

SAUL CENTERS INC  
Form 10-Q  
November 09, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

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**FORM 10-Q**

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**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**

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**SAUL CENTERS, INC.**

(Exact name of registrant as specified in its charter)

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<b>Maryland</b> (State or other jurisdiction of incorporation or organization)	<b>52-1833074</b> (I.R.S. Employer Identification No.)
<b>7501 Wisconsin Avenue, Bethesda, Maryland 20814</b>  (Address of principal executive office) (Zip Code)	

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

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the 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  NO

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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  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

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**

<i>(Dollars in thousands, except per share amounts)</i>	<b>September 30, 2006 (Unaudited)</b>	<b>December 31, 2005</b>
<b>Assets</b>		
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
<b>Liabilities</b>		
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
<b>Minority interests</b>	5,926	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, 17,184,131 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)*

	For The Three Months		For The Nine Months	
<i>(Dollars in thousands, except per share amounts)</i>	Ended September 30, 2006	2005	Ended September 30, 2006	2005
<b>Revenue</b>				
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
<b>Operating expenses</b>				
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
<b>Operating income before minority interests</b>	10,328	9,694	29,485	27,285
<b>Minority interests</b>				
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)
<b>Net income</b>	8,321	7,856	23,825	21,337
Preferred dividends	(2,000)	(2,000)	(6,000)	(6,000)
<b>Net income available to common stockholders</b>	\$ 6,321	\$ 5,856	\$ 17,825	\$ 15,337
<b>Per share net income available to common stockholders</b>				
Basic	\$ 0.37	\$ 0.35	\$ 1.05	\$ 0.92
Diluted	\$ 0.37	\$ 0.35	\$ 1.04	\$ 0.92
<b>Distributions declared per common share outstanding</b>	\$ 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)*

<i>(Dollars in thousands, except per share amounts)</i>	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Total
<b>Stockholders equity:</b>					
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)*

<i>(Dollars in thousands)</i>	<b>For The Nine Months Ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
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
<b>Net cash provided by operating activities</b>	<b>47,992</b>	<b>43,485</b>
<b>Cash flows from investing activities:</b>		
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)
<b>Net cash used in investing activities</b>	<b>(56,387)</b>	<b>(37,468)</b>
<b>Cash flows from financing activities:</b>		
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)
<b>Net cash provided (used) by financing activities</b>	<b>7,902</b>	<b>(12,234)</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(493)</b>	<b>(6,217)</b>
Cash and cash equivalents, beginning of period	8,007	33,561
<b>Cash and cash equivalents, end of period</b>	<b>\$ 7,514</b>	<b>\$ 27,344</b>

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\* 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 4<sup>th</sup> 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.

Notes to Consolidated Financial Statements

(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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Saul Centers, Inc.

Notes to Consolidated Financial Statements

(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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Saul Centers, Inc.

Notes to Consolidated Financial Statements

(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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Saul Centers, Inc.

Notes to Consolidated Financial Statements

(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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Saul Centers, Inc.

Notes to Consolidated Financial Statements

(Unaudited)

**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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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		Nine months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	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's share of net income for the nine month period, and \$861,000 related to distributions to minority interests in excess of allocated net income for the nine month period.



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**7. Related Party Transactions**

Chevy Chase Bank, an affiliate of The Saul Organization, leases space in 17 of the Company's properties. Total rental income from Chevy Chase Bank amounted to \$1,575,000 and \$1,310,000, for the nine months ended September 30, 2006 and 2005, respectively.

The Company utilizes Chevy Chase Bank for its various checking and short-term investment accounts. As of September 30, 2006, approximately \$7,373,000 was held in deposit in these 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, at the discretionary amount of up to six percent of the employee's cash compensation, subject to certain limits, were \$226,000 and \$213,000, for the nine months ended September 30, 2006 and 2005, 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. The Company is required to contribute three times the amount deferred by employees. The Company's contribution totaled \$55,000 and \$17,000, for the nine months ended September 30, 2006 and 2005, respectively. All amounts deferred by employees and the Company are fully vested. The cumulative unfunded liability under this plan was \$640,000 and \$570,000 at September 30, 2006 and December 31, 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

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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 nine months ended September 30, 2006 and 2005, which included rental payments for the Company's headquarters lease, totaled \$2,793,000 and \$2,565,000, respectively. The amounts are expensed when billed and are primarily reported as general and administrative expenses in these consolidated financial statements. As of September 30, 2006 and December 31, 2005, accounts payable, accrued expenses and other liabilities included \$304,000 and \$305,000, respectively, representing billings due to The Saul Organization for the Company's share of these ancillary costs and expenses.

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. Pursuant to the above described Agreement, the participants pay 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 nine months ended September 30, 2006 and 2005 were \$527,000 and \$498,000, respectively. Expenses arising from the lease are included in general and administrative 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 within the next six months.

