over 92% leased in each of the past 5 years, and have collectively increased property operating income every year during this period.

During 2006, the office portfolio averaged 97.0% leased. Over 94% of the office leases have fixed annual escalations averaging over 2.5% per year, and as of March 1, 2007, only 8.7% of the office space as measured by current annualized monthly base rent is scheduled to expire during 2007. These facts, combined with a high credit quality tenant base, with credit loss averaging less than 0.2% of total office



**601 Pennsylvania Avenue**

*Our 1.2 million square foot office portfolio contributed 25.1% of the 2006 property operating income.*



**Washington Square**





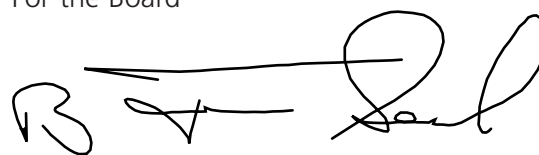
revenue over the past 5 years, are expected to produce continued stable operating performance in this portfolio.

### *Capital Strategy*

We continue to fund our acquisition and development capital requirements with a combination of equity raised through our dividend reinvestment program, cash flow from operating activities and 15-year non-recourse mortgage debt. At the end of 2006, over 93% of our debt was fixed-rate, with a weighted average maturity date of 8.5 years, and the next maturity in December 2011. The weighted average interest rate was 6.8% and our interest expense coverage was 3.1 times for the year. We maintained a prudent leverage of approximately 28% debt to total capitalization at December 31, 2006, which provides capacity to increase debt to pursue development and acquisition opportunities. As of March 1, 2007, we had borrowing availability of \$115 million on our \$150 million revolving credit line for general corporate use and for funding any future developments and acquisitions.

We take great pride in our core portfolio leasing and property management accomplishments of 2006, and in the value added to our portfolio by our development and acquisition team throughout the year. Our growth strategy which is based on diligence in our analysis of both core leasing and new investment opportunities will continue into 2007. Once again, our business model will emphasize operating cash flow stability and long-term asset value enhancement. Our dedicated team of professionals are all responsible for our outstanding results this year and we are most grateful for their efforts.

For the Board



B. Francis Saul II  
March 9, 2007

### *Seven Corners Center*





*Lansdowne Town Center  
saw its first tenant  
openings in late 2006.*







As of December 31, 2006, 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 71% of the portfolio's gross leasable area.

# Portfolio PROPERTIES

| PROPERTY/LOCATION                            | GROSS LEASABLE<br>SQUARE FEET | PROPERTY/LOCATION                          | GROSS LEASABLE<br>SQUARE FEET |
|--|-------------------------------|--|-------------------------------|
| <i>Shopping Centers</i>                      |                               |  |                               |
| ASHBURN VILLAGE, ASHBURN, VA                 | 221,687                       | SHOPS AT MONOCACY, FREDERICK, MD           | 109,144                       |
| BEACON CENTER, ALEXANDRIA, VA                | 356,115                       | OLDE FORTE VILLAGE, FT. WASHINGTON, MD     | 143,062                       |
| BELVEDERE, BALTIMORE, MD                     | 54,941                        | OLNEY, OLNEY, MD                           | 53,765                        |
| BOCA VALLEY PLAZA, BOCA RATON, FL            | 121,269                       | PALM SPRINGS CENTER, ALTAMONTE SPRINGS, FL | 126,446                       |
| BOULEVARD, FAIRFAX, VA                       | 56,350                        | RAVENWOOD, BALTIMORE, MD                   | 93,328                        |
| BRIGGS CHANEY MARKETPLACE, SILVER SPRING, MD | 194,347                       | SEABREEZE PLAZA, PALM HARBOR, FL           | 146,673                       |
| BROADLANDS VILLAGE I & II, ASHBURN, VA       | 137,479                       | SEVEN CORNERS, FALLS CHURCH, VA            | 567,291                       |
| BROADLANDS VILLAGE III, ASHBURN, VA          | 22,255                        | SHOPS AT FAIRFAX, FAIRFAX, VA              | 68,743                        |
| CLARENDON/CLARENDON STATION, ARLINGTON, VA   | 11,808                        | SMALLWOOD VILLAGE CENTER, WALDORF, MD      | 197,861                       |
| COUNTRYSIDE, STERLING, VA                    | 141,696                       | SOUTHDAL, GLEN BURNIE, MD                  | 484,115                       |
| CRUSE MARKETPLACE, CUMMING, 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                 | 354,726                       |
| GERMANTOWN, GERMANTOWN, MD                   | 27,241                        | 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                       | <b>TOTAL SHOPPING CENTERS</b>              | <b>6,708,344</b>              |
| HAMPSHIRE LANGLEY, TAKOMA PARK, MD           | 131,700                       |  |                               |
| HUNT CLUB CORNERS, APOPKA, FL                | 101,454                       | <i>Office Properties</i>                   |                               |
| JAMESTOWN PLACE, ALTAMONTE SPRINGS, FL       | 96,372                        | AVENEL BUSINESS PARK, GAITHERSBURG, MD     | 390,579                       |
| KENTLANDS SQUARE, GAITHERSBURG, MD           | 114,381                       | CROSTOWN BUSINESS CENTER, TULSA, OK        | 197,135                       |
| KENTLANDS PLACE, GAITHERSBURG, MD            | 40,648                        | 601 PENNSYLVANIA AVE., WASHINGTON, DC      | 226,604                       |
| LANSDOWNE TOWN CENTER, LEESBURG, VA          | 188,346                       | VAN NESS SQUARE, WASHINGTON, DC            | 156,493                       |
| LEESBURG PIKE, BAILEYS CROSSROADS, VA        | 97,752                        | WASHINGTON SQUARE, ALEXANDRIA, VA          | 235,042                       |
| LEXINGTON PADS, LEXINGTON, KY                | 13,646                        | <b>TOTAL OFFICE PROPERTIES</b>             | <b>1,205,853</b>              |
| LUMBERTON PLAZA, LUMBERTON, NJ               | 193,044                       |  |                               |
|  |                               | <b>TOTAL PORTFOLIO</b>                     | <b>7,914,197</b>              |



*Briggs Chaney MarketPlace*



*Since 2003, we have increased our leasable area by 1.6 million square feet, or over 25%, by acquisitions and developments.*



*Kentlands Place*



|  |             |
|--|-------------|
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## Selected Financial Data ♦

(In thousands, except per share data)

|  | Years Ended December 31, |             |              |             |             |
|--|--------------------------|-------------|--------------|-------------|-------------|
|  | 2006                     | 2005        | 2004         | 2003        | 2002        |
| <b>Operating Data</b>  |                          |             |              |             |             |
| Total revenue  | \$ 137,978               | \$ 127,015  | \$ 112,842   | \$ 97,884   | \$ 93,963   |
| Operating expenses   | 97,505                   | 89,990      | 79,135       | 70,738      | 67,753      |
| Operating income   | 40,473                   | 37,025      | 33,707       | 27,146      | 26,210      |
| Non-operating income (loss)  |                          |             |              |             |             |
| Gain on sale of property   | —                        | —           | 572          | 182         | 1,426       |
| Income before minority interests   | 40,473                   | 37,025      | 34,279       | 27,328      | 27,636      |
| Minority interests   | (7,793)                  | (7,798)     | (8,105)      | (8,086)     | (8,070)     |
| Net income   | 32,680                   | 29,227      | 26,174       | 19,242      | 19,566      |
| Preferred dividends  | (8,000)                  | (8,000)     | (8,000)      | (1,244)     | —           |
| Net income available to common stockholders  | \$ 24,680                | \$ 21,227   | \$ 18,174    | \$ 17,998   | \$ 19,566   |
| <b>Per Share Data (diluted)</b>  |                          |             |              |             |             |
| Net income available to common stockholders  | \$ 1.43                  | \$ 1.27     | \$ 1.12      | \$ 1.15     | \$ 1.31     |
| Basic and Diluted Shares Outstanding   |                          |             |              |             |             |
| Weighted average common shares - basic   | 17,075                   | 16,663      | 16,154       | 15,591      | 14,865      |
| Effect of dilutive options   | 158                      | 107         | 57           | 17          | 22          |
| Weighted average common shares - diluted   | 17,233                   | 16,770      | 16,211       | 15,608      | 14,887      |
| Weighted average convertible limited partnership units                                 | 5,395                    | 5,233       | 5,194        | 5,182       | 5,172       |
| Weighted average common shares and fully converted limited partnership units - diluted | 22,628                   | 22,003      | 21,405       | 20,790      | 20,059      |
| <b>Dividends Paid</b>  |                          |             |              |             |             |
| Cash dividends to common stockholders <sup>(1)</sup>                                   | \$ 28,579                | \$ 26,542   | \$ 25,061    | \$ 24,171   | \$ 23,030   |
| Cash dividends per share   | \$ 1.68                  | \$ 1.60     | \$ 1.56      | \$ 1.56     | \$ 1.56     |
| <b>Balance Sheet Data</b>  |                          |             |              |             |             |
| Real Estate Investments  |                          |             |              |             |             |
| (net of accumulated depreciation)  | \$ 627,651               | \$ 567,417  | \$ 501,388   | \$ 387,292  | \$ 353,628  |
| Total assets   | 700,537                  | 631,469     | 583,396      | 471,616     | 388,687     |
| Total debt, including accrued interest   | 525,125                  | 484,902     | 455,925      | 359,051     | 382,619     |
| Preferred stock  | 100,000                  | 100,000     | 100,000      | 100,000     | —           |
| Total stockholders' equity (deficit)   | 132,091                  | 111,414     | 100,964      | 92,643      | (13,267)    |
| <b>Other Data</b>  |                          |             |              |             |             |
| Cash flow provided by (used in):   |                          |             |              |             |             |
| Operating activities   | \$ 62,174                | \$ 58,401   | \$ 50,686    | \$ 37,716   | \$ 36,369   |
| Investing activities   | \$ (65,699)              | \$ (73,805) | \$ (113,467) | \$ (49,121) | \$ (40,169) |
| Financing activities   | \$ 3,579                 | \$ (10,150) | \$ 51,098    | \$ 55,340   | \$ 3,304    |
| Funds from operations <sup>(2)</sup>   |                          |             |              |             |             |
| Net income   | \$ 32,680                | \$ 29,227   | \$ 26,174    | \$ 19,242   | \$ 19,566   |
| Minority Interests   | 7,793                    | 7,798       | 8,105        | 8,086       | 8,070       |
| Real Estate Depreciation and Amortization  | 25,648                   | 24,197      | 21,324       | 17,838      | 17,821      |
| Gain on sale of property   | —                        | —           | (572)        | (182)       | (1,426)     |
| Funds from operations  | 66,121                   | 61,222      | 55,031       | 44,984      | 44,031      |
| Preferred dividends  | (8,000)                  | (8,000)     | (8,000)      | (1,244)     | —           |
| Funds from operations available to common shareholders                                 | \$ 58,121                | \$ 53,222   | \$ 47,031    | \$ 43,740   | \$ 44,031   |

(1) For the years 2006, 2005, 2004, 2003 and 2002, shareholders reinvested \$14,842, \$15,330, \$13,774, \$13,349 and \$12,882, respectively, in newly issued common stock by operation of the Company's dividend reinvestment plan.

(2) Funds From Operations (FFO) is a non-GAAP financial measure. See page 29 for a definition of FFO and reconciliation to Net Income.



