SAUL CENTERS INC
Form 10-Q
November 09, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

FOR QUARTER ENDED September 30, 2006

COMMISSION FILE NUMBER 1-12254

SAUL CENTERS, INC.

(Exact name of registrant as specified in its charter)

Maryland	**52-1833074**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

7501 Wisconsin Avenue, Bethesda, Maryland 20814

(Address of principal executive office) (Zip Code)

Registrant s telephone number, including area code (301) 986-6200

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirement for the past 90 days. YES x NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b 2 of the Exchange Act. (Check one):

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x

Number of shares of common stock, par value $0.01 per share outstanding as of November 9, 2006: 17,314,000

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Basis of Presentation

In the opinion of management, the accompanying consolidated financial statements reflect all adjustments necessary for the fair presentation of the financial position and results of operations of Saul Centers, Inc. for the interim periods. All such adjustments are of a normal recurring nature. These consolidated financial statements and the accompanying notes should be read in conjunction with the audited consolidated financial statements of Saul Centers, Inc. for the year ended December 31, 2005, which are included in its Annual Report on Form 10-K. The results of operations for interim periods are not necessarily indicative of results to be expected for the year.

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Saul Centers, Inc.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except per share amounts)	**September 30, 2006 (Unaudited)**	**December 31, 2005**
Assets		
Real estate investments		
Land	$ 149,863	$ 139,421
Buildings and equipment	611,585	575,504
Construction in progress	72,603	47,868
	834,051	762,793
Accumulated depreciation	(210,025)	(195,376)
	624,026	567,417
Cash and cash equivalents	7,514	8,007
Accounts receivable and accrued income, net	24,497	23,410
Deferred leasing costs, net	19,056	19,834
Prepaid expenses, net	3,961	2,540
Deferred debt costs, net	5,595	5,875
Other assets	5,090	4,386
Total assets	$ 689,739	$ 631,469
Liabilities		
Mortgage notes payable	$ 490,897	$ 471,931
Revolving credit facility outstanding	31,000	10,500
Dividends and distributions payable	11,492	11,319
Accounts payable, accrued expenses and other liabilities	18,624	13,679
Deferred income	12,684	9,558
Total liabilities	564,697	516,987
Minority interests	5,926	3,068
Stockholders equity		
Series A Cumulative Redeemable Preferred stock, 1,000,000 shares authorized and 40,000 shares issued and outstanding	100,000	100,000
Common stock, $0.01 par value, 30,000,000 shares authorized, 17,184,131 and 16,877,244 shares issued and outstanding, respectively	172	169
Additional paid-in capital	134,699	123,339
Accumulated deficit	(115,755)	(112,094)
Total stockholders equity	119,116	111,414
Total liabilities and stockholders equity	$ 689,739	$ 631,469

The accompanying notes are an integral part of these statements

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Saul Centers, Inc.

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

(Dollars in thousands, except per share amounts)	For The Three Months Ended September 30, 2006	2005	For The Nine Months Ended September 30, 2006	2005
Revenue				
Base rent	$ 27,736	$ 25,023	$ 81,826	$ 73,664
Expense recoveries	5,802	5,004	16,722	14,684
Percentage rent	326	407	924	1,418
Other	996	2,748	2,603	4,475
Total revenue	34,860	33,182	102,075	94,241
Operating expenses				
Property operating expenses	4,264	3,437	12,195	10,693
Provision for credit losses	115	50	302	183
Real estate taxes	3,129	2,830	9,175	8,170
Interest expense and amortization of deferred debt	8,145	7,525	24,236	22,549
Depreciation and amortization of leasing costs	6,463	7,162	19,239	18,309
General and administrative	2,416	2,484	7,443	7,052
Total operating expenses	24,532	23,488	72,590	66,956
Operating income before minority interests	10,328	9,694	29,485	27,285
Minority interests				
Minority share of income	(2,007)	(1,838)	(5,660)	(5,087)
Distributions in excess of earnings				(861)
Total minority interests	(2,007)	(1,838)	(5,660)	(5,948)
Net income	8,321	7,856	23,825	21,337
Preferred dividends	(2,000)	(2,000)	(6,000)	(6,000)
Net income available to common stockholders	$ 6,321	$ 5,856	$ 17,825	$ 15,337
Per share net income available to common stockholders				
Basic	$ 0.37	$ 0.35	$ 1.05	$ 0.92
Diluted	$ 0.37	$ 0.35	$ 1.04	$ 0.92
Distributions declared per common share outstanding	$ 0.42	$ 0.42	$ 1.26	$ 1.21