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**8. Stock Option Plans**

The Company has established two stock incentive plans, the 1993 plan and the 2004 plan (together, the Plans). Under the Plans, options were granted at an exercise price not less than the market value of the common stock on the date of grant and expire ten years from the date of grant. Officer options vest ratably over four years following the grant and are expensed straight-line over the vesting period. Director options vest immediately and are expensed as of the date of grant. The following table summarizes the amount and activity of each grant, the total value and variables used in the computation and the amount expensed and included in general and administrative expense in the Consolidated Statements of Operations for the quarter ended September 30, 2006:

**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	59,422	17,500	3,750				80,672
Forfeited	7,500	7,500	11,250				26,250
Remaining unexercised	153,078	97,500	117,500	30,000	30,000	30,000	458,078
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 during the nine month period ended September 30, 2006	\$ 58,513	\$ 51,161	\$ 72,638	\$	\$	\$ 143,400	\$ 325,712
Future expense	\$ 47,816	\$ 101,699	\$ 236,763	\$	\$	\$	\$ 386,278
Weighted average term of future expense							2.1 yrs

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The table below summarizes the option activity for the nine months ended September 30, 2006:

	Number of Shares	Wtd Avg Exercise Price/sh	Aggregate Intrinsic Value
Outstanding at January 1	513,125	\$ 27.80	
Granted	30,000	40.35	
Exercised	58,797	25.67	\$ 1,031,000
Expired/Forfeited	26,250	28.72	427,350
Outstanding September 30	458,078	28.84	7,402,937
Exercisable at September 30	268,703	28.71	4,377,475

The intrinsic value presented in the table above 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 September 30, 2006, the closing share price was \$45.00 and weighted average remaining contractual life of the Company's exercisable and outstanding options are both 7.7 years.

**9. 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.

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**10. Business Segments**

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

*(Dollars in thousands)*

	Shopping Centers	Office Properties	Corporate and Other	Consolidated Totals
<b>Quarter ended September 30, 2006</b>				
Real estate rental operations:				
Revenue	\$ 25,612	\$ 9,194	\$ 54	\$ 34,860
Expenses	(5,247)	(2,261)		(7,508)
Income from real estate	20,365	6,933	54	27,352
Interest expense & amortization of debt expense			(8,145)	(8,145)
General and administrative			(2,416)	(2,416)
Subtotal	20,365	6,933	(10,507)	16,791
Depreciation and amortization of leasing costs	(4,444)	(2,019)		(6,463)
Minority interests			(2,007)	(2,007)
Net income	\$ 15,921	\$ 4,914	\$ (12,514)	\$ 8,321
Capital investment	\$ 11,373	\$ 1,616	\$ 1,085	\$ 14,074
Total assets	\$ 527,955	\$ 132,604	\$ 29,180	\$ 689,739
<b>Quarter ended September 30, 2005</b>				
Real estate rental operations:				
Revenue	\$ 24,023	\$ 8,935	\$ 224	\$ 33,182
Expenses	(4,139)	(2,178)		(6,317)
Income from real estate	19,884	6,757	224	26,865
Interest expense & amortization of debt expense			(7,525)	(7,525)
General and administrative			(2,484)	(2,484)
Subtotal	19,884	6,757	(9,785)	16,856
Depreciation and amortization of leasing costs	(5,219)	(1,943)		(7,162)
Minority interests			(1,838)	(1,838)
Net income	\$ 14,665	\$ 4,814	\$ (11,623)	\$ 7,856
Capital investment	\$ 7,622	\$ 518	\$ 370	\$ 8,510
Total assets	\$ 422,433	\$ 135,735	\$ 47,094	\$ 605,262





**Table of Contents***(Dollars in thousands)*

	Shopping Centers	Office Properties	Corporate and Other	Consolidated Totals
<b>Nine months ended September 30, 2006</b>				
Real estate rental operations:				
Revenue	\$ 75,004	\$ 26,851	\$ 220	\$ 102,075
Expenses	(14,988)	(6,684)		(21,672)
Income from real estate	60,016	20,167	220	80,403
Interest expense & amortization of debt expense			(24,236)	(24,236)
General and administrative			(7,443)	(7,443)
Subtotal	60,016	20,167	(31,459)	48,724
Depreciation and amortization of leasing costs	(13,272)	(5,967)		(19,239)
Minority interests			(5,660)	(5,660)
Net income	\$ 46,744	\$ 14,200	\$ (37,119)	\$ 23,825
Capital investment	\$ 51,565	\$ 2,684	\$ 2,138	\$ 56,387
Total assets	\$ 527,955	\$ 132,604	\$ 29,180	\$ 689,739
<b>Nine months ended September 30, 2005</b>				
Real estate rental operations:				
Revenue	\$ 67,050	\$ 26,666	\$ 525	\$ 94,241
Expenses	(12,519)	(6,527)		(19,046)
Income from real estate	54,531	20,139	525	75,195
Interest expense & amortization of debt expense			(22,549)	(22,549)
General and administrative			(7,052)	(7,052)
Subtotal	54,531	20,139	(29,076)	45,594
Depreciation and amortization of leasing costs	(12,460)	(5,849)		(18,309)
Minority interests			(5,948)	(5,948)
Net income	\$ 42,071	\$ 14,290	\$ (35,024)	\$ 21,337
Capital investment	\$ 34,306	\$ 2,127	\$ 1,035	\$ 37,468
Total assets	\$ 422,433	\$ 135,735	\$ 47,094	\$ 605,262

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This section should be read in conjunction with the consolidated financial statements of the Company and the accompanying notes in Item 1. Financial Statements of this report and the more detailed information contained in our Form 10-K for the year ended December 31, 2005. Historical results and percentage relationships set forth in Item 1 and this section should not be taken as indicative of future operations of the Company. Capitalized terms used but not otherwise defined in this section, have the meanings given to them in Item 1 of this Form 10-Q.

#### Forward-Looking Statements

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements are generally characterized by terms such as believe, expect and may.