## ◆ 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 19, discusses the Company's results of operations for the past two years. Beginning on page 23, 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 29, 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 the Annual Report on Form 10-K, including the consolidated financial statements and notes thereto, and Risk Factors included in Item 1A of the Form 10-K. Historical results set forth in Selected Financial Data and the Financial Statements 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, 2005 and 2006, the Company also acquired five grocery-anchored neighborhood shopping centers in Florida, totaling 592,000 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 U.S. generally accepted accounting principles ("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 or future 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.



## ◆ Management's Discussion & Analysis

### of Financial Condition & Results of Operations

Expense recoveries 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 revenue, 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 |              |
|------------------------|---------------------------------|------------|------------|-------------------|--------------|
|                        | 2006                            | 2005       | 2004       | 2006 to 2005      | 2005 to 2004 |
| Base rent              | \$ 110,121                      | \$ 99,448  | \$ 91,125  | 10.7%             | 9.1%         |
| Expense recoveries     | 22,636                          | 20,027     | 16,712     | 13.0              | 19.8         |
| Percentage rent        | 1,767                           | 2,057      | 1,635      | (14.1)            | 25.8         |
| Other                  | 3,454                           | 5,483      | 3,370      | (37.0)            | 62.7         |
| Total revenue          | \$ 137,978                      | \$ 127,015 | \$ 112,842 | 8.6%              | 12.6%        |

Total revenue increased 8.6% for the 2006 year compared to 2005 primarily due to (1) the contribution of operating revenue from two development properties (Broadlands Village III and Lansdowne Town Center) and two acquisition properties (Smallwood Village Center and Hunt Club Corners) placed in service during 2006 and four operating properties developed or acquired during 2005, (Kentlands Place, Palm Springs, Jamestown Place and Seabreeze Plaza) together defined as the "2006/2005 Development and Acquisition Properties" whose operating results are included in 2006's operating income but not fully in the previous year's results, which was offset in part by (2) the payment related to resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall included in 2005 other revenue. The 2006/2005 Development and Acquisition Properties contributed \$8,184,000 or 74.7% of the increase in revenue. The increase in revenue from 2005 to 2006 was

offset by the net payment related to the resolution of the Lexington Mall land use dispute of \$1,801,000 included in 2005 revenue (-16.4% of the change in revenue). Also contributing to the 2006 revenue increase were rents earned at the Company's Great Eastern Plaza, Shops at Monocacy, The Glen (impacted by a 22,000 square foot expansion completed November 2005) and Southside Plaza shopping centers, which provided increased revenue of \$736,000 or 6.7%, \$691,000 or 6.3%, \$562,000 or 5.1% and \$493,000 or 4.5%, respectively.

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,

# Management's Discussion & Analysis ♦

## of Financial Condition & Results of Operations

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 revenue. 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 revenue. 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 revenue of \$533,000 or 3.8%, \$392,000 or 2.8% and \$376,000 or 2.7%, respectively. A discussion of the components of revenue follows.

### Base rent

The \$10,673,000 increase in base rent for 2006 versus 2005 was primarily attributable (58.4% or approximately \$6,229,000) to leases in effect at the 2006/2005 Development and Acquisition Properties. Base rent was also increased by (1) the maturation of 2004 development property, Shops at Monocacy (5.4% or approximately \$577,000), (2) 22,000 square feet of new space placed in service at The Glen during 2005 (4.9% or approximately \$524,000) and (3) improved leasing at Southside Plaza (4.8% or approximately \$507,000). New leases at higher base rental rates than the predecessor leases at certain other properties accounted for the balance of the increase.

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). Rent increases associated with new leasing activity 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 \$2,609,000 increase in expense

recovery income from 2005 to 2006 was contributed by the 2006/2005 Development and Acquisition Properties (65.4% or approximately \$1,707,000). Increased expense recovery income was provided by the leasing of a large space at Great Eastern Plaza, which was not contributing expense recovery income in 2005 (10.2% or approximately \$265,000). Increased real estate taxes, insurance, repairs and utilities expenses at several of the Company's other properties were incurred and recovered from tenants.

The majority of the \$3,315,000 increase in expense recovery income from 2004 to 2005 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.

### Percentage rent

Percentage rent is rental revenue calculated on the portion of a tenant's sales revenue that exceeds a specified breakpoint. Percentage rent decreased \$290,000 in 2006 versus 2005 primarily as a result of two tenants renewing leases at Leesburg Pike (88.3% or approximately \$256,000) and Southdale (36.6% or approximately \$106,000) at higher base rents in lieu of percentage rents and timing differences in the submission of sales reports used to calculate percentage rent by a restaurant tenant at 601 Pennsylvania Avenue (37.6% or approximately \$109,000). Percentage rental income was positively impacted by new tenants in the 2006/2005 Development and Acquisition Properties (73.4% or approximately \$213,000).

The majority of the \$422,000 increase in percentage rents from 2004 to 2005 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.

### Other revenue

Other revenue consists primarily of parking revenue at three of the Office Properties, temporary lease rental income, payments associated with early termination of leases and interest income from the investment of cash balances. Other revenue decreased \$2,029,000 during



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### of Financial Condition & Results of Operations

2006 versus 2005 as a result of \$1,801,000 (88.8 % of decrease) related to resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall and decreased interest income from short-term investments (16.1% or \$327,000). Other revenue was also impacted by the collection of a lease termination fee and settlement of a rent dispute in 2005 with two former tenants at 601 Pennsylvania Avenue (12.9% or \$262,000), the negative impact of which was more than offset by increased parking revenue in the office portfolio (16.6% or \$336,000), primarily at 601 Pennsylvania Avenue where parking revenues increased compared to the prior year, when spaces were temporarily placed out of service during scheduled maintenance.

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% 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.

#### ◆ OPERATING EXPENSES

| <i>(Dollars in thousands)</i>                      | For the year ended December 31, |           |           | Percentage Change |              |
|--|---------------------------------|-----------|-----------|-------------------|--------------|
|  | 2006                            | 2005      | 2004      | 2006 to 2005      | 2005 to 2004 |
| Property operating expenses                        | \$ 16,278                       | \$ 14,724 | \$ 12,070 | 10.6%             | 22.0%        |
| Provision for credit losses                        | 400                             | 237       | 488       | 68.8              | (51.4)       |
| Real estate taxes                                  | 12,503                          | 11,040    | 9,789     | 13.3              | 12.8         |
| Interest expense and amortization of deferred debt | 32,534                          | 30,207    | 27,022    | 7.7               | 11.8         |
| Depreciation and amortization                      | 25,648                          | 24,197    | 21,324    | 6.0               | 13.5         |
| General and administrative                         | 10,142                          | 9,585     | 8,442     | 5.8               | 13.5         |
| Total operating expenses                           | \$ 97,505                       | \$ 89,990 | \$ 79,135 | 8.4%              | 13.7%        |

#### Property operating expenses

Property operating expenses consist primarily of repairs and maintenance, utilities, payroll, insurance and other property related expenses. The \$1,554,000 increase in 2006 versus 2005 property operating expenses was caused primarily by the operation of the 2006/2005 Development and Acquisition Properties (90.3% or approximately \$1,403,000). Property operating expenses increased an average of 1.1% at the Company's remaining properties compared to the prior year period.

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).

#### 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 increased \$163,000 for 2006 versus 2005 due primarily to the absence of significant credit losses experienced during 2005. The provision for credit losses is less than three tenths of one percent (0.3%) of total revenue for each period, a reflection of the relative credit quality of the Company's tenants.

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

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## of Financial Condition & Results of Operations

### Real estate taxes

The \$1,463,000 increase in real estate taxes for 2006 versus 2005 was impacted by the 2006/2005 Development and Acquisition Properties (67.0% or approximately \$980,000). In addition, several of the Company's properties received increases in assessed values during 2006, primarily properties located in the Metropolitan Washington, DC area.

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.

### Interest and amortization of deferred debt

Interest expense increased \$2,399,000 and deferred debt cost amortization decreased \$72,000 in 2006 versus 2005. Interest expense increased due to new borrowings, as the Company placed permanent 15-year fixed rate mortgages on selected 2006/2005 Development and Acquisition Properties. The increase in average outstanding borrowings of approximately \$51,000,000 resulted from financing selected 2006/2005 Development and Acquisition Properties and construction in progress (approximately \$3,538,000 increase in interest expense). Offsetting the increase in interest expense was (1) an approximately 13 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 \$638,000 decrease in interest expense), (2) interest capitalized as a cost of construction and development projects during 2006 compared to 2005 in the amount of \$3,673,000 and \$3,258,000, respectively (\$415,000 decrease in interest expense) and (3) the inclusion in 2005 interest expense of a \$92,000 prepayment premium on the refinancing of a mortgage loan in order to obtain a new 15-year loan at a lower interest rate. Deferred debt cost amortization expense was \$1,089,000 and \$1,161,000, for the 2006 and 2005 periods, respectively. The decreased expense (\$72,000) resulted primarily from the early write-off of unamortized costs incident to the refinancing of the Company's revolving credit facility during 2005.

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 2005.

### Depreciation and amortization

The \$1,451,000 increase in depreciation and amortization expense resulted primarily from the 2006/2005 Development and Acquisition Properties placed in service during 2006 and 2005.

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 when an anchor tenant(s) and resulting final development plan is identified.



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#### General and administrative

General and administrative expenses consists of payroll, administrative and other overhead expenses. The \$557,000 increase in general and administrative expenses for 2006 versus 2005 was attributable primarily to increased local and state taxes (52.2% or approximately \$291,000), increased corporate expenses related to the 2006 annual meeting of shareholders and other legal expenses related to property acquisitions (58.7% or approximately \$327,000) and the increased expense of employee health and retirement benefits (32.5% or approximately \$181,000). Also contributing to the increase in general and administrative expenses was an increase in non-cash expense related to the issue of options to the Company's officers and directors (15.4% or approximately \$86,000). The impact of the expense increases was offset in part by the write-off of abandoned Lexington Mall development costs in the 2005 Period (44.2% or \$246,000).

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).

#### Gain on Sale of Property

The Company recognized a gain on the sale of real estate of \$572,000 in 2004. There were no property dispositions in 2006 and 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.

#### ◆ 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 \$8,061,000 and \$8,007,000 at December 31, 2006 and 2005, respectively. The changes in cash and cash equivalents during the years ended December 31, 2006 and 2005 were attributable to operating, investing and financing activities, as described below.

|  | Year Ended December 31, |            |
|--|-------------------------|------------|
| <i>(Dollars in thousands)</i>                | 2006                    | 2005       |
| Cash provided by operating activities        | \$ 62,174               | \$ 58,674  |
| Cash used in investing activities            | (65,699)                | (73,805)   |
| Cash provided (used) by financing activities | 3,579                   | (10,423)   |
| Increase (decrease) in cash                  | \$ 54                   | \$(25,554) |

#### Operating Activities

Cash provided by operating activities increased \$3,500,000 to \$62,174,000 for the year ended December 31, 2006 compared to \$58,674,000 for the year ended December 31, 2005 primarily reflecting increased operating income of the 2006/2005 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 \$8,106,000 to \$65,699,000 for the year ended December 31, 2006 compared to \$73,805,000 for the year ended December 31, 2005 and primarily reflects the acquisition of properties (Smallwood Village Center and Hunt Club Corners in 2006 and Palm Springs Center, Jamestown Place and Seabreeze Plaza and land parcels at Lansdowne Town Center and New Market in 2005), the construction of new shopping center properties (Lansdowne Town Center, Broadlands Village III as well as the Ravenwood and Ashburn Village expansions in 2006 and The Glen expansion in 2005), construction in progress, tenant improvements and property capital expenditures throughout the portfolio. Tenant improvement and property capital expenditures totaled \$10,145,000 and \$9,175,000, for 2006 and 2005, respectively.