The accompanying notes are an integral part of these statements

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Saul Centers, Inc.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(Unaudited)

(Dollars in thousands, except per share amounts)	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Total
Stockholders equity:					
Balance, December 31, 2005	$ 100,000	$ 169	$ 123,339	$ (112,094)	$ 111,414
Issuance of 87,317 shares of common stock:					
43,404 shares due to dividend reinvestment plan		1	1,557		1,558
43,913 shares due to employee stock options and directors deferred stock plan and stock option awards			1,219		1,219
Net income				7,707	7,707
Distributions payable preferred stock ($50.00 per share)				(2,000)	(2,000)
Distributions payable common stock ($0.42 per share)				(7,126)	(7,126)
Balance, March 31, 2006	100,000	170	126,115	(113,513)	112,772
Issuance of 42,327 shares of common stock:					
35,807 shares due to dividend reinvestment plan			1,420		1,420
6,520 shares due to employee stock options and directors deferred stock plan and stock option awards			474		474
Net income				7,797	7,797
Distributions payable preferred stock ($50.00 per share)				(2,000)	(2,000)
Distributions payable common stock ($0.42 per share)				(7,143)	(7,143)
Balance, June 30, 2006	100,000	170	128,009	(114,859)	113,320
Issuance of 177,243 shares of common stock:					
153,298 shares due to dividend reinvestment plan		2	5,931		5,933
23,945 shares due to employee stock options and directors deferred stock plan and stock option awards			759		759
Net income				8,321	8,321
Distributions payable preferred stock ($50.00 per share)				(2,000)	(2,000)
Distributions payable common stock ($0.42 per share)				(7,217)	(7,217)
Balance, September 30, 2006	$ 100,000	$ 172	$ 134,699	$ (115,755)	$ 119,116

The accompanying notes are an integral part of these statements

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Saul Centers, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Dollars in thousands)	**For The Nine Months Ended September 30, 2006**	**2005**
Cash flows from operating activities:		
Net income	$ 23,825	$ 21,337
Adjustments to reconcile net income to net cash provided by operating activities:		
Minority share of income	5,660	5,948
Depreciation and amortization of leasing costs	19,239	18,309
Amortization of deferred debt costs	814	902
Non cash compensation costs from stock grants and options	944	767
Provision for credit losses	302	183
Increase in accounts receivable and accrued income	(1,352)	(1,904)
Increase in deferred leasing costs	(1,953)	(1,688)
Increase in prepaid expenses	(1,421)	(1,283)
Increase in other assets	(704)	(721)
Increase in accounts payable, accrued expenses and other liabilities	2,723	1,000
(Decrease) increase in deferred income	(85)	635
Net cash provided by operating activities	47,992	43,485
Cash flows from investing activities:		
Acquisitions of real estate investments, net*	(17,618)	(20,403)
Additions to real estate investments	(9,848)	(4,627)
Additions to development and redevelopment activities	(28,921)	(12,438)
Net cash used in investing activities	(56,387)	(37,468)
Cash flows from financing activities:		
Proceeds from notes payable	17,500	25,500
Repayments on notes payable	(9,868)	(17,730)
Proceeds from revolving credit facility	27,000	
Repayments on revolving credit facility	(6,500)	
Additions to deferred debt costs	(534)	(1,821)
Proceeds from the issuance of:		
Common Stock	10,419	11,697
Convertible limited partnership units in the Operating Partnership	4,001	1,934
Distributions to:		
Preferred stockholders	(6,000)	(6,000)
Common stockholders	(21,357)	(19,677)
Convertible limited partnership units in the Operating Partnership	(6,759)	(6,137)
Net cash provided (used) by financing activities	7,902	(12,234)
Net decrease in cash and cash equivalents	(493)	(6,217)
Cash and cash equivalents, beginning of period	8,007	33,561
Cash and cash equivalents, end of period	$ 7,514	$ 27,344

* Supplemental discussion of non-cash investing and financing activities:
The 2006 real estate acquisition costs of $17,618 are presented exclusive of a mortgage loan assumed. 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 accompanying notes are an integral part of these statements

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Saul Centers, Inc.