Although the Company believes that the expectations reflected in such forward-looking statements are based upon reasonable assumptions, the Company's actual results could differ materially from those given in the forward-looking statements as a result of changes in factors which include among others, the following:

risks that the Company's tenants will not pay rent;

risks related to the Company's reliance on shopping center anchor tenants and other significant tenants;

risks related to the Company's substantial relationships with members of The Saul Organization;

risks of financing, such as increases in interest rates, restrictions imposed by the Company's debt, the Company's ability to meet existing financial covenants and the Company's ability to consummate planned and additional financings on acceptable terms;

risks related to the Company's development activities;

risks that the Company's growth will be limited if the Company cannot obtain additional capital;

risks that planned and additional acquisitions or redevelopments may not be consummated, or if they are consummated, that they will not perform as expected;

risks generally incident to the ownership of real property, including adverse changes in economic conditions, changes in the investment climate for real estate, changes in real estate taxes and other operating expenses, adverse changes in governmental rules and fiscal policies, the relative illiquidity of real estate and environmental risks;

risks related to the Company's status as a REIT for federal income tax purposes, such as the existence of complex regulations relating to the Company's status as a REIT, the effect of future changes in REIT requirements as a result of new legislation and the adverse consequences of the failure to qualify as a REIT; and

such other risks as described in Item 1A of our Form 10-K for the year ended December 31, 2005



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### General

The following discussion is based primarily on the consolidated financial statements of the Company, as of September 30, 2006 and for the three and nine month periods ended September 30, 2006.

### Critical Accounting Policies

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

#### *Real Estate Investments*

Real estate investment properties are stated at historic cost basis less depreciation. Management believes that these assets have generally appreciated in value and, accordingly, the aggregate current value exceeds their aggregate net book value and also exceeds the value of the Company's liabilities as reported in these financial statements. Because these financial statements are prepared in conformity with GAAP, they do not report the current value of the Company's real estate assets. The purchase price of real estate assets acquired is allocated between land, building and in-place acquired leases based on the relative fair values of the components at the date of acquisition. Base 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, including properties under development and land held for future development, the Company assesses an 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 with future development expenditures. 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.

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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.

### *Deferred leasing 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. 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. Such activities include evaluating prospective tenants' financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating lease terms, preparing lease documents and closing transactions.

### *Revenue Recognition*

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

### *Allowance for Doubtful Accounts - Current and Deferred Receivables*

Accounts receivable primarily represent amounts 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. 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.

**Table of Contents***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**Quarter ended September 30, 2006 compared to quarter ended September 30, 2005**Revenue

<i>(Dollars in thousands)</i>	Quarters ended September 30,		2006 to 2005 Change	
	2006	2005	\$	%
Base rent	\$ 27,736	\$ 25,023	\$ 2,713	10.8%
Expense recoveries	5,802	5,004	798	15.9%
Percentage rent	326	407	(81)	-19.9%
Other	996	2,748	(1,752)	-63.8%
<b>Total revenue</b>	<b>\$ 34,860</b>	<b>\$ 33,182</b>	<b>\$ 1,678</b>	<b>5.1%</b>

Total revenue increased 5.1% in the quarter ended September 30, 2006 ( 2006 Quarter ) compared to the comparative prior year's quarter ( 2005 Quarter ). The revenue increase for the 2006 Quarter resulted primarily from the operations of a newly developed property and several acquisition properties whose operating results are included in the current quarter but not fully in the comparative prior year's results. The development property (Kentlands Place) and the acquisition properties (Jamestown Place, Seabreeze Plaza, Smallwood Village Center and Hunt Club Corners) together defined as the Development and Acquisition Properties, contributed \$2,041,000 of the revenue increase. Improved operating results at the remaining properties contributed \$1,608,000 of the quarter over quarter revenue growth. These increases were offset by the reduction in other income related to the resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall in 2005 (\$1,801,000) and reduced interest income (\$170,000). A discussion of the components of revenue follows.

*Base rent.* The increase in base rent for the 2006 Quarter versus the 2005 Quarter was primarily attributable (58.4% or approximately \$1,584,000) to leases in effect at the Development and Acquisition Properties. The lease-up of space at Shops at Monocacy, The Glen, Olde Forte Village, and Southside Plaza (20.0% or approximately \$542,000) substantially accounted for the balance of the increase.

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*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 increase in expense recovery income was contributed by the Development and Acquisition Properties (52.5% or approximately \$419,000). The balance of the increase (47.5% or approximately \$379,000) resulted from billings to tenants for their share of increased real estate tax expense and property operating expenses throughout the remainder of the operating properties.

*Percentage rent.* Percentage rent is rental revenue calculated on the portion of a tenant's sales revenue that exceeds a specified breakpoint. Percentage rent for the 2006 Quarter decreased due to the conversion of percentage rent to base rent upon the renewal of a lease with a tenant at Leesburg Pike of approximately \$87,000, slightly offset by net increases in percentage rent at several other properties.

*Other revenue.* Other revenue consists primarily of parking revenue at three of the Office Properties, temporary leases, payments associated with early termination of leases and interest income from the investment of cash balances. Other revenue decreased during the 2006 Quarter versus the 2005 Quarter as a result of net proceeds received upon the resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall during the 2005 Quarter (\$1,801,000) and to a lesser extent, decreased interest income from short-term investments (\$170,000). The overall decrease in other revenue was mitigated in part by increased lease termination payments received in the 2006 Quarter (\$170,000) and increased parking revenue at the Company's office properties (\$39,000).

**Operating Expenses***(Dollars in thousands)*

	Quarters ended September 30,		2006 to 2005 Change	
	2006	2005	\$	%
Property operating expenses	\$ 4,264	\$ 3,437	\$ 827	24.1%
Provision for credit losses	115	50	65	130.0%
Real estate taxes	3,129	2,830	299	10.6%
Interest expense and amortization of deferred debt expense	8,145	7,525	620	8.2%
Depreciation and amortization of leasing costs	6,463	7,162	(699)	-9.8%
General and administrative	2,416	2,484	(68)	-2.7%
<b>Total operating expenses</b>	<b>\$ 24,532</b>	<b>\$ 23,488</b>	<b>\$ 1,044</b>	<b>4.4%</b>

Increases in operating expenses resulted primarily from operating and financing the Development and Acquisition Properties and to a lesser extent, nominal expense increases to operate the balance of Company's Current Portfolio Properties.