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### Financing Activities

Cash provided by financing activities for the year ended December 31, 2006 was \$3,579,000 and cash used by financing activities for the year ended December 31, 2005 was \$10,423,000. Cash provided by financing activities for the year ended December 31, 2006 primarily reflects:

- amounts borrowed from the revolving credit facility totaling \$31,000,000;
- proceeds received from two new mortgage notes payable totaling \$17,500,000; and
- \$21,054,000 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 scheduled repayment (amortization) of mortgage notes payable totaling \$13,322,000;
- the partial repayments of the revolving credit facility totaling \$6,500,000;
- distributions made to common stockholders and holders of convertible limited partnership units in the Operating Partnership during the year totaling \$37,611,000;
- distributions made to preferred stockholders during the year totaling \$8,000,000; and
- payments of \$542,000 for financing costs of two new mortgage loans during 2006.

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.

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
- \$19,283,000 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.

### 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, 2006, the Company had unfunded contractual payment obligations of approximately \$42.7 million, excluding operating obligations, due within the next 12 months. The table below specifies the total contractual payment obligations as of December 31, 2006.

| Contractual Obligations            |            |                        |           |            |               |
|------------------------------------|------------|------------------------|-----------|------------|---------------|
| (Dollars in thousands)             | Total      | Payments Due By Period |           |            |               |
|                                    |            | Less than 1 Year       | 1-3 Years | 4-5 Years  | After 5 Years |
| Notes Payable                      | \$ 522,443 | \$ 14,423              | \$ 67,136 | \$ 99,412  | \$ 341,472    |
| Operating Leases (1)               | 11,428     | 164                    | 329       | 342        | 10,593        |
| Corporate Headquarters Lease (1)   | 3,991      | 726                    | 1,518     | 1,610      | 137           |
| Development Obligations            | 7,224      | 7,224                  | —         | —          | —             |
| Contracts to acquire land (2)      | 20,170     | 20,170                 | —         | —          | —             |
| Total Contractual Cash Obligations | \$ 565,256 | \$ 42,707              | \$ 68,983 | \$ 101,364 | \$ 352,202    |

(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) As of December 31, 2006, the Company had executed several contracts to acquire land for future retail development (see Acquisitions, Redevelopments and Renovations for a discussion of one of these projects—Westview Village). All purchases are subject to the sellers' performance of certain specific closing requirements. Amounts are scheduled net of good faith deposits totaling \$1,330.

Management believes that the Company's capital resources, which at December 31, 2006 included cash balances of \$8.1 million and borrowing availability of \$113.4 million on its revolving line of credit (\$50.4 million for general corporate use and \$63.0 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 358,563 and 455,494 shares under the Plan at a weighted average discounted price of \$41.43 and \$33.66 per share during the years ended December 31, 2006 and 2005, respectively.

Additionally, the Operating Partnership issued 106,157 and 110,910 limited partnership units under a dividend reinvestment plan mirroring the Plan at a weighted average discounted price of \$37.69 and \$35.15 per unit during the years ended December 31, 2006 and 2005, respectively.

# Management's Discussion & Analysis ♦

## of Financial Condition & Results of Operations

### ♦ 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, 2006.

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, 2006 and 2005:

| Notes Payable             |               |            |               |            |
|---------------------------|---------------|------------|---------------|------------|
|                           | December 31,  |            | Interest      | Scheduled  |
| (Dollars in thousands)    | 2006          | 2005       | Rate *        | Maturity * |
| Fixed rate mortgages:     | \$ 87,307 (a) | \$ 91,203  | 8.00%         | Dec-2011   |
|                           | 123,130 (b)   | 126,637    | 7.67%         | Oct-2012   |
|                           | 11,188 (c)    | —          | 6.12%         | Jan-2013   |
|                           | 31,155 (d)    | 32,185     | 7.88%         | Jan-2013   |
|                           | 8,331 (e)     | 8,520      | 5.77%         | Jul-2013   |
|                           | 13,253 (f)    | 13,554     | 5.28%         | May-2014   |
|                           | 12,337 (g)    | 12,712     | 8.33%         | Jun-2015   |
|                           | 39,886 (h)    | 40,627     | 6.01%         | Feb-2018   |
|                           | 45,516 (i)    | 46,479     | 5.88%         | Jan-2019   |
|                           | 14,726 (j)    | 15,040     | 5.76%         | May-2019   |
|                           | 20,338 (k)    | 20,774     | 5.62%         | Jul-2019   |
|                           | 20,100 (l)    | 20,514     | 5.79%         | Sep-2019   |
|                           | 18,015 (m)    | 18,407     | 5.22%         | Jan-2020   |
|                           | 12,723 (n)    | 12,901     | 5.60%         | May-2020   |
|                           | 12,125 (o)    | 12,378     | 5.30%         | Jun-2020   |
|                           | 10,341 (p)    | —          | 5.81%         | Feb-2021   |
|                           | 6,972 (q)     | —          | 6.01%         | Aug-2021   |
| Total fixed rate          | 487,443       | 471,931    | 6.84%         | 8.5 Years  |
| Variable rate loan:       |               |            |               |            |
| Revolving credit facility | 35,000 (r)    | 10,500     | LIBOR + 1.5 % | Jan-2008   |
| Total variable rate       | 35,000        | 10,500     | 6.85%         | 1.1 Years  |
| Total notes payable       | \$ 522,443    | \$ 482,431 | 6.84%         | 8.0 Years  |

\* Interest rate and scheduled maturity data presented as of December 31, 2006. Totals computed using weighted averages.



## ◆ Management's Discussion & Analysis

### of Financial Condition & Results of Operations

- (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 \$3,896,000 was amortized during 2006.
- (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 \$3,507,000 was amortized during 2006.
- (c) The loan is collateralized by Smallwood Village Center and requires equal monthly principal and interest payments of \$71,000 based upon a 30-year amortization schedule and a final payment of \$10,071,000 at loan maturity. Principal of \$146,000 was amortized during 2006.
- (d) 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 \$1,030,000 was amortized during 2006.
- (e) 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 \$189,000 was amortized during 2006.
- (f) 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 \$301,000 was amortized during 2006.
- (g) 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 \$375,000 was amortized during 2006.
- (h) 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 \$741,000 was amortized during 2006.
- (i) The loan, consisting of two notes dated December 2003 and two notes dated February and December 2004, is currently collateralized by three shopping centers, Broadlands Village (Phases I, II & III), The Glen and Kentlands Square, and requires equal monthly principal and interest payments of \$306,000 based upon a 25-year amortization schedule and a final payment of \$28,393,000 at loan maturity. Principal of \$963,000 was amortized during 2006.
- (j) 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 \$314,000 was amortized during 2006.
- (k) 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 \$436,000 was amortized during 2006.
- (l) 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 \$414,000 was amortized during 2006.
- (m) 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 \$392,000 was amortized during 2006.
- (n) 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 \$178,000 was amortized during 2006.
- (o) 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 \$253,000 was amortized during 2006.
- (p) The loan is collateralized by Jamestown Place and requires equal monthly principal and interest payments of \$66,000 based upon a 25-year amortization schedule and a final payment of \$6,102,000 at loan maturity. Principal of \$159,000 was amortized during 2006.
- (q) The loan is collateralized by Hunt Club Corners and requires equal monthly principal and interest payments of \$42,000 based upon a 30-year amortization schedule and a final payment of \$5,018,000 at loan maturity. Principal of \$28,000 was amortized during 2006.
- (r) 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 ♦

### of Financial Condition & Results of Operations

The December 31, 2006 and 2005 depreciation adjusted cost of properties collateralizing the mortgage notes payable totaled \$508,236,000 and \$467,015,000, respectively. Notes payable at December 31, 2006 and 2005, totaling \$189,285,000 and \$169,322,000, 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, 2006, the material covenants required the Company, on a consolidated basis, to:

- limit the amount of debt so as to maintain a gross asset value, as defined in the loan agreement, in excess of liabilities of at least \$400 million plus 90% of our future net equity proceeds;
- 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;
- limit the amount of debt so that interest, scheduled principal amortization and preferred dividend coverage exceeds 1.55 to 1; and
- limit the amount of variable rate debt and debt with initial loan terms of less than 5 years to no more than 40% of total debt.

As of December 31, 2006, the Company was in compliance with all such covenants.

#### 2006 Financing Activity

The Company obtained two new fixed-rate, non-recourse financings during the first quarter of 2006. 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 27, 2006, the Company assumed the obligation of a secured mortgage obligation in conjunction with the acquisition of Smallwood Village Center. The outstanding balance on the loan was \$11,334,000 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 Company also obtained a new fixed-rate, non-recourse financing on July 12, 2006 when it closed on a new fixed-rate mortgage financing in the amount of \$7,000,000, secured by Hunt Club Corners, acquired June 1, 2006. The loan matures August 11, 2021, requires equal monthly principal and interest payments of \$42,000, based upon a 6.01% interest rate and 30-year principal amortization, and requires a final payment of \$5,018,000 at maturity.

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 loan application was approved as a commitment in March 2006. 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 during the 2007 first quarter. The Company paid a loan deposit fee of \$850,000 which is refundable at closing.

#### ♦ 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, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources.



## ◆ Management's Discussion & Analysis

### of Financial Condition & Results of Operations

#### ◆ FUNDS FROM OPERATIONS

In 2006, the Company reported Funds From Operations (FFO)<sup>1</sup> available to common shareholders (common stockholders and limited partner unitholders) of \$58,121,000 representing a 9.2% increase over 2005 FFO available to common shareholders of \$53,222,000. The following table presents a reconciliation from net income to FFO available to common shareholders for the periods indicated:

| (Dollars in thousands)                                 | For the Year Ended December 31, |           |           |           |           |
|--|---------------------------------|-----------|-----------|-----------|-----------|
|  | 2006                            | 2005      | 2004      | 2003      | 2002      |
| Net income   | \$ 32,680                       | \$ 29,227 | \$ 26,174 | \$ 19,242 | \$ 19,566 |
| Subtract:  |                                 |           |           |           |           |
| Gain on sale of property                               | —                               | —         | (572)     | (182)     | (1,426)   |
| Add:   |                                 |           |           |           |           |
| Minority interests                                     | 7,793                           | 7,798     | 8,105     | 8,086     | 8,070     |
| Real estate depreciation and amortization              | 25,648                          | 24,197    | 21,324    | 17,838    | 17,821    |
| FFO  | 66,121                          | 61,222    | 55,031    | 44,984    | 44,031    |
| Preferred dividends                                    | (8,000)                         | (8,000)   | (8,000)   | (1,244)   | --        |
| FFO available to common shareholders                   | \$ 58,121                       | \$ 53,222 | \$ 47,031 | \$ 43,740 | \$ 44,031 |
| Average shares and units used to compute FFO per share | 22,628                          | 22,003    | 21,405    | 20,790    | 20,059    |

<sup>1</sup> The National Association of Real Estate Investment Trusts (NAREIT) developed FFO as a relative non-GAAP financial measure of performance of an equity REIT in order to recognize that income-producing real estate historically has not depreciated on the basis determined under GAAP. FFO is defined by NAREIT 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 Company's 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 a indicator of the Company's operating performance, or as an alternative to cash flows as a measure of liquidity. Management considers FFO a meaningful supplemental measure of operating performance because it primarily excludes the assumption that the value of the real estate assets diminishes predictably over time (i.e. depreciation), which is contrary to what we believe occurs with our assets, and because industry analysts have accepted it as a performance measure. 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 2006 and 2005.