Notes to Consolidated Financial Statements

(Unaudited)

1. Organization, Formation and Structure

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.

Saul Centers was formed to continue and expand the shopping center business previously owned and conducted by the B.F. Saul Real Estate Investment Trust, the B.F. Saul Company, Chevy Chase Bank, F.S.B. and certain other affiliated entities, each of which is controlled by B. Francis Saul II and his family members (collectively, The Saul Organization). On August 26, 1993, members of The Saul Organization transferred to Saul Holdings Limited Partnership, a newly formed Maryland limited partnership (the Operating Partnership), and two newly formed subsidiary limited partnerships (the Subsidiary Partnerships , and collectively with the Operating Partnership, the Partnerships), shopping center and office properties, and the management functions related to the transferred properties. Since its formation, the Company has developed and purchased additional properties. The Company has developed and purchased several properties since mid year 2003. In July 2003 the Company purchased Olde Forte Village, a grocery anchored shopping center located in Fort Washington, Maryland. In November 2004 the Company completed construction of Shops at Monocacy, a grocery anchored shopping center in Frederick, Maryland, the land of which was acquired in November 2003. During the fourth quarter of 2003, the Company completed construction of Broadlands Village Phase I, an in-line retail and retail pad, grocery anchored shopping center. Phase II, a 30,000 square foot addition to the center was completed in November 2004. The Company is currently developing Phase III, a 22,000 square foot addition to the center to be completed during the 4th quarter 2006. In January 2004, the Company purchased a land parcel adjacent to its Kentlands Square shopping center, and constructed a 41,000 square foot retail/office property known as Kentlands Place. During the period from 2004 through September 30, 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, 101,500 square feet, located in Apopka, FL. As of September 30, 2006, the Company s properties (the Current Portfolio Properties) consisted of 41 operating shopping center properties (the Shopping Centers), five predominantly office operating properties (the Office Properties) and six (non-operating) development properties.

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Saul Centers, Inc.

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(Unaudited)

The Company established Saul QRS, Inc., a wholly owned subsidiary of Saul Centers, to facilitate the placement of collateralized mortgage debt in September 1997. 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.

2. Summary of Significant Accounting Policies

Nature of Operations

The Company, which conducts all of its activities through its subsidiaries, the Operating Partnership and Subsidiary Partnerships, engages in the ownership, operation, management, leasing, acquisition, renovation, expansion, development and financing of community and neighborhood shopping centers and office properties, primarily in the Washington, DC/Baltimore metropolitan area.

Because the properties are located primarily in the Washington, DC/Baltimore metropolitan area, the Company is subject to a concentration of credit risk related to these properties. A majority of the Shopping Centers are anchored by several major tenants. As of September 30, 2006, twenty-seven of the Shopping Centers were anchored by a grocery store and offer primarily day-to-day necessities and services. No single property accounted for more than 7.3% of the total gross leasable area. Only two retail tenants, Giant Food (4.8%), 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 revenues for the nine months ended September 30, 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.

Basis of Presentation

In the opinion of management, the accompanying consolidated financial statements reflect all adjustments necessary for the fair presentation of the financial position and results of operations of Saul Centers for the interim periods. All such adjustments are of a normal recurring nature. These consolidated financial statements and the accompanying notes should be read in conjunction with the audited consolidated financial statements of Saul Centers for the year ended December 31, 2005, which are included in its Annual Report on Form 10-K. The results of operations for interim periods are not necessarily indicative of results to be expected for the year.

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(Unaudited)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make certain 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 lease 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, including properties under development and land held for future development, 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 cash flows of the property over its remaining useful life, on an undiscounted basis, to the carrying amount of that property and estimated cash flows associated

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(Unaudited)

with future development expenditures. If such carrying amount is in excess of the estimated projected cash flows of the assets, the Company would recognize an impairment loss equivalent to an amount required to adjust the carrying amount to its estimated fair market value. Saul Centers adopted SFAS 144, Accounting for Impairment or Disposal of Long-Lived Assets, effective January 1, 2002. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The Company has not recognized an impairment loss 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 $2,719,000 and $2,499,000, for the nine month periods ended September 30, 2006 and 2005, respectively. In the initial rental operations of development projects, a project is considered substantially complete and available for occupancy upon completion of tenant improvements, but no later than one year from the cessation of major construction activity. Substantially completed portions of a project are accounted for as separate projects.