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*Property operating expenses.* Property operating expenses consist of repairs and maintenance, utilities, payroll, insurance and other property related expenses. The majority of the property operating expense increase was contributed by the Development and Acquisition Properties (54.1% or approximately \$447,000). The balance of the property operating expense increase (45.9% or approximately \$380,000), primarily resulted from increased repair and maintenance expense (\$452,000) partially offset by reduced property insurance expense (\$91,000).

*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 totals approximately three tenths of one percent (0.3%) of total revenue for the 2006 Quarter and one and a half tenths of one percent (0.15%) for the 2005 Quarter (0.15%), a reflection of the relative credit quality of the Company's tenants.

*Real estate taxes.* The increase in real estate taxes for the 2006 Quarter versus the 2005 Quarter was largely impacted by the Development and Acquisition Properties (72.6% or approximately \$217,000). The balance of the increase represents an approximately 3.6% quarter over quarter increase in real estate taxes for the remainder of the Company's Current Portfolio Properties.

*Interest and amortization of deferred debt expense.* Interest expense increased in the 2006 Quarter versus the 2005 Quarter due to increased borrowing for the Development and Acquisition Properties. The increase in average outstanding borrowings of approximately \$54,600,000 (\$28,700,000 fixed rate and \$25,900,000 variable rate line of credit borrowing) resulted from financing the Development and Acquisition Properties and construction in progress (approximately \$955,000 increase in interest expense). Offsetting the increase in interest expense was an approximately 10 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 \$133,000 decrease in interest expense). Interest was capitalized as a cost of construction and development projects during the 2006 and 2005 Quarters in the amounts of \$1,067,000 and \$820,000, respectively (approximately \$247,000 decrease in interest expense). Deferred debt cost amortization was \$274,000 and \$257,000, for the 2006 and 2005 Quarters, respectively (approximately \$17,000 increase).

*Depreciation and amortization of leasing costs.* The decrease in depreciation and amortization of leasing costs resulted primarily from the acceleration of depreciation expense during the 2005 Quarter related to the shortened useful life of vacant buildings at Lexington Mall, exclusive of the former 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 (\$1,515,000) offset by increased depreciation and amortization of leasing costs for the Development and Acquisition Properties placed in service during the preceding twelve months.

*General and administrative.* General and administrative expenses consist of payroll, administrative and other overhead expenses. The decrease in general and administrative expenses for the 2006 Quarter versus the 2005 Quarter was primarily attributable to the write-off of abandoned redevelopment costs associated with the Lexington Mall (\$246,000) offset in part by increased corporate and other legal expenses related to property acquisitions (\$123,000) and the payment of increased local and state taxes (\$42,000).



**Table of Contents****Nine months ended September 30, 2006 compared to nine months ended September 30, 2005****Revenue***(Dollars in thousands)*

	Nine months ended September 30,		2006 to 2005 Change	
	2006	2005	\$	%
Base rent	\$ 81,826	\$ 73,664	\$ 8,162	11.1%
Expense recoveries	16,722	14,684	2,038	13.9%
Percentage rent	924	1,418	(494)	-34.8%
Other	2,603	4,475	(1,872)	-41.8%
<b>Total revenue</b>	<b>\$ 102,075</b>	<b>\$ 94,241</b>	<b>\$ 7,834</b>	<b>8.3%</b>

Total revenue increased 8.3% in the nine month period ended September 30, 2006 ( 2006 Period ) compared to the comparative prior year nine month period ( 2005 Period ), resulting primarily due to the operations of (1) the Development and Acquisition Properties and (2) Palm Springs Center acquired in March 2005 (the YTD Development and Acquisition Properties ) whose operating results are included in the current period but not fully in the comparative prior year period s results. These properties contributed \$6,005,000 of the revenue increase. Improved operating results at the remaining properties contributed \$3,931,000 of the period over period revenue growth. These increases were offset by the decrease in other income related to the Lexington Mall land use settlement during the 2005 Period (\$1,801,000) and decreased interest income (\$301,000). A discussion of the components of revenue follows.

*Base rent.* The increase in base rent for the 2006 Period versus the 2005 Period was primarily attributable (57.3% or approximately \$4,678,000) to leases in effect at the YTD Development and Acquisition Properties. The lease-up of space at Shops at Monocacy, The Glen, Olde Forte Village, Great Eastern Plaza, and Southside Plaza (26.1% or approximately \$2,134,000) 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 increase in expense recovery income was contributed by the YTD Development and Acquisition Properties (60.2% or approximately \$1,226,000). The balance of the increase (39.8% or approximately \$812,000) resulted from billings to tenants for their share of increased real estate tax expense and property operating expenses throughout the remainder of the operating properties.

*Percentage rent.* Percentage rent is rental revenue calculated on the portion of a tenant s sales revenue that exceeds a specified breakpoint. Percentage rent for the 2006 Period decreased due to timing differences in the submission of sales reports used to calculate percentage rent by a tenant at 601 Pennsylvania Avenue (40.3% or approximately \$199,000) and the conversion of percentage rent to base rent upon the renewal of a lease with a tenant at Leesburg Pike (39.5% or approximately \$195,000).