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### **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 the then 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 redeveloped in 2005. 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, were approximately \$22 million. The center was 93% leased at December 31, 2006.

### **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 was substantially completed in 2004. The Company's total development costs of both phases, including the land acquisition, were approximately \$22 million. The center was 100% leased at December 31, 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 site locations. Construction was substantially completed in June 2006. Development costs for this phase totaled approximately \$7.5 million. All of the new space was leased and all tenants were in occupancy at December 31, 2006.

### **The Glen**

In February 2005, the Company commenced construction of a 22,000 square foot expansion building to provide additional restaurants and small shop service space at The Glen shopping center in Prince William County, Virginia. Construction of the expansion building was substantially completed in the fall of 2005, and development costs were approximately \$4.1 million. The resulting 134,000 square foot Safeway anchored center was 98% leased at December 31, 2006.

### **Kentlands Place**

In January 2004, the Company purchased 3.4 acres of undeveloped land adjacent to its 114,000 square foot Kentlands Square shopping center in Gaithersburg, Maryland. The Company substantially completed construction of a 40,600 square foot retail/office property, comprised of 23,800 square feet of in-line retail space and 16,800 square feet of professional office suites, in early 2005. Development costs, including the land acquisition, were approximately \$8.5 million. The property was 100% leased at December 31, 2006 and includes significant retail tenants Bonefish Grill and Elizabeth Arden's Red Door Salon.

### **Briggs Chaney MarketPlace**

In April 2004, the Company acquired Briggs Chaney MarketPlace in Silver Spring, Maryland. Briggs Chaney MarketPlace is a 194,000 square foot neighborhood shopping center on Route 29 in Montgomery County, Maryland. The center, constructed in 1983, was 100% leased at December 31, 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. During 2005, the Company completed interior construction to reconfigure a portion of space vacant at acquisition, totaling approximately 11,000 square feet of leasable area, and completed construction of a façade renovation of the shopping center. Redevelopment costs totaled approximately \$1.9 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 plans to develop the parcel into a grocery-anchored neighborhood shopping center. The Company received site plan approval from Prince William County during the third quarter of 2006 to develop approximately 125,000 square feet of retail space. Approvals for an additional 35,000 square feet of commercial space are expected to be received in 2007. During the third quarter of 2006, the Company commenced site work consisting primarily of clearing, grading and site utility construction. A lease has been executed with Chevy Chase Bank for a branch to be built on a pad site, with construction expected to be completed in mid-2007. The balance of the space is being marketed to grocers and other retail businesses, with a development timetable yet to be finalized.

### **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 (metropolitan Orlando). The center was 100% leased at December 31, 2006 and was acquired for a purchase price of \$17.5 million.

## ◆ Management's Discussion & Analysis

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#### **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 \$1.5 million. Together, these parcels will accommodate a neighborhood shopping center development in excess of 120,000 square feet of leasable space. The Company has contracted to purchase one additional parcel with the intent to assemble additional acreage for further retail development near this I-70 interchange, east of Frederick, Maryland.

#### **Lansdowne Town Center**

During the first quarter of 2005, the Company received approval of a zoning submission to Loudoun County which allowed the development of a neighborhood shopping center named 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. In November 2005, the Company commenced construction of an approximately 188,000 square foot retail center. A lease was executed with Harris Teeter for a 55,000 square foot grocery store, which opened in November 2006. Construction was substantially completed during the fourth quarter of 2006, with project costs expected to total approximately \$41.5 million. The project was 85% leased as of December 31, 2006 and 45% of the space was in operation at that time (approximately 85,000 square feet of retail space). The remaining retail space (65,000 square feet) is expected to be operational by spring 2007, while the second floor office space is expected to be fully operational by fall 2007 (38,000 square feet).

#### **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 (metropolitan Orlando). The center was 100% leased at December 31, 2006 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 (metropolitan Tampa). The center was 91% leased at December 31, 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 center was 84% leased at December 31, 2006 and was acquired for a purchase price of \$17.5 million subject to the assumption of an \$11.3 million mortgage loan. The Company is planning and will seek permits for a capital improvement project to improve access to the center, reconfigure the center and upgrade the center's façade. A construction timetable has yet to be established.

#### **Ravenwood**

In January 2006, the Company commenced construction of a 7,380 square foot shop space expansion to the Giant anchored Ravenwood shopping center, located in Towson, Maryland. Construction was substantially completed in June 2006. All of the new space was leased and substantially all of the tenants were in occupancy at December 31, 2006. Development costs totaled approximately \$2.2 million.

#### **Lexington Center**

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. 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 architects to prepare conceptual designs for the shopping center's development and marketing to prospective retailers.

#### **Hunt Club Corners**

On June 1, 2006, the Company completed the acquisition of the 101,500 square foot Publix-anchored Hunt Club Corners shopping center located in Apopka, Florida (metropolitan Orlando). The center was 94% leased at December 31, 2006 and was acquired for a purchase price of \$11.1 million.



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#### Ashburn Village-Phase V

The Company completed construction during the fourth quarter of 2006 of a 10,000 square foot shop space expansion to the Ashburn Village shopping center located in Loudoun County, Virginia. The space was 100% leased at December 31, 2006. Tenants are expected to commence operations during the 1st quarter of 2007. Development costs are projected to total approximately \$2.2 million.

#### Clarendon Center

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. In June 2006, the Company obtained zoning approvals for a mixed-use development project to include up to approximately 50,000 square feet of retail space, 170,000 square feet of office space and 244 residential units. The

Company has engaged architects and engineers and is proceeding with construction documents. A development timetable has not yet been finalized.

#### Westview Village

In January 2006, the Company contracted to purchase a 10.4 acre site in the Westview development on Buckeystown Pike (MD Route 85) in Frederick, Maryland. The purchase price is \$5.0 million and the closing of this land purchase is subject to the seller's completion of certain site work. Construction documents have been completed for development of approximately 105,000 square feet of commercial space, including 60,000 square feet of retail shop space, 15,000 square feet of retail pads and 30,000 square feet of professional office space. The Company is currently marketing the space and expects to commence construction upon closing of the land acquisition in the summer of 2007.

### ♦ 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 |
| 2006               | 42               | 5      | 6,698,000            | 1,206,000 | 96.1%            | 97.3%  |
| 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%  |

The December 31, 2006 leasing percentage excludes the Lansdowne Town Center development property which was 85.0% leased. The 2006 shopping center leasing percentages decreased due to the departure of two local grocery anchors at the Belvedere and West Park shopping centers totaling 59,000 square feet. 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.

## 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, 2006, 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 33 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 32 of this Annual Report, that Saul Centers, Inc. maintained effective internal control over financial reporting as of December 31, 2006, 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, 2006, 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, 2006, 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, 2006 and 2005, the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006 of Saul Centers, Inc. and our report dated March 8, 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP  
McLean, Virginia

March 8, 2007

## 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, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. 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, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, in 2006 the Company adopted the provisions of U.S. Securities and Exchange Commission Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements," pursuant to which the Company recorded a cumulative adjustment to retained earnings as of January 1, 2006 to correct prior period misstatements in recording rental income.

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, 2006, 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, 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP  
McLean, Virginia

March 8, 2007



## ◆ Consolidated Balance Sheets

|   | December 31,<br>2006 | December 31,<br>2005 |
|---|----------------------|----------------------|
| <i>(Dollars in thousands, except per share amounts)</i>   |                      |                      |
| <b>Assets</b>   |                      |                      |
| Real estate investments   |                      |                      |
| Land  | \$ 154,047           | \$ 139,421           |
| Buildings and equipment   | 631,797              | 575,504              |
| Construction in progress  | 56,017               | 47,868               |
|   | 841,861              | 762,793              |
| Accumulated depreciation  | (214,210)            | (195,376)            |
|   | 627,651              | 567,417              |
| Cash and cash equivalents   | 8,061                | 8,007                |
| Accounts receivable and accrued income, net   | 33,248               | 23,410               |
| Deferred leasing costs, net   | 18,137               | 19,834               |
| Prepaid expenses, net   | 2,507                | 2,540                |
| Deferred debt costs, net  | 5,328                | 5,875                |
| Other assets  | 5,605                | 4,386                |
| Total assets  | \$ 700,537           | \$ 631,469           |
| <b>Liabilities</b>  |                      |                      |
| Mortgage notes payable  | \$ 487,443           | \$ 471,931           |
| Revolving credit facility outstanding   | 35,000               | 10,500               |
| Dividends and distributions payable   | 11,558               | 11,319               |
| Accounts payable, accrued expenses and other liabilities  | 16,409               | 13,679               |
| Deferred income   | 12,251               | 9,558                |
| Total liabilities   | 562,661              | 516,987              |
| Minority interests  | 5,785                | 3,068                |
| <b>Stockholders' equity</b>   |                      |                      |
| 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, 17,341,441 and 16,877,244 shares issued and outstanding, respectively | 173                  | 169                  |
| Additional paid-in capital  | 141,554              | 123,339              |
| Accumulated deficit   | (109,636)            | (112,094)            |
| Total stockholders' equity  | 132,091              | 111,414              |
| Total liabilities and stockholders' equity  | \$ 700,537           | \$ 631,469           |

The accompanying notes are an integral part of these statements.

# Consolidated Statements of Operations ◆

| (Dollars in thousands, except per share amounts)                               | For The Year Ended December 31, |           |           |
|--|---------------------------------|-----------|-----------|
|  | 2006                            | 2005      | 2004      |
| <b>Revenue</b>   |                                 |           |           |
| Base rent  | \$ 110,121                      | \$ 99,448 | \$ 91,125 |
| Expense recoveries   | 22,636                          | 20,027    | 16,712    |
| Percentage rent  | 1,767                           | 2,057     | 1,635     |
| Other  | 3,454                           | 5,483     | 3,370     |
| Total revenue  | 137,978                         | 127,015   | 112,842   |
| <b>Operating expenses</b>  |                                 |           |           |
| Property operating expenses  | 16,278                          | 14,724    | 12,070    |
| Provision for credit losses  | 400                             | 237       | 488       |
| Real estate taxes  | 12,503                          | 11,040    | 9,789     |
| Interest expense and amortization of deferred debt                             | 32,534                          | 30,207    | 27,022    |
| Depreciation and amortization of leasing costs                                 | 25,648                          | 24,197    | 21,324    |
| General and administrative   | 10,142                          | 9,585     | 8,442     |
| Total operating expenses   | 97,505                          | 89,990    | 79,135    |
| <b>Operating income before minority interests and gain on sale of property</b> | 40,473                          | 37,025    | 33,707    |
| Non-operating item: Gain on sale of property                                   | —                               | —         | 572       |
| <b>Net operating income before minority interests</b>                          | 40,473                          | 37,025    | 34,279    |
| <b>Minority interests</b>  |                                 |           |           |
| Minority share of income   | (7,793)                         | (6,937)   | (6,386)   |
| Distributions in excess of earnings  | —                               | (861)     | (1,719)   |
| Total minority interests   | (7,793)                         | (7,798)   | (8,105)   |
| <b>Net income</b>  | 32,680                          | 29,227    | 26,174    |
| Preferred dividends  | (8,000)                         | (8,000)   | (8,000)   |
| <b>Net income available to common stockholders</b>                             | \$ 24,680                       | \$ 21,227 | \$ 18,174 |
| <b>Per share net income available to common stockholders</b>                   |                                 |           |           |
| Basic  | \$ 1.45                         | \$ 1.27   | \$ 1.13   |
| Diluted  | \$ 1.43                         | \$ 1.27   | \$ 1.12   |
| <b>Distributions declared per common share outstanding</b>                     | \$ 1.68                         | \$ 1.63   | \$ 1.56   |

The accompanying notes are an integral part of these statements.