Depreciation is calculated using the straight-line method and estimated useful lives of 35 to 50 years for base buildings and up to 20 years for certain other improvements that extend the useful lives. In addition, we capitalize leasehold improvements when certain criteria are met, including when we supervise construction and will own the improvement. Leasehold improvements are amortized, over the shorter of the lives of the related leases or the useful life of the improvement, using the straight-line method. The depreciation component included in depreciation and amortization expense in the consolidated statements of operations, totaled $15,049,000 and $15,061,000, for the nine month periods ended September 30, 2006 and 2005, respectively. Repair and maintenance expense, included in property operating expenses for the nine month periods ended September 30, 2006 and 2005, was $5,584,000 and $4,554,000, respectively.

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 $19,056,000 and $19,834,000, net of accumulated amortization of $13,332,000 and $11,392,000, as of September 30, 2006 and December 31, 2005, respectively. Amortization expense, included in depreciation and amortization in the consolidated statements of operations, totaled $4,190,000 and $3,248,000, for the nine months ended September 30, 2006 and 2005, respectively. Deferred 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 for successful leases. 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 these costs is written-off to expense if the applicable lease is terminated prior to expiration of the initial lease term.

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(Unaudited)

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 September 30, 2006 and December 31, 2005 are as follows:

Construction in Progress

(Dollars in thousands)

	September 30, 2006	December 31, 2005
Clarendon Center	$ 18,880	$ 16,629
Lansdowne Town Center	32,177	10,348
Ashland Square	8,059	7,262
Olde Forte Village		5,667
Broadlands Village III	6,848	3,638
Lexington Center	2,380	1,972
Ravenwood		607
Ashburn Village Phase V	1,651	
Other	2,608	1,745
	$ 72,603	$ 47,868

Accounts Receivable, Accrued Income and Allowance for Doubtful Accounts

Accounts receivable primarily represent amounts currently due from tenants in accordance with the terms of the respective leases. Receivables are reviewed monthly and when, in the opinion of management, collection of the entire receivable is doubtful, revenue accrual is discontinued and an allowance for doubtful accounts is established. Accounts receivable in the accompanying financial statements are shown net of an allowance for doubtful accounts of $443,000 and $430,000, at September 30, 2006 and December 31, 2005, respectively.

In addition to rents due currently, accounts receivable include $16,403,000 and $14,701,000, at September 30, 2006 and December 31, 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 $91,000 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.

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Saul Centers, Inc.

Notes to Consolidated Financial Statements

(Unaudited)

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 or 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 amortized over the terms of the respective loans or agreements, which approximates the effective interest method. Deferred debt costs totaled $5,595,000 and $5,875,000, and are presented net of accumulated amortization of $3,969,000 and $3,155,000, at September 30, 2006 and December 31, 2005, respectively.

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 scheduled rent increases, income is recognized on a straight-line basis throughout the initial term of the lease. 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 revenues, known as percentage rent, is accrued when a tenant reports sales that exceed a specified breakpoint.

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Income Taxes

The Company made an election to be treated, and intends to continue operating so as to qualify as a REIT under the Internal Revenue Code, commencing with its taxable year ended 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 No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure. 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 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 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 authorized the Compensation Committee of the Board of Directors to grant options at an exercise price not less than the market value of the common stock on the date the option is granted. Following a May 23, 2003 grant of shares, no additional shares remained for issuance 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.

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Saul Centers, Inc.

Notes to Consolidated Financial Statements

(Unaudited)

Pursuant to the 2004 Plan, the Compensation Committee established a Deferred Compensation Plan for Directors for the benefit of its directors and their beneficiaries. The 2004 Plan replaced 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 September 30, 2006, 199,000 shares had been allocated to the directors pursuant to the deferred compensation plans.

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, as of the 2006 Annual Meeting of Shareholders and for each of the years ended December 31, 2005 and 2004, respectively. The shares were valued at the closing stock price on the dates the shares were awarded and the total value is included in general and administrative expenses for the period of the award.

Minority Interests

Saul Centers is the sole general partner of the Operating Partnership, owning a 75.9% common interest as of September 30, 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 No. 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.