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*Other revenue.* Other revenue consists primarily of parking revenue at three of the Office Properties, temporary leases, payments associated with early termination of leases and interest income from the investment of cash balances. Other revenue decreased during the 2006 Period versus the 2005 Period as a result of net proceeds received upon the resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall during the 2005 Period (\$1,801,000) and to a lesser extent, decreased interest income from short-term investments (\$301,000). The overall decrease in other revenue was mitigated in part by increased parking revenue at the Company's office properties in the 2006 Period (\$301,000), resulting primarily from the temporary curtailment of available parking spaces at 601 Pennsylvania Avenue while the parking deck was being refurbished during the prior year period.

**Operating Expenses***(Dollars in thousands)*

	Nine months ended September 30,		2006 to 2005 Change	
	2006	2005	\$	%
Property operating expenses	\$ 12,195	\$ 10,693	\$ 1,502	14.0%
Provision for credit losses	302	183	119	65.0%
Real estate taxes	9,175	8,170	1,005	12.3%
Interest expense and amortization of deferred debt expense	24,236	22,549	1,687	7.5%
Depreciation and amortization of leasing costs	19,239	18,309	930	5.1%
General and administrative	7,443	7,052	391	5.5%
<b>Total operating expenses</b>	<b>\$ 72,590</b>	<b>\$ 66,956</b>	<b>\$ 5,634</b>	<b>8.4%</b>

Increases in operating expenses resulted primarily from operating and financing the YTD Development and Acquisition Properties and to a lesser extent, nominal expense increases to operate the balance of Company's Current Portfolio Properties.

*Property operating expenses.* Property operating expenses consist of repairs and maintenance, utilities, payroll, insurance and other property related expenses. The majority of the increase in property operating expenses was contributed by the YTD Development and Acquisition Properties (71.0% or approximately \$1,066,000) and hurricane related repair expenses at Boca Valley Plaza (5.2% or approximately \$78,000). These expense increases were partially offset by reduced operating expenses at the Company's Lexington Mall (10.9% or approximately \$163,000), where all but pad spaces have been taken out of operation in order to redevelop the shopping center. The balance of the property operating expense increase, (31.2% or approximately \$468,000), resulted from increased repair and maintenance expense (\$437,000) at the remaining Current Portfolio Properties.

*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 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.

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*Real estate taxes.* The increase in real estate taxes was impacted by the YTD Development and Acquisition Properties (62.6% or approximately \$629,000). The balance of the increase represents an approximately 4.7% period over period increase in real estate taxes for the remainder of the operating properties.

*Interest and amortization of deferred debt expense.* Interest expense increased in the 2006 Period versus the 2005 Period due to increased borrowing for the YTD Development and Acquisition Properties. The increase in average outstanding borrowings of approximately \$49,000,000 (\$31,000,000 fixed rate and \$18,000,000 variable rate line of credit borrowing) resulted from financing the YTD Development and Acquisition Properties and construction in progress (approximately \$2,590,000 increase in interest expense). Offsetting the increase in interest expense was an approximately 14 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 \$530,000 decrease in interest expense). Interest was capitalized as a cost of construction and development projects during the 2006 and 2005 Periods in the amounts of \$2,719,000 and \$2,499,000, respectively (approximately \$220,000 decrease in interest expense). Deferred debt cost amortization was \$814,000 and \$902,000, for the 2006 and 2005 Periods, respectively (approximately \$88,000 decrease). The decrease in deferred debt cost amortization resulted primarily from the write-off of unamortized debt costs in 2005 when the Company refinanced its revolving credit facility and a mortgage loan in order to obtain a new 15-year loan at a lower interest rate. The Company also paid a \$92,000 prepayment premium to retire the original mortgage loan.

*Depreciation and amortization of leasing costs.* The increase in depreciation and amortization of leasing costs expense resulted primarily from the YTD Development and Acquisition Properties placed in service during the 2005 and 2006 Periods. The increase was limited \$1,515,000 by the acceleration of depreciation expense during the 2005 Period related to the shortened useful life of vacant buildings at Lexington Mall, exclusive of the former 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.

*General and administrative.* General and administrative expenses consist of payroll, administrative and other overhead expenses. General and administrative expenses increased for the 2006 Period versus the 2005 Period despite the write-off of abandoned Lexington Mall development costs in the 2005 Period (-62.9% or \$246,000). Offsetting this period over period expense decline was increased local and state taxes (65.7% or \$257,000) and increased corporate expenses related to the 2006 annual meeting of shareholders and other legal expenses related to property acquisitions (46.3% 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 (24.6% or approximately \$96,000).

**Table of Contents****Liquidity and Capital Resources**

Cash and cash equivalents were \$7,514,000 and \$27,344,000 at September 30, 2006 and 2005, respectively. The Company's cash flow is affected by its operating, investing and financing activities, as described below.

<i>(dollars in thousands)</i>	<b>Nine months ended September 30,</b>	
	<b>2006</b>	<b>2005</b>
Cash provided by operating activities	\$ 47,992	\$ 43,485
Cash used in investing activities	(56,387)	(37,468)
Cash provided (used) by financing activities	7,902	(12,234)
Decrease in cash	\$ (493)	\$ (6,217)

*Operating Activities*

Cash provided by operating activities represents 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 includes property acquisitions, developments, redevelopments, tenant improvements and other property capital expenditures. Investing activities for 2006 primarily reflect the acquisition of properties (Smallwood Village Center and Hunt Club Corners), the development and construction costs of new properties (Lansdowne Towne Center, Broadlands Village III, Ashburn Village V, Ashland Square and Clarendon Center), and the construction costs of redevelopments (Ravenwood). Investing activities for 2005 primarily reflect the acquisition of properties (Palm Springs Center, Lansdowne Town Center land and New Market land), the construction costs of new developments (Kentlands Place), and the construction costs of redevelopments (Olde Forte Village, Briggs Chaney MarketPlace and the Glen).