## ◆ Consolidated Statements of Stockholder's Equity

| <i>(Dollars in thousands, except per share amounts)</i>   | Preferred<br>Stock | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Total     |
|---|--------------------|-----------------|----------------------------------|------------------------|-----------|
| <b>Stockholders' equity:</b>  |                    |                 |                                  |                        |           |
| 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<br>reinvestment plan   | —                  | 5               | 14,077                           | —                      | 14,082    |
| 40,928 shares due to employee stock options<br>and directors' deferred stock plan and stock<br>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 (\$0.39 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<br>reinvestment plan   | —                  | 5               | 15,402                           | —                      | 15,407    |
| 22,308 shares due to employee stock options<br>and directors' deferred stock plan and stock<br>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 (\$0.42 per share)   | —                  | —               | —                                | (7,089)                | (7,089)   |
| Balance, December 31, 2005  | 100,000            | 169             | 123,339                          | (112,094)              | 111,414   |
| Issuance of 464,197 shares of common stock:   |                    |                 |                                  |                        |           |
| 358,563 shares due to dividend<br>reinvestment plan   | —                  | 4               | 14,838                           | —                      | 14,842    |
| 105,634 shares due to employee stock options<br>and directors' deferred stock plan and stock<br>option awards | —                  | —               | 3,377                            | —                      | 3,377     |
| Net income  | —                  | —               | —                                | 32,680                 | 32,680    |
| Cumulative effect of SAB 108 adjustment (see Note 2)  | —                  | —               | —                                | 6,551                  | 6,551     |
| Preferred stock distributions   | —                  | —               | —                                | (6,000)                | (6,000)   |
| Distributions payable preferred stock (\$50.00 per share)   | —                  | —               | —                                | (2,000)                | (2,000)   |
| Common stock distributions  | —                  | —               | —                                | (21,490)               | (21,490)  |
| Distributions payable common stock (\$0.42 per share)   | —                  | —               | —                                | (7,283)                | (7,283)   |
| Balance, December 31, 2006  | \$ 100,000         | \$ 173          | \$ 141,554                       | \$(109,636)            | \$132,091 |

The accompanying notes are an integral part of these statements.



# Consolidated Statements of Cash Flows ◆

| (Dollars in thousands)  | For the Year Ended December 31, |           |           |
|---|---------------------------------|-----------|-----------|
|   | 2006                            | 2005      | 2004      |
| <b>Cash flows from operating activities:</b>                                      |                                 |           |           |
| Net income  | \$ 32,680                       | \$ 29,227 | \$ 26,174 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                 |           |           |
| Gain on sale of property  | —                               | —         | (572)     |
| Minority interests  | 7,793                           | 7,798     | 8,105     |
| Depreciation and amortization of deferred leasing costs                           | 25,648                          | 24,197    | 21,324    |
| Amortization of deferred debt costs   | 1,089                           | 1,161     | 929       |
| Non cash compensation costs from stock grants and options                         | 1,166                           | 991       | 842       |
| Provision for credit losses   | 400                             | 237       | 488       |
| Increase in accounts receivable and accrued income                                | (3,650)                         | (2,843)   | (6,003)   |
| Increase in deferred leasing costs  | (2,256)                         | (2,940)   | (2,266)   |
| (Increase) decrease in prepaid expenses   | 33                              | (119)     | 188       |
| Increase in other assets  | (1,219)                         | (1,770)   | (355)     |
| Increase in accounts payable, accrued expenses and other liabilities              | 1,008                           | 1,425     | 1,630     |
| (Decrease) increase in deferred income  | (518)                           | 1,310     | 473       |
| Net cash provided by operating activities   | 62,174                          | 58,674    | 50,957    |
| <b>Cash flows from investing activities:</b>                                      |                                 |           |           |
| Acquisitions of real estate investments, net*                                     | (17,318)                        | (47,745)  | (78,509)  |
| Additions to real estate investments  | (10,145)                        | (9,175)   | (6,425)   |
| Additions to development and redevelopment activities                             | (38,236)                        | (16,885)  | (29,366)  |
| Proceeds from sale of asset   | —                               | —         | 833       |
| Net cash used in investing activities   | (65,699)                        | (73,805)  | (113,467) |
| <b>Cash flows from financing activities:</b>                                      |                                 |           |           |
| Proceeds from notes payable   | 17,500                          | 25,500    | 94,800    |
| Repayments on notes payable   | (13,322)                        | (20,794)  | (16,427)  |
| Proceeds from revolving credit facility   | 31,000                          | 10,500    | 33,000    |
| Repayments on revolving credit facility   | (6,500)                         | —         | (33,000)  |
| Additions to deferred debt costs  | (542)                           | (2,025)   | (1,716)   |
| Proceeds from the issuance of:  |                                 |           |           |
| Common Stock  | 17,053                          | 15,384    | 14,260    |
| Convertible limited partnership units in the Operating Partnership                | 4,001                           | 3,899     | 320       |
| Distributions to:   |                                 |           |           |
| Preferred stockholders  | (8,000)                         | (8,000)   | (7,244)   |
| Common stockholders   | (28,579)                        | (26,542)  | (25,061)  |
| Convertible limited partnership units in the Operating Partnership                | (9,032)                         | (8,345)   | (8,105)   |
| Net cash provided (used) by financing activities                                  | 3,579                           | (10,423)  | 50,827    |
| Net increase (decrease) in cash and cash equivalents                              | 54                              | (25,554)  | (11,683)  |
| Cash and cash equivalents, beginning of year                                      | 8,007                           | 33,561    | 45,244    |
| Cash and cash equivalents, end of year  | \$ 8,061                        | \$ 8,007  | \$ 33,561 |
| Supplemental disclosure of cash flow information:                                 |                                 |           |           |
| Cash paid for interest  | \$ 34,906                       | \$ 32,112 | \$ 28,682 |

\* Supplemental discussion of non-cash investing and financing activities:

The 2006 real estate acquisition costs of \$17,318 are presented exclusive of a mortgage loan assumed and a \$300 seller rent deficiency reimbursement. On January 27, 2006, the Company paid the \$17,815 acquisition cost of Smallwood Village Center by assuming an \$11,334 mortgage loan and paying cash of \$6,481. In June 2006, the Company paid \$11,137 for the cash only purchase of Hunt Club Corners. The 2005 real estate acquisition costs of \$47,745 are presented exclusive of a mortgage loan assumed. On November 30, 2005, the Company paid the \$25,912 acquisition cost of Seabreeze Plaza by assuming a \$13,579 mortgage loan and paying cash of \$12,333.

The 2004 real estate acquisition costs of \$78,509 are presented exclusive of mortgage loans assumed in the amount of \$18,025 for two of the properties acquired during the year. On February 13, 2004, the Company paid the \$17,678 acquisition cost of Boca Valley Plaza by assuming a \$9,200 mortgage loan and paying cash of \$8,478. On March 25, 2004, the Company paid the \$12,897 acquisition cost for Cruse MarketPlace by assuming an \$8,825 mortgage loan and paying cash of \$4,072.

The accompanying notes are an integral part of these statements.

## 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, purchased and redeveloped several properties in 2004, 2005 and 2006. 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 2004 and Phase III, a 22,500 square foot addition was completed in 2006. In 2005 the Company constructed a 41,000 square foot retail/office property known as Kentlands Place on a land parcel adjacent to its Kentlands Square shopping center. During the fourth quarter of 2006, the Company substantially completed construction of Lansdowne Town Center, a 188,000 square foot life-style, grocery anchored center, located in Loudoun County, Virginia (45% of the project

was in operation as of December 31, 2006). During 2004, 2005 and 2006 the Company acquired nine 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, (7) Seabreeze Plaza, 147,000 square feet, located in Palm Harbor, Florida (8) Smallwood Village Center, 198,000 square feet, located in Waldorf, Maryland and (9) Hunt Club Corners, 101,000 square feet, located in Apopka, FL. As of December 31, 2006, the Company's properties (the "Current Portfolio Properties") consisted of 42 operating shopping center properties (the "Shopping Centers"), five predominantly office operating properties (the "Office Properties") and four (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.

## 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

## Notes to Consolidated Financial Statements ◆

to these properties. A majority of the Shopping Centers are anchored by several major tenants. As of December 31, 2006, twenty-eight 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 7.2% of the total gross leasable area. Only two retail tenants, Giant Food (4.9%), a tenant at nine Shopping Centers and Safeway (3.2%), a tenant at seven Shopping Centers and one office tenant, the United States Government (3.0%), a tenant at six properties, individually accounted for more than 2.5% of the Company's total revenue for the year ended December 31, 2006.

### 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 U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from 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 or projected 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 2006, 2005 or 2004 on any of its real estate.

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 \$3,673,000, \$3,258,000 and \$3,227,000, for 2006, 2005 and 2004, 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.



## ◆ Notes to Consolidated Financial Statements

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, 2006, 2005 and 2004 was \$20,236,000, \$19,824,000 and \$17,061,000, respectively. Repairs and maintenance expense totaled \$7,364,000, \$6,329,000 and \$4,927,000, for 2006, 2005 and 2004, respectively, and is included in operating expenses in the accompanying consolidated financial statements.

### Deferred Leasing 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 \$18,137,000 and \$19,834,000, net of accumulated amortization of \$13,308,000 and \$11,392,000 as of December 31, 2006 and 2005, respectively. Amortization expense, included in depreciation and amortization in the consolidated statements of operations, totaled \$5,412,000, \$4,373,000 and \$4,263,000, for the years ended December 31, 2006, 2005 and 2004, respectively. Capitalized leasing costs consist of commissions paid to third party leasing agents as well as internal direct costs for successful leases 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, 2006 and 2005 are as follows:

| Construction in Progress |              |           |
|--------------------------|--------------|-----------|
|                          | December 31, |           |
| (In thousands)           | 2006         | 2005      |
| Clarendon Center         | \$ 20,431    | \$ 16,629 |
| Lansdowne Town Center    | 19,972       | 10,348    |
| Ashland Square           | 8,878        | 7,262     |
| Ashburn Village Phase V  | 1,846        | —         |
| Olde Forte Village       | —            | 5,667     |
| Broadlands Village III   | —            | 3,638     |
| Lexington Center         | 2,480        | 1,972     |
| Ravenwood                | —            | 607       |
| Other                    | 2,410        | 1,745     |
| Total                    | \$ 56,017    | \$ 47,868 |

As of December 31, 2006, 45% of Lansdowne Town Center's leasable area had been placed in operation (approximately 85,000 square feet of retail space). The development costs related to the area in operation have been classified to land and buildings. The costs reported in Construction in Progress above reflect the costs incurred as of December 31, 2006 for the remaining 55% of the project.