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The options are currently dilutive because the average share price of the Company s common stock exceeds the exercise prices. The treasury stock method was used to measure the effect of the dilution.

Basic and Diluted Shares Outstanding

(In thousands)	Quarter ended September 30, 2006	Quarter ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
Weighted average common shares outstanding-Basic	17,118	16,733	17,008	16,604
Effect of dilutive options	148	127	144	103
Weighted average common shares outstanding-Diluted	17,266	16,860	17,152	16,707

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. Once it has been determined that a loss is probable to occur, the estimated amount of the loss is recorded in the financial statements.

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 adopted EITF 04-5 with respect to existing agreements and the adoption of EITF 04-5 did not materially impact 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

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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 is currently evaluating the impact, if any, that FIN 48 will have on the Company s financial statements.

3. Real Estate Acquired

Palm Springs Center

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

New Market

On March 3, 2005, the Company acquired a 7.1 acre parcel of land located in New Market, Maryland for a purchase price of $500,000. On September 8, 2005, the Company acquired a 28.4 acre contiguous parcel for a purchase price of $1,500,000. 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 the I-70 interchange.

Lansdowne Town Center

During the first quarter of 2005, the Company received approval of a zoning submission to Loudoun County which will allow the development of a neighborhood shopping center to be known as Lansdowne Town Center, within the Lansdowne community in northern Virginia. On March 29, 2005, the Company finalized the acquisition of an additional 4.5 acres of land to bring the total acreage of the

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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 190,000 square foot retail center. A lease was executed with Harris Teeter for a 55,000 square foot grocery store to anchor this development. Substantial completion of construction is scheduled in the fourth quarter of 2006, with project costs expected to total approximately $41.5 million. The development is currently 68% pre-leased.

Jamestown Place

On November 17, 2005, the Company completed the acquisition of the 96,000 square foot Publix-anchored Jamestown Place located in Altamonte Springs, Florida. The center is 100% leased and was acquired for a purchase price of $14.8 million.

Seabreeze Plaza

On November 30, 2005, the Company completed the acquisition of the 147,000 square foot Publix-anchored Seabreeze Plaza located in Palm Harbor, Florida. The center is 93% leased and was acquired for a purchase price of $25.9 million subject to the assumption of a $13.6 million mortgage loan. 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. The center is 84% leased and was acquired for a purchase price of $17.5 million subject to the assumption of an $11.3 million mortgage loan. The obligation assumed was treated as a non-cash acquisition in the Statement of Cash Flows. The Company has determined that the terms of the assumed mortgage did not materially differ from existing market rates and that the loan was fairly valued at acquisition.

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, FL. The center is 96% leased and was acquired for a purchase price of $11.1 million.

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

The Company accounted for the operating property acquisitions using the purchase method of accounting in accordance with SFAS No. 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.

The $17.5 million total cost of acquiring Smallwood Village Center included both the property s purchase price and closing costs. A total of $889,000 of the total cost was allocated as lease intangible assets and included in deferred leasing costs at September 30, 2006. The lease intangible assets are being amortized over the remaining periods of the leases acquired, a weighted average term of 10.0 years. The value of below market leases totaled $1,218,000 and are being amortized over a weighted average term of 15.9 years, and were recorded as deferred income at the time of acquisition. The value of above market leases totaled $37,000 and are being amortized over a weighted average term of 1.3 years, and were recorded as a deferred asset in accounts receivable at the time of acquisition. The results of operations of the acquired property are included in the consolidated statements of operations as of the acquisition date.

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The $11.1 million total cost of acquiring Hunt Club Corners included both the purchase price and closing costs. A total of $570,000 of the total cost was allocated as lease intangible assets and included in deferred leasing costs at September 30, 2006. The lease intangible assets are being amortized over the remaining periods of the leases acquired, a weighted average term of 30.2 years. The value of below market leases totaled $1,993,000 and are being amortized over a weighted average term of 34.2 years, and were recorded as deferred income at the time of acquisition. This acquisition had no above market leases. The results of operations of the acquired property are included in the consolidated statements of operations as of the acquisition date.