*Financing Activities*

Cash provided by financing activities for the period ended September 30, 2006 primarily reflects:

Proceeds of \$17,500,000 received from mortgage notes payable originated during the period;

Proceeds of \$27,000,000 from borrowings on the revolving credit facility;

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Proceeds of \$10,419,000 received from the issuance of common stock from the exercise of employee stock options and shares issued under the dividend reinvestment program; and

Proceeds of \$4,001,000 received from the issuance of convertible limited partnership interests in the Operating Partnership; which was substantially offset by:

the repayment of borrowings on mortgage notes payable totaling \$9,868,000;

repayments of \$6,500,000 on the revolving credit facility;

distributions to common stockholders during the period totaling \$21,357,000;

distributions to holders of convertible limited partnership units in the Operating Partnership during the period totaling \$6,759,000;

distributions made to preferred stockholders during the period totaling \$6,000,000; and

payment of \$534,000 for financing costs of new mortgage loans.

Cash used by financing activities for the period ended September 30, 2005 primarily reflects:

the repayment of mortgage note payable borrowings totaling \$17,730,000;

distributions to common stockholders during the period totaling \$19,677,000;

distributions to holders of convertible limited partnership units in the Operating Partnership during the period totaling \$6,137,000;

distributions made to preferred stockholders during the period totaling \$6,000,000; and

payments of \$1,821,000 for financing costs of the revolving credit facility and mortgage notes payable; which was partially offset by:

Proceeds of \$25,500,000 received from mortgage notes payable originated during the period;

Proceeds of \$11,697,000 received from the issuance of common stock from the exercise of employee stock options and shares issued under the dividend reinvestment program; and

Proceeds of \$1,934,000 received from the issuance of convertible limited partnership interests in the Operating Partnership;



**Table of Contents***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 Internal Revenue 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 and its existing line of credit. The Company anticipates that any additional property acquisitions and developments in the next 12 months will be funded with future long-term secured and unsecured debt and the public or private issuance of common or preferred equity or units, each of which may be initially funded with our existing line of credit.

Long-term liquidity requirements consisted primarily of obligations under our long-term debt and dividends paid to our preferred shareholders. The Company anticipates that long-term liquidity requirements will also include amounts required for property acquisitions and developments. The Company expects to meet long-term liquidity requirements through cash provided from operations, long-term secured and unsecured borrowings, private or public offerings of debt or equity securities and proceeds from the sales 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.

As of September 30, 2006, the scheduled maturities, including scheduled principal amortization, of all debt for years ended December 31, are 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

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Management believes that the Company's capital resources, which at September 30, 2006 included cash balances of approximately \$7.5 million and borrowing availability of \$54.4 million on its revolving line of credit, will be sufficient to meet its liquidity needs for the foreseeable future. The Company may also borrow an additional \$63.0 million on its revolving credit line for funding working capital and operating property acquisitions as unencumbered properties' internal cash flow grows and operating income is provided by future unencumbered acquisitions.

### *Preferred Stock Issue*

The Company has preferred stock outstanding of 4,000,000 depositary shares, each representing 1/100th of a share of 8% Series A Cumulative Redeemable Preferred Stock. The depositary shares may be redeemed, in whole or in part, at the \$25.00 per depositary share liquidation preference at the Company's option on or after November 5, 2008. The depositary shares pay an annual dividend of \$2.00 per share, equivalent to 8% of the \$25.00 per depositary share liquidation preference. 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 and Stock Purchase 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 232,509 and 347,361 shares under the Plan at a weighted average discounted price of \$38.33 and \$33.56 per share, during the nine month periods ended September 30, 2006 and 2005, respectively.

Additionally, the Operating Partnership issued 106,157 and 53,035 limited partnership units under a dividend reinvestment plan mirroring the 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.



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**Capital Strategy and Financing Activity**

As a general policy, the Company intends to maintain a ratio of its total debt to total asset value of 50% or less and to actively manage the Company's leverage and debt expense on an ongoing basis in order to maintain prudent coverage of fixed charges. Asset value is the aggregate fair market value of the Current Portfolio Properties and any subsequently acquired properties as reasonably determined by management by reference to the properties' aggregate cash flow. Given the Company's current debt level, it is management's belief that the ratio of the Company's debt to total asset value was below 50% as of September 30, 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 Company maintains a \$150 million unsecured revolving credit facility. The facility is intended to provide working capital and funds for acquisitions, certain developments and redevelopments. The credit facility has a three-year term expiring January 27, 2008 and provides for an additional one-year extension at the Company's option, subject to the Company's satisfaction of certain conditions. Until January 27, 2007, certain or all of the lenders may, upon request by the Company and payment of certain fees, increase the revolving credit facility line by up to \$50,000,000. Letters of credit may be issued under the revolving credit facility. The 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. As of September 30, 2006, \$31,000,000 was outstanding under the facility. The facility requires the Company and its subsidiaries to maintain certain financial covenants. As of September 30, 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;

limit the amount of debt as a percentage of gross asset value, as defined in the loan agreement, to less than 60% (leverage ratio);

limit the amount of debt so that interest coverage will exceed 2.1 to 1 on a trailing four quarter basis; and

limit the amount of debt so that interest, scheduled principal amortization and preferred dividend coverage exceeds 1.55 to 1.

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As of September 30, 2006, the Company was in compliance with all such covenants.