### 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 \$479,000 and \$430,000, at December 31, 2006 and 2005, respectively.

| Allowance for Doubtful Accounts |                                    |          |
|---------------------------------|------------------------------------|----------|
|                                 | For the Year Ended<br>December 31, |          |
| (In thousands)                  | 2006                               | 2005     |
| Beginning Balance               | \$ 430                             | \$ 1,125 |
| Provision for Credit Losses     | 400                                | 237      |
| Charge-offs                     | (351)                              | (932)    |
| Ending Balance                  | \$ 479                             | \$ 430   |

## Notes to Consolidated Financial Statements ◆

In addition to rents due currently, accounts receivable include \$23,341,000 and \$14,701,000, at December 31, 2006 and 2005, 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 \$213,000 and \$64,000, respectively, for tenants whose rent payment history or financial condition cast doubt upon the tenant's ability to perform under its lease obligations. See Recent Accounting Pronouncements-SAB 108 for an explanation for \$6,415,000 of the accounts receivable increase for 2006.

### 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 \$5,328,000 and \$5,875,000, net of accumulated amortization of \$4,244,000 and \$3,155,000, at December 31, 2006 and 2005, 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 U.S. generally accepted accounting principles. 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 revenue ("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.

### 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 is 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

## ◆ Notes to Consolidated Financial Statements

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 per share 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 per share 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 per share 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 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.

Effective May 1, 2006, the Compensation Committee granted options to purchase a total of 30,000 shares (all nonqualified stock options) to the twelve Company directors (the "2006 Options"). The options were immediately exercisable. The exercise price of \$40.35 per share 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 2006 Options to be \$143,400. Because the directors' options vest immediately, the entire \$143,400 was expensed as of the date of grant. The 2006 Options are due to expire April 30, 2016. (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, 2006, 203,000 shares had been credited to the directors' deferred fee accounts.



## Notes to Consolidated Financial Statements ◆

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 shares, for each of the years ended December 31, 2006, 2005 and 2004. 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 \$97,000, \$80,000, and \$71,000, for the years ended December 31, 2006, 2005 and 2004, respectively.

### Minority Interests

Saul Centers is the sole general partner of the Operating Partnership, owning a 76.2% common interest as of December 31, 2006. 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 in certain situations for 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, 2006, 2005 and 2004 the options are dilutive because the average share price of the Company's common stock exceeded the exercise prices. The treasury stock method was used to measure the effect of the dilution.

### Basic and Diluted Shares Outstanding

|  | December 31 |          |          |
|--|-------------|----------|----------|
| (In thousands)                                       | 2006        | 2005     | 2004     |
| Weighted average common shares outstanding – Basic   | 17,075      | 16,663   | 16,154   |
| Effect of dilutive options                           | 158         | 107      | 57       |
| Weighted average common shares outstanding – Diluted | 17,233      | 16,770   | 16,211   |
| Average Share Price                                  | \$ 43.04    | \$ 35.20 | \$ 30.66 |

### 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.

### 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 has evaluated the potential impact of EITF 04-5 with respect to existing agreements and has determined that the adoption of EITF 04-5, if applicable, did not have a 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." Saul Centers adopted 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 adopted FAS No. 123R using the modified prospective transition method. The Company has determined that the adoption of FAS No. 123R did not have a material impact upon (1) Income from continuing operations, (2) Net income, (3) Cash flow from operations (4) Cash flow from financing activities and (5) Basic and diluted earnings per share. The adoption of the modified prospective method did not affect the prior year period's financial statements, so there are no restated amounts resulting from the adoption of the modified prospective method.

In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 is an interpretation of FASB Statement No. 109, "Accounting for Income Taxes," and it seeks to reduce the diversity in practice associated with certain aspects of measurement and recognition in accounting for income taxes. In addition, FIN 48 requires expanded disclosure with respect to the uncertainty in income taxes and is effective as of the beginning of the 2007 reporting year. The Company believes that FIN 48 will not have a material impact on the Company's financial statements.

On September 13, 2006 the SEC staff published Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements in Current Year Financial Statements ("SAB 108"). SAB 108 addresses how the effects of a prior year uncorrected misstatement must be considered in quantifying misstatements in the current year financial statements and provides guidance on the correction of misstatements. SAB 108 offers a transition provision for correcting immaterial prior period misstatements that were uncorrected as of the beginning of the fiscal year of adoption. SAB 108 is effective for fiscal

years ending after November 15, 2006. It was the Company's policy, for leases entered into prior to 1998, to recognize rental revenue on a straight-line basis when rental payments due under leases varied, because of free rent periods or fixed rent increases (excluding those increases which approximate inflationary increases). It was the Company's policy that annual scheduled base rent increases of 3% or less were determined to approximate inflationary increases and were not recognized ratably over the life of the lease. Subsequent to 1998, the Company has annually analyzed these uncorrected misstatements and determined that the uncorrected misstatement was immaterial for all reporting periods. The Company has determined that less than 5% of its leases were not recognizing base rent on a straight-line basis and that the cumulative under-reporting of straight-line rental income related to these long term leases totaled approximately \$6,551,000. According to the provisions of SAB 108, the Company recorded an accumulated accounts receivable balance of \$6,551,000 for these leases and recorded a corresponding increase to Stockholders' Equity as of January 1, 2006. Commencing in 2006 and pursuant to the accounting for recognizing rental income on a straight-line basis, a portion of the \$6,551,000 receivable was amortized as a non-cash reduction of rental income (\$136,000 for 2006) and the remaining balance of \$6,415,000 will be amortized as a non-cash reduction of base rent over the remaining life of the affected leases.

### 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, was 97% leased at December 31, 2006 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 was 96% leased at December 31, 2006 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 was 97% leased at December 31, 2006. The center was purchased

## Notes to Consolidated Financial Statements ◆

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 194,000 square foot Safeway-anchored Briggs Chaney MarketPlace shopping center located in Silver Spring, Maryland. The center was 100% leased at December 31, 2006 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.

### **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 (metropolitan Orlando). The center was 100% leased at December 31, 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 \$1.5 million. Together, these parcels will accommodate a neighborhood shopping center development in excess of 120,000 square feet of leasable space. The Company has contracted to purchase one additional parcel with the intent to assemble additional acreage for further retail development near this I-70 interchange, east of Frederick, Maryland.

### **Lansdowne Town Center**

During the first quarter of 2005, the Company received approval of a zoning submission to Loudoun County which allowed the development of a neighborhood shopping center named 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. In November 2005, the Company commenced construction of an approximately 188,000 square foot retail center. A lease was executed with Harris Teeter for a 55,000 square foot grocery store, which opened in November 2006. Construction was substantially completed during the fourth quarter of 2006, with project costs expected to total approximately \$41.5 million. The project was 85% leased as of December 31, 2006 and 45% of the space was in operation at that time (approximately 85,000 square feet of retail space). The remaining retail space (65,000 square feet) is expected to be operational by spring 2007, while the second floor office space is expected to be fully operational by fall 2007 (38,000 square feet).

### **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 (metropolitan Orlando). The center was 100% leased at December 31, 2006 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 (metropolitan Tampa). The center was 91% leased at December 31, 2006 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.

### **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 center was 84% leased at December 31, 2006 and was acquired for a purchase price of \$17.5 million subject to the assumption of an \$11.3 million mortgage loan.

### **Hunt Club Corners**

On June 1, 2006, the Company completed the acquisition of the 101,500 square foot Publix-anchored Hunt Club Corners shopping center located in Apopka, Florida (metropolitan Orlando). The center was 94% leased at December 31, 2006 and was acquired for a purchase price of \$11.1 million.



## ◆ Notes to Consolidated Financial Statements

### 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 \$28,538,000 total cost of the operating property acquisitions in 2006 and \$58,464,000 in 2005, of which both amounts include the properties' purchase price and closing costs, a total of \$1,459,000 and \$3,523,000, was allocated as lease intangible assets and included in lease acquisition costs at December 31, 2006 and December 31, 2005, respectively. Each year's lease intangible assets are being amortized over the remaining periods of the leases acquired, a weighted average term of 22 and 13 years, for 2006 and 2005, respectively. The value of below market leases totaling \$3,211,000 and \$2,203,000, are being amortized over a weighted average term of 30 and 19 years, for 2006 and 2005, respectively, and are included in deferred income. The value of above market leases totaling \$37,000 and \$151,000, are being amortized over a weighted average term of one and 5 years, respectively, and are included as a deferred asset in accounts receivable.

As of December 31, 2006 and 2005, the gross carrying amount of lease intangible assets included in lease acquisition costs was \$10,580,000 and \$9,121,000, respectively, and accumulated amortization was \$5,680,000 and \$3,088,000, respectively. Total amortization of these assets was \$2,592,000, \$1,504,000 and \$1,456,000, for the years ended December 31, 2006, 2005 and 2004, respectively. As of December 31, 2006 and 2005, the gross carrying amount of below market lease intangible assets included in deferred income was \$6,573,000 and \$3,362,000, respectively, and accumulated amortization was \$1,019,000 and \$415,000, respectively. Total amortization of these assets was \$604,000, \$267,000 and \$136,000, for the years ended December 31, 2006, 2005 and 2004, respectively. As of December 31, 2006 and 2005, the gross carrying amount of above market lease intangible assets included in accounts receivable was \$726,000 and \$689,000, respectively, and accumulated amortization was \$457,000 and \$299,000 respectively. Total amortization of these assets was \$158,000, \$157,000 and \$137,000, for the years ended December 31, 2006, 2005 and 2004, respectively.

As of December 31, 2006, the scheduled amortization of intangible assets and deferred income related to in place leases are as follows:

| <b>Amortization of Intangible Assets and Deferred Income Related to In-place Leases</b> |                         |                     |                     |            |
|---|-------------------------|---------------------|---------------------|------------|
| <i>(In thousands)</i>   | Lease acquisition costs | Above market leases | Below market leases | Total      |
| 2007  | \$ (1,599)              | \$ (107)            | \$ 475              | \$ (1,231) |
| 2008  | (917)                   | (82)                | 374                 | (625)      |
| 2009  | (587)                   | (45)                | 338                 | (294)      |
| 2010  | (419)                   | (33)                | 314                 | (138)      |
| 2011  | (243)                   | (2)                 | 273                 | 28         |
| Thereafter  | (1,135)                 | —                   | 3,780               | 2,645      |
| Total   | \$ (4,900)              | \$ (269)            | \$ 5,554            | \$ 385     |

The results of operations of the acquired properties are included in the consolidated statements of operations as of the acquisition date.

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

The Saul Organization has a 23.8% limited partnership interest, represented by 5,416,000 convertible limited partnership units in the Operating Partnership, as of December 31, 2006. These convertible limited partnership units are convertible into shares of Saul Centers' common stock, at the option of the unit holder, on a one-for-one basis provided that, in accordance with the Saul Centers, Inc. Articles of Incorporation, the rights may not be exercised at any time that The Saul Organization beneficially owns, directly or indirectly, in the aggregate more than 39.9% of the value of the outstanding common stock and preferred stock of Saul Centers (the "Equity Securities").

The Operating Partnership issued 106,157 and 110,910 limited partnership units pursuant to the Dividend Reinvestment and Stock Purchase Plan at a weighted average discounted price of \$37.69 and \$35.15 per share during the years ended December 31, 2006 and 2005, respectively.

The impact of The Saul Organization's 23.8% 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, 2006, 2005 and 2004, were 22,628,000, 22,003,000, and 21,405,000, respectively.

### 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 \$522,443,000 at December 31, 2006, of which \$487,443,000 was fixed rate debt and \$35,000,000 was variable rate debt. At the prior year's end, notes payable 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 December 31, 2006, the Company had a \$150 million unsecured revolving credit facility with \$35,000,000 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. Based upon the terms of the facility as of December 31, 2006, the unencumbered properties support line availability of \$87,000,000 of which \$1,627,000 has been issued under a letter of credit and \$35,000,000 has been borrowed, leaving \$50,373,000 available for working capital uses. An additional \$63,000,000 could become available for funding working capital and operating property acquisitions as unencumbered properties' internal cash flow grows and operating income is provided by future unencumbered acquisitions.