4. Minority Interests - Holders of Convertible Limited Partner Units in the Operating Partnership

The Saul Organization has a 24.1% limited partnership interest, represented by 5,416,000 convertible limited partnership units in the Operating Partnership, as of September 30, 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). However, the limited partnership units were not convertible as of September 30, 2006 because pursuant to the limited partnership agreement of the Operating Partnership, The Saul Organization owns in excess of 24.9% of the Company s Equity Securities.

The Operating Partnership issued 106,157 and 53,035 limited partnership units pursuant to the Dividend Reinvestment and Stock Purchase Plan at a weighted average discounted price of $37.69 and $36.46 per share during the nine month periods ended September 30, 2006 and 2005, respectively.

The impact of The Saul Organization s 24.1% 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 nine months ended September 30, 2006 and 2005, were 22,539,000 and 21,921,000, respectively.

5. Mortgage Notes Payable, Revolving Credit Facility, Interest and Amortization of Deferred Debt Costs

The Company s outstanding debt totaled $521,897,000 at September 30, 2006, of which $490,897,000 was fixed rate mortgage debt and $31,000,000 was variable rate debt outstanding on the Company s $150 million unsecured revolving credit facility. The facility provides working capital and funds for acquisitions, certain developments and redevelopments, has a three-year term expiring on January 27, 2008 and provides for an additional one-year extension at the Company s option, subject

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to the Company s satisfaction of certain conditions. Until January 27, 2007, certain or all of the lenders may, upon request by the Company and payment of certain fees, increase the revolving credit facility line by up to $50,000,000. Letters of credit may be issued under the revolving credit facility. The facility requires monthly interest payments, if applicable, at a rate of LIBOR plus a spread of 1.40% to 1.625% (determined by certain leverage tests) or upon the bank s reference rate at the Company s option.

Loan availability under the facility is determined by operating income from the Company s existing unencumbered properties. Based upon the terms of the facility, the unencumbered properties support line availability of $87,000,000, of which $1,627,000 has been issued under a letter of credit and $31,000,000 has been borrowed, leaving $54,373,000 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 September 30, 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 $486,397,000 are non-recourse.

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 $11,333,000 at settlement. The loan matures January 2013, requires equal monthly principal and interest payments of $71,000, based upon a 6.12% interest rate and 30-year principal amortization, and requires a final payment of $10,071,000 at maturity.

On July 12, 2006, the Company 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.

At December 31, 2005, the Company s outstanding debt totaled $482,431,000, of which $471,931,000 was fixed rate mortgage debt and $10,500,000 was variable rate debt outstanding on the Company s $150 million unsecured revolving credit facility. Operating income from the Company s unencumbered properties, as of December 31, 2005, supported line availability of $83,000,000 leaving $72,500,000 available for working capital uses. An additional $67,000,000 was available for funding working capital and operating property acquisitions supported by the unencumbered properties internal cash flow growth and operating income of future acquisitions.

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At September 30, 2006, the scheduled maturities of all debt, including scheduled principal amortization, for years ending December 31, were as follows:

Debt Maturity Schedule

(Dollars in thousands)	
October 1 through December 31, 2006	$ 3,459
2007	14,423
2008	46,473
2009	16,663
2010	17,915
2011	81,497
Thereafter	341,467
	$ 521,897

Interest expense and amortization of deferred debt costs for the quarter and nine months ended September 30, 2006 and 2005, respectively were as follows:

Interest Expense and Amortization of Deferred Debt Costs

(Dollars in thousands)	**Quarter ended September 30,**		**Nine months ended September 30,**	
	2006	**2005**	**2006**	**2005**
Interest incurred	$ 8,938	$ 8,088	$ 26,141	$ 24,146
Amortization of deferred debt costs	274	257	814	902
Capitalized interest	(1,067)	(820)	(2,719)	(2,499)
	$ 8,145	$ 7,525	$ 24,236	$ 22,549

6. Stockholders Equity (Deficit) and Minority Interests

The Consolidated Statement of Operations for the three months ended September 30, 2006 and September 30, 2005, includes a charge for minority interests of $2,007,000 and $1,838,000, respectively, representing The Saul Organization s limited partnership interest share of net income for each quarter. The Consolidated Statement of Operations for the nine months ended September 30, 2006 includes a charge for minority interests of $5,660,000 representing The Saul Organization s limited partnership share of net income for the nine month period. The minority interests charge for the nine months ended September 30, 2005 of $5,948,000 consists of $5,087,000 related to The Saul Organization