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

**Table of Contents****Funds From Operations**

For the quarter and nine months ended September 30, 2006, the Company reported Funds From Operations (FFO)<sup>(1)</sup> available to common shareholders of \$14,791,000 and \$42,724,000, representing a 0.4% decrease and 7.9% increase over the comparative 2005 Period's FFO available to common shareholders, respectively. The following table presents a reconciliation from net income to FFO available to common stockholders for the periods indicated:

**Funds From Operations Reconciliation**

<i>(Amounts in thousands)</i>	Quarter ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Net income	\$ 8,321	\$ 7,856	\$ 23,825	\$ 21,337
Add:				
Depreciation & amortization of real property	6,463	7,162	19,239	18,309
Minority interests	2,007	1,838	5,660	5,948
FFO	16,791	16,856	48,724	45,594
Subtract:				
Preferred stock dividends	(2,000)	(2,000)	(6,000)	(6,000)
FFO available to common stockholders	\$ 14,791	\$ 14,856	\$ 42,724	\$ 39,594
Average shares & units used to compute FFO per share	22,683	22,096	22,539	21,921

- (1) 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 an 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

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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, development, 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, Lexington Center and Clarendon Center. The following describes the acquisition, development, redevelopment and renovation activities of the Company in 2004, 2005 and the nine months ended September 30, 2006.

*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 has recently redeveloped. 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. Construction at Olde Forte Village was substantially completed during the second quarter of 2005. The center was 94% leased at September 30, 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 the fourth quarter of 2004. The Company's total development costs of both phases, including the land acquisition, were approximately \$22 million. The center was 100% leased at September 30, 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. Leases have been executed for 100% of the new shop space. Construction was substantially completed in June 2006. Development costs for this phase are estimated to total approximately \$7.5 million. All tenants are projected to be in occupancy by year end 2006.

*The Glen*

In February 2005, the Company commenced construction of a 22,000 square foot expansion building at The Glen shopping center in Prince William County, Virginia. The existing 120,000 square foot Safeway anchored center is 100% leased and this expansion will

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provide additional restaurants and small shop service space. Construction of the expansion building was substantially completed in the fall of 2005, and development costs were approximately \$4.1 million. All of the new space is leased and all tenants are in occupancy.

*Shops at Monocacy*

In November 2003, the Company acquired 13 acres of undeveloped land in Frederick, Maryland at the southeast corner of Maryland Route 26 and Monocacy Boulevard. Construction commenced in early December 2003 of a 105,000 square foot shopping center anchored by a 57,000 square foot Giant grocery store. The Company's total development costs, including the land acquisition, were approximately \$22.3 million. Construction was completed and Giant opened for business during October 2004. The property was 100% leased at September 30, 2006.

*Kentlands Place*

In January 2004, the Company purchased 3.4 acres of undeveloped land adjacent to its 109,000 square foot Kentlands Square shopping center in Gaithersburg, Maryland. The Company substantially completed construction of a 41,300 square foot retail/office property, comprised of 24,400 square feet of in-line retail space and 16,900 square feet of professional office suites, in early 2005. Development costs, including the land acquisition, total approximately \$8.5 million. The property was 100% leased at September 30, 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 197,000 square foot neighborhood shopping center on Route 29 in Montgomery County, Maryland. The center, constructed in 1983, was 100% leased at September 30, 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 the vacant space 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 preliminary 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 early 2007. During the third quarter, the Company commenced site work consisting primarily of clearing, grading and site utility construction. A lease has been executed with a bank for a branch to be built on a pad site. Construction is 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.

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*Palm Springs Center*

On March 3, 2005, the Company completed the acquisition of the 126,000 square foot Albertson's anchored Palm Springs Center located in Altamonte Springs, Florida. The center was 100% leased at September 30, 2006 and was acquired for a purchase price of \$17.5 million.

*New Market*

On March 3, 2005, the Company acquired a 7.1 acre parcel of land located in New Market, Maryland for a purchase price of \$500,000. On September 8, 2005, the Company acquired a 28.4 acre contiguous parcel for a purchase price of \$1,500,000. 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 will allow the development of a neighborhood shopping center to be known as Lansdowne Town Center, within the Lansdowne Community in northern Virginia. On March 29, 2005, the Company finalized the acquisition of an additional 4.5 acres of land to bring the total acreage of the development parcel to 23.4 acres (including the 18.9 acres acquired in 2002). The additional purchase price was approximately \$1.0 million. 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, and tenants commenced opening for business in October 2006.

*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.

*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 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.

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*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. All of this space has been leased, and construction was substantially completed in June 2006. Tenants commenced occupancy during the third quarter of 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. During the past several years, the Company has not been renewing small shop leases pending settlement with the adjacent owner. The departure of Dillard's now leaves the mall vacant and combined with the new land use agreement, expands potential redevelopment options. The Company has engaged land planners and assembled a team to proceed with conceptual designs.

*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 (metropolitan Orlando, FL). The center is 96% leased and was acquired for a purchase price of \$11.1 million.

*Ashburn Village-Phase V*

The Company is constructing a 10,000 square foot shop space expansion to the Ashburn Village shopping center located in Loudoun County, Virginia. The space is 50% pre-leased and substantial completion of construction is scheduled in the fourth quarter of 2006. 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.

**Table of Contents****Portfolio Leasing Status**

The following chart sets forth certain information regarding the operating portfolio for the periods ended September 30, 2006 and 2005, respectively.

As of	Total Properties		Total Square Footage		Percent Leased	
	Shopping Centers	Office	Shopping Centers	Office	Shopping Centers	Office
September 30, 2006	41	5	6,477,000	1,206,000	96.9%	97.3%
2005	37	5	6,071,000	1,206,000	97.3%	96.8%

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company is exposed to certain financial market risks, the most predominant being fluctuations in interest rates. Interest rate fluctuations are monitored by management as an integral part of the Company's overall risk management program, which recognizes the unpredictability of financial markets and seeks to reduce the potentially adverse effect on the Company's results of operations. The Company does not enter into financial instruments for trading purposes.

The Company is exposed to interest rate fluctuations primarily as a result of its variable rate debt used to finance the Company's development and acquisition activities and for general corporate purposes. As of September 30, 2006, the Company had variable rate indebtedness totaling \$31,000,000. Interest rate fluctuations will affect the Company's annual interest expense on its variable rate debt. If the interest rate on the Company's variable rate debt instruments outstanding at September 30, 2006 had been one percent higher, our annual interest expense relating to these debt instruments would have increased by \$310,000, based on those balances. Interest rate fluctuations will also affect the fair value of the Company's fixed rate debt instruments. As of September 30, 2006, the Company had fixed rate indebtedness totaling \$490,897,000. If interest rates on the Company's fixed rate debt instruments at September 30, 2006 had been one percent higher, the fair value of those debt instruments on that date would have decreased by approximately \$26,000,000.

**Item 4. Controls and Procedures**

The Company maintains disclosure controls and procedures that are designed to provide reasonable assurance that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chairman and Chief Executive Officer, its Senior Vice President-Chief Financial Officer, Secretary and Treasurer, and its Vice President-Chief Accounting Officer as appropriate, to



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allow timely decisions regarding required disclosure based closely on the definition of disclosure controls and procedures in Rule 13a-15(e) promulgated under the Exchange Act. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

The Company carried out an evaluation under the supervision and with the participation of the Company's management, including its Chairman and Chief Executive Officer, its Senior Vice President-Chief Financial Officer, Secretary and Treasurer, and its Vice President-Chief Accounting Officer of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of September 30, 2006. Based on the foregoing, the Company's Chairman and Chief Executive Officer, its Senior Vice President-Chief Financial Officer, Secretary and Treasurer and its Vice President-Chief Accounting Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level as of September 30, 2006.

During the three months ended September 30, 2006, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

None

**Item 1A. Risk Factors**

The Company has no material updates to Item 1A. Risk Factors, as presented in the 2005 Annual Report of the Company on Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

132,890 shares were acquired at a price of \$38.70 per share, by B. Francis Saul II, the Company's Chairman of the Board and Chief Executive Officer, and various individuals and entities affiliated with Mr. Saul, through participation in the Company's Dividend Reinvestment and Stock Purchase Plan for the July 29, 2006 dividend distribution. In addition, 66,100 shares were acquired in open market purchases at an average cost of \$44.27 per share during the period August 11 through September 29, 2006.

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**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

3. (a) First Amended and Restated Articles of Incorporation of Saul Centers, Inc. filed with the Maryland Department of Assessments and Taxation on August 23, 1994 and filed as Exhibit 3.(a) of the 1993 Annual Report of the Company on Form 10-K are hereby incorporated by reference. Articles of Amendment to the First Amended and Restated Articles of Incorporation of Saul Centers, Inc., filed with the Maryland Department of Assessments and Taxation on May 28, 2004 and filed as Exhibit 3.(a) of the June 30, 2004 Quarterly Report of the Company is hereby incorporated by reference. Articles of Amendment to the First Amended and Restated Articles of Incorporation of Saul Centers, Inc., filed with the Maryland Department of Assessments and Taxation on May 26, 2006 and filed as Exhibit 3.(a) of the Company's Current Report on Form 8-K filed May 30, 2006 is hereby incorporated by reference.
- (b) Amended and Restated Bylaws of Saul Centers, Inc. as in effect at and after August 24, 1993 and as of August 26, 1993 and filed as Exhibit 3.(b) of the 1993 Annual Report of the Company on Form 10-K are hereby incorporated by reference. The First Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary I Limited Partnership, the Second Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary I Limited Partnership, the Third Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary I Limited Partnership and the Fourth Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary I Limited Partnership as filed as Exhibit 3.(b) of the 1997 Annual Report of the Company on Form 10-K are hereby incorporated by reference.

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- (c) Articles Supplementary to First Amended and Restated Articles of Incorporation of the Company, dated October 30, 2003, filed as Exhibit 2 to the Company's Current Report on Form 8-A dated October 31, 2003, is hereby incorporated by reference.
- 4. (a) Deposit Agreement, dated November 5, 2003, among the Company, Continental Stock Transfer & Trust Company, as Depositary, and the holders of depositary receipts, each representing 1/100th of a share of 8% Series A Cumulative Redeemable Preferred Stock of Saul Centers, Inc. and filed as Exhibit 4 to the Registration Statement on Form 8-A on October 31, 2003 is hereby incorporated by reference.
- (b) Form specimen of receipt representing the depositary shares, each representing 1/100th of a share of 8% Series A Cumulative Redeemable Preferred Stock of Saul Centers, Inc. and included as part of Exhibit 4 to the Registration Statement on Form 8-A on October 31, 2003 is hereby incorporated by reference.
- 10. (a) First Amended and Restated Agreement of Limited Partnership of Saul Holdings Limited Partnership filed as Exhibit No. 10.1 to Registration Statement No. 33-64562 is hereby incorporated by reference. The First Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Holdings Limited Partnership, the Second Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Holdings Limited Partnership, and the Third Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Holdings Limited Partnership filed as Exhibit 10.(a) of the 1995 Annual Report of the Company on Form 10-K is hereby incorporated by reference. The Fourth Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Holdings Limited Partnership filed as Exhibit 10.(a) of the March 31, 1997 Quarterly Report of the Company is hereby incorporated by reference. The Fifth Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Holdings Limited Partnership filed as Exhibit 