Saul Centers has guaranteed a portion of one of the Partnerships' mortgage notes payable totaling \$4,500,000, the amount of which is considered a recourse obligation to Saul Centers as of December 31, 2006. 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 \$482,943,000 are non-recourse.

The Company obtained three new fixed-rate, non-recourse financings during 2006. 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 27, 2006, the Company assumed the obligation of a secured mortgage obligation in conjunction with the acquisition of Smallwood Village Center. The outstanding balance on the loan was \$11,334,000 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 Company also obtained a new fixed-rate, non-recourse financing on July 12, 2006 when it closed on a new fixed-rate mortgage financing in the amount of \$7,000,000, secured by Hunt Club Corners, acquired June 1, 2006. The loan matures August 11, 2021, requires equal monthly principal and interest payments of \$42,000, based upon a 6.01% interest rate and 30-year principal amortization, and requires a final payment of \$5,018,000 at maturity.

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 loan application was approved as a commitment in March 2006. 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 during the 2007 first quarter. The Company paid a loan deposit fee of \$850,000 which is refundable at closing.

## ◆ Notes to Consolidated Financial Statements

The following is a summary of notes payable as of December 31, 2006 and 2005:

| Notes Payable             |               |            |               |            |
|---------------------------|---------------|------------|---------------|------------|
| (Dollars in thousands)    | December 31,  |            | Interest      | Scheduled  |
|                           | 2006          | 2005       | Rate *        | Maturity * |
| Fixed rate mortgages:     | \$ 87,307 (a) | \$ 91,203  | 8.00%         | Dec-2011   |
|                           | 123,130 (b)   | 126,637    | 7.67%         | Oct-2012   |
|                           | 11,188 (c)    | –          | 6.12%         | Jan-2013   |
|                           | 31,155 (d)    | 32,185     | 7.88%         | Jan-2013   |
|                           | 8,331 (e)     | 8,520      | 5.77%         | Jul-2013   |
|                           | 13,253 (f)    | 13,554     | 5.28%         | May-2014   |
|                           | 12,337 (g)    | 12,712     | 8.33%         | Jun-2015   |
|                           | 39,886 (h)    | 40,627     | 6.01%         | Feb-2018   |
|                           | 45,516 (i)    | 46,479     | 5.88%         | Jan-2019   |
|                           | 14,726 (j)    | 15,040     | 5.76%         | May-2019   |
|                           | 20,338 (k)    | 20,774     | 5.62%         | Jul-2019   |
|                           | 20,100 (l)    | 20,514     | 5.79%         | Sep-2019   |
|                           | 18,015 (m)    | 18,407     | 5.22%         | Jan-2020   |
|                           | 12,723 (n)    | 12,901     | 5.60%         | May-2020   |
|                           | 12,125 (o)    | 12,378     | 5.30%         | Jun-2020   |
|                           | 10,341 (p)    | –          | 5.81%         | Feb-2021   |
|                           | 6,972 (q)     | –          | 6.01%         | Aug-2021   |
| Total fixed rate          | 487,443       | 471,931    | 6.84%         | 8.5 Years  |
| Variable rate loan:       |               |            |               |            |
| Revolving credit facility | 35,000 (r)    | 10,500     | LIBOR + 1.5 % | Jan-2008   |
| Total variable rate       | 35,000        | 10,500     | 6.85%         | 1.1 Years  |
| Total notes payable       | \$ 522,443    | \$ 482,431 | 6.84%         | 8.0 Years  |

\* Interest rate and scheduled maturity data presented as of December 31, 2006. 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 \$3,896,000 was amortized during 2006.
- (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 \$3,507,000 was amortized during 2006.
- (c) The loan is collateralized by Smallwood Village Center and requires equal monthly principal and interest payments of \$71,000 based upon a 30-year amortization schedule and a final payment of \$10,071,000 at loan maturity. Principal of \$146,000 was amortized during 2006.
- (d) 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 \$1,030,000 was amortized during 2006.
- (e) 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 \$189,000 was amortized during 2006.
- (f) 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 \$301,000 was amortized during 2006.
- (g) 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 \$375,000 was amortized during 2006.



## Notes to Consolidated Financial Statements ◆

- (h) 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 \$741,000 was amortized during 2006.
- (i) The loan, consisting of two notes dated December 2003 and two notes dated February and December 2004, is currently collateralized by three shopping centers, Broadlands Village (Phases I, II & III), The Glen and Kentlands Square, and requires equal monthly principal and interest payments of \$306,000 based upon a 25-year amortization schedule and a final payment of \$28,393,000 at loan maturity. Principal of \$963,000 was amortized during 2006.
- (j) 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 \$314,000 was amortized during 2006.
- (k) 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 \$436,000 was amortized during 2006.
- (l) 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 \$414,000 was amortized during 2006.
- (m) 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 \$392,000 was amortized during 2006.
- (n) 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 \$178,000 was amortized during 2006.
- (o) 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 \$253,000 was amortized during 2006.
- (p) The loan is collateralized by Jamestown Place and requires equal monthly principal and interest payments of \$66,000 based upon a 25-year amortization schedule and a final payment of \$6,102,000 at loan maturity. Principal of \$159,000 was amortized during 2006.
- (q) The loan is collateralized by Hunt Club Corners and requires equal monthly principal and interest payments of \$42,000 based upon a 30-year amortization schedule and a final payment of \$5,018,000 at loan maturity. Principal of \$28,000 was amortized during 2006.
- (r) 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, 2006 and 2005 depreciation adjusted cost of properties collateralizing the mortgage notes payable totaled \$508,236,000 and \$467,015,000, respectively. The Company's credit facility requires the Company and its subsidiaries to maintain certain financial covenants. As of December 31, 2006, the material covenants required the Company, on a consolidated basis, to:

- limit the amount of debt so as to maintain a gross asset value, as defined in the loan agreement, in excess of liabilities of at least \$400 million plus 90% of our future net equity proceeds;
- 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;
- limit the amount of debt so that interest, scheduled principal amortization and preferred dividend coverage exceeds 1.55 to 1; and
- limit the amount of variable rate debt and debt with initial loan terms of less than 5 years to no more than 40% of total debt.

As of December 31, 2006, the Company was in compliance with all such covenants.

Notes payable at December 31, 2006 and 2005, totaling \$189,285,000 and \$169,322,000, respectively, are guaranteed by members of The Saul Organization. As of December 31, 2006, the scheduled maturities of all debt including scheduled principal amortization for years ended December 31, are as follows:

| Debt Maturity Schedule |            |
|------------------------|------------|
| (In thousands)         |            |
| 2007                   | \$ 14,423  |
| 2008                   | 50,473     |
| 2009                   | 16,663     |
| 2010                   | 17,915     |
| 2011                   | 81,497     |
| Thereafter             | 341,472    |
| Total                  | \$ 522,443 |

## ◆ Notes to Consolidated Financial Statements

### Interest Expense and Amortization of Deferred Debt Costs

| (In thousands)                      | Year ended December 31, |          |          |
|-------------------------------------|-------------------------|----------|----------|
|                                     | 2006                    | 2005     | 2004     |
| Interest incurred                   | \$35,118                | \$32,304 | \$29,320 |
| Amortization of deferred debt costs | 1,089                   | 1,161    | 929      |
| Capitalized interest                | (3,673)                 | (3,258)  | (3,227)  |
| Total                               | \$32,534                | \$30,207 | \$27,022 |

## 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, 2006, 2005 and 2004, amounted to \$110,121,000, \$99,448,000 and \$91,125,000, respectively. Future contractual payments under noncancelable leases for years ended December 31, (which exclude the effect of straight-lining rents), are as follows:

### Future Contractual Payments

| (In thousands) |            |
|----------------|------------|
| 2007           | \$ 110,657 |
| 2008           | 100,279    |
| 2009           | 88,099     |
| 2010           | 76,343     |
| 2011           | 60,675     |
| Thereafter     | 300,536    |
| Total          | \$ 736,589 |

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, 2006, 2005 and 2004 amounted to \$22,636,000, \$20,027,000 and \$16,712,000, 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 \$1,767,000, \$2,057,000 and \$1,635,000, for the years ended December 31, 2006, 2005 and 2004, 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, 2006, 2005 and 2004, respectively.

The future minimum rental commitments under these ground leases are as follows:

### Ground Lease Rental Commitments

| (In thousands) | Annually  |       |       |       | Total Thereafter |
|----------------|-----------|-------|-------|-------|------------------|
|                | 2007-2008 | 2009  | 2010  | 2011  |                  |
| Beacon Center  | \$ 53     | \$ 53 | \$ 53 | \$ 57 | \$ 3,019         |
| Olney          | 51        | 52    | 56    | 56    | 4,209            |
| Southdale      | 60        | 60    | 60    | 60    | 3,365            |
| Total          | \$164     | \$165 | \$169 | \$173 | \$10,593         |

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, 2006, 2005 and 2004 were \$726,000, \$661,000 and \$621,000, respectively. Expenses arising from the lease are included in general and administrative expense (see Note 9 – Related Party Transactions).

## 8. STOCKHOLDERS' EQUITY AND MINORITY INTERESTS

The consolidated statement of operations for the year ended December 31, 2006 includes a charge for minority interests of \$7,793,000, representing The Saul Organization's share of the net income for the year. The

## Notes to Consolidated Financial Statements ◆

charge for the year ended December 31, 2005 was \$7,798,000, consisting of \$6,937,000 related to The Saul 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.

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 16 of the Company's properties. Total rental income from Chevy Chase Bank amounted to \$2,220,000, \$1,768,000 and \$1,733,000, for the years ended December 31, 2006, 2005 and 2004, respectively. As of December 31, 2006, deferred income included \$16,000 of prepaid rent and as of December 31, 2005, accounts receivable and accrued income included \$8,000 from various Chevy Chase Bank leases.

The Company utilizes Chevy Chase Bank for its various checking accounts and as of December 31, 2006 had \$7,884,000 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 \$289,000, \$266,000 and \$269,000 for 2006, 2005 and 2004, 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, 2006, 2005 and 2004, the Company was required to contribute three times the amount deferred by employees. The Company's expense, included in general and administrative expense, totaled \$106,000, \$118,000 and \$650,000, for the years ended December 31, 2006, 2005 and 2004, respectively. All amounts deferred by employees and the Company are fully vested. The cumulative unfunded liability under this plan was \$709,000 and \$570,000 at December 31, 2006 and 2005, 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 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, 2006, 2005 and 2004, which included rental payments for the Company's headquarters lease (see Note 7. Long Term Lease Obligations), totaled \$3,963,000, \$3,462,000 and \$3,139,000, 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, 2006 and 2005, accounts payable, accrued expenses and other liabilities included \$255,000 and \$305,000, respectively, represent billings due to The Saul Organization for the Company's share of these ancillary costs and expenses.

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. The parties anticipate closing on the transaction during the summer of 2007.

### 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 per share 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 per share 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 per share was the market trading price of the Company's common stock at the time of the award. The table below 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.

Effective May 1, 2006, the Compensation Committee granted options to purchase a total of 30,000 shares of nonqualified stock options to the twelve Company directors (the "2006 Options"). The options are exercisable immediately. The exercise price of \$40.35 per share was the market trading price of the Company's common stock at the time of the award.

## Notes to Consolidated Financial Statements ◆

The following table summarizes the status of the 2006, 2005 and 2004 Option grants and the value of the options expensed and included in general and administrative expense in the Consolidated Statements of Operations:

| Stock Options                           |            |            |            |            |            |            |              |
|---|------------|------------|------------|------------|------------|------------|--------------|
|   | Officers   |            |            | Directors  |            |            | Total        |
| Grant date                              | 05/23/2003 | 04/26/2004 | 05/06/2005 | 04/26/2004 | 05/06/2005 | 05/01/2006 |              |
| Total grant                             | 220,000    | 122,500    | 132,500    | 30,000     | 30,000     | 30,000     | 565,000      |
| Vested                                  | 165,000    | 61,250     | 33,125     | 30,000     | 30,000     | 30,000     | 349,375      |
| Exercised                               | 81,422     | 21,875     | 5,000      | —          | —          | —          | 108,297      |
| Forfeited                               | 7,500      | 7,500      | 11,250     | —          | —          | —          | 26,250       |
| Remaining unexercised                   | 131,078    | 93,125     | 116,250    | 30,000     | 30,000     | 30,000     | 430,453      |
| Exercise price                          | \$ 24.91   | \$ 25.78   | \$ 33.22   | \$ 25.78   | \$ 33.22   | \$ 40.35   |              |
| Volatility                              | 0.175      | 0.183      | 0.207      | 0.183      | 0.198      | 0.206      |              |
| Expected life (years)                   | 7.0        | 7.0        | 8.0        | 5.0        | 10.0       | 9.0        |              |
| Assumed yield                           | 7.00%      | 5.75%      | 6.37%      | 5.75%      | 6.91%      | 5.93%      |              |
| Risk-free rate                          | 4.00%      | 4.05%      | 4.15%      | 3.57%      | 4.28%      | 5.11%      |              |
| Total value at grant date               | \$ 332,200 | \$ 292,775 | \$ 413,400 | \$ 66,600  | \$ 71,100  | \$ 143,400 | \$ 1,319,475 |
| Expensed previous yrs                   | 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      |
| Expensed in 2006                        | 76,444     | 67,220     | 95,550     | —          | —          | 143,400    | 382,614      |
| Forfeited options                       | 11,325     | 17,925     | 35,100     | —          | —          | —          | 64,350       |
| Future expense                          | 28,431     | 84,630     | 213,750    | —          | —          | —          | 326,811      |
| Weighted average term of future expense |            |            |            |            |            |            | 1.9 yrs      |

The table below summarizes the option activity for the years 2006, 2005 and 2004:

|                            | 2006     |                        | 2005    |                        | 2004     |                        |
|----------------------------|----------|------------------------|---------|------------------------|----------|------------------------|
|                            | Shares   | Wtd Avg Exercise Price | Shares  | Wtd Avg Exercise Price | Shares   | Wtd Avg Exercise Price |
| Outstanding at January 1   | 513,125  | \$ 27.80               | 352,500 | \$ 25.29               | 220,000  | \$ 24.91               |
| Granted                    | 30,000   | 40.35                  | 162,500 | 33.22                  | 152,500  | 25.78                  |
| Exercised                  | (86,422) | 25.59                  | (1,875) | 25.78                  | (20,000) | 24.91                  |
| Expired/Forfeited          | (26,250) | 28.72                  | —       | —                      | —        | —                      |
| Outstanding December 31    | 430,453  | 29.06                  | 513,125 | 27.80                  | 352,500  | 25.29                  |
| Exercisable at December 31 | 241,078  | 29.09                  | 178,750 | 26.59                  | 65,000   | 25.31                  |

The intrinsic value of options exercised in 2006, 2005 and 2004 was \$1,871,000, \$23,000 and \$187,000, respectively. The intrinsic value of options outstanding and exercisable at year end 2006 was \$11,248,000 and \$6,293,000, respectively. The intrinsic value measures the price difference between the options' exercise price and the closing share price quoted by the New York Stock Exchange as of the date of measurement. At December 29, the final trading day of 2006, the closing share price was \$55.19. The weighted average remaining contractual life of the Company's exercisable and outstanding options is 7.5 years each as of December 31, 2006.

### 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. There were no property dispositions in 2006 or 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

## ◆ Notes to Consolidated Financial Statements

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 \$487,443,000 and \$471,931,000 carrying value at December 31, 2006 and 2005, respectively. Management estimates that the fair value of these fixed rate notes payable, assuming long term interest rates of approximately 5.96% and 5.65%, would be approximately \$504,562,000 and \$501,550,000, as of December 31, 2006 and 2005, 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 \$1.68 per share, \$1.60 per share and \$1.56 per share, during 2006, 2005 and 2004, respectively, and paid preferred stock dividends of \$2.00 per depositary share during each of the years. For the common stock dividends paid, \$1.445, \$1.520 and \$1.248 per share, represented ordinary dividend income and \$0.235, \$0.080 and \$0.312 per share, represented return of capital to the shareholders for the years 2006, 2005 and 2004, respectively. All of the preferred stock dividends paid were considered ordinary dividend income.

The following summarizes distributions paid during the years ended December 31, 2006, 2005 and 2004, and includes activity in the Plan as well as limited partnership units issued from the reinvestment of unit distributions:

|                                  | Total Distributions to |                     |                                 | Dividend Reinvestments |              |                        |
|----------------------------------|------------------------|---------------------|---------------------------------|------------------------|--------------|------------------------|
|                                  | Preferred Stockholders | Common Stockholders | Limited Partnership Unitholders | Common Stock Issued    | Units Issued | Discounted Share Price |
| <i>(Dollars in thousands)</i>    |                        |                     |                                 |                        |              |                        |
| <b>Distributions during 2006</b> |                        |                     |                                 |                        |              |                        |
| October 31                       | \$ 2,000               | \$ 7,219            | \$ 2,274                        | 126,054                | —            | \$ 47.14               |
| July 28                          | 2,000                  | 7,145               | 2,274                           | 153,298                | —            | 38.70                  |
| April 28                         | 2,000                  | 7,126               | 2,254                           | 35,807                 | 50,736       | 39.66                  |
| January 31                       | 2,000                  | 7,089               | 2,230                           | 43,404                 | 55,421       | 35.89                  |
| Total 2006                       | \$ 8,000               | \$ 28,579           | \$ 9,032                        | 358,563                | 106,157      |                        |
| <b>Distributions during 2005</b> |                        |                     |                                 |                        |              |                        |
| 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      |                        |
| <b>Distributions during 2004</b> |                        |                     |                                 |                        |              |                        |
| 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       |                        |



## Notes to Consolidated Financial Statements ◆

In December 2006, 2005 and 2004, the Board of Directors of the Company authorized a distribution of \$0.42, \$0.42 and \$0.39 per common share payable in January 2007, 2006 and 2005, to holders of record on January 17, 2006, January 17, 2005 and January 17, 2004, respectively. As a result, \$7,284,000, \$7,089,000 and \$6,396,000, were paid to common shareholders on January 31, 2007, January 31, 2006 and January 31, 2005, respectively. Also, \$2,275,000, \$2,230,000 and \$2,028,000, were paid to limited partnership unitholders on January 31, 2007, January 31, 2006 and January 31, 2005 (\$0.42, \$0.42 and \$0.39 per Operating Partnership unit), respectively. The

Board of Directors authorized preferred stock dividends of \$0.50 per depositary share, to holders of record on January 2, 2007, January 3, 2006 and January 3, 2005, respectively. As a result, \$2,000,000 was paid to preferred shareholders on January 12, 2007, January 13, 2006 and January 14, 2005, 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 2006 and 2005.

| <i>(In thousands, except per share amounts)</i>                         | 2006        |             |             |             |
|---|-------------|-------------|-------------|-------------|
|   | 1st Quarter | 2nd Quarter | 3rd Quarter | 4th Quarter |
| Revenue   | \$ 33,467   | \$ 33,748   | \$ 34,860   | \$ 35,903   |
| Operating income before minority interests and gain on sale of property | 9,509       | 9,648       | 10,328      | 10,988      |
| Net income  | 7,707       | 7,797       | 8,321       | 8,855       |
| Net income available to common shareholders                             | 5,707       | 5,797       | 6,321       | 6,855       |
| Net income available to common shareholders per share (diluted)         | 0.33        | 0.34        | 0.37        | 0.39        |
|   | 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 shareholders.                            | 4,610       | 4,871       | 5,856       | 5,890       |
| Net income available to common shareholders per share (diluted)         | 0.28        | 0.29        | 0.35        | 0.35        |

## ◆ Notes to Consolidated Financial Statements

### 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<br>Centers | Office<br>Properties | Corporate<br>and Other | Consolidated<br>Totals |
|--|---------------------|----------------------|------------------------|------------------------|
| <b>2006</b>                                      |                     |                      |                        |                        |
| Real estate rental operations:                   |                     |                      |                        |                        |
| Revenue  | \$ 101,460          | \$ 36,184            | \$ 334                 | \$137,978              |
| Expenses   | (20,172)            | (9,009)              | –                      | (29,181)               |
| Income from real estate                          | 81,288              | 27,175               | 334                    | 108,797                |
| Interest expense & amortization of deferred debt | –                   | –                    | (32,534)               | (32,534)               |
| General and administrative                       | –                   | –                    | (10,142)               | (10,142)               |
| Subtotal   | 81,288              | 27,175               | (42,342)               | 66,121                 |
| Depreciation and amortization                    | (17,646)            | (8,002)              | –                      | (25,648)               |
| Minority interests                               | –                   | –                    | (7,793)                | (7,793)                |
| Net income                                       | \$ 63,642           | \$ 19,173            | \$ (50,135)            | \$ 32,680              |
| Capital investment                               | \$ 59,679           | \$ 3,109             | \$ 2,911               | \$ 65,699              |
| Total assets                                     | \$ 539,283          | \$ 131,317           | \$ 29,937              | \$700,537              |
| <b>2005</b>                                      |                     |                      |                        |                        |
| 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 deferred debt | –                   | –                    | (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           | \$ 1,509             | \$ 1,644               | \$ 73,805              |
| Total assets                                     | \$ 467,687          | \$ 135,211           | \$ 28,571              | \$631,469              |
| <b>2004</b>                                      |                     |                      |                        |                        |
| 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 deferred debt | –                   | –                    | (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          | \$ 2,658             | \$ 1,768               | \$114,300              |
| Total assets                                     | \$ 394,674          | \$ 138,273           | \$ 50,449              | \$583,396              |

# 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

**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](http://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 2006, 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     |
| October 1, 2006 – December 31, 2006                             | \$56.99     | \$44.99 |
| July 1, 2006 – September 30, 2006                               | \$45.55     | \$38.37 |
| April 1, 2006 – June 30, 2006                                   | \$42.35     | \$35.67 |
| January 1, 2006 – March 31, 2006                                | \$43.96     | \$36.04 |
| October 1, 2005 – December 31, 2005                             | \$38.46     | \$33.82 |
| July 1, 2005 – September 30, 2005                               | \$39.48     | \$35.10 |
| April 1, 2005 – June 30, 2005                                   | \$36.41     | \$31.80 |
| January 1, 2005 – March 31, 2005                                | \$37.25     | \$32.00 |
| On March 9, 2007, the closing price was \$60.25.                |             |         |
| There were approximately 300 holders of record as of that date. |             |         |

The Annual Meeting of Shareholders will be held at 11:00 a.m., local time, on April 27, 2007, 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.)



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Bethesda, MD 20814-6522  
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Website: [www.saulcenters.com](http://www.saulcenters.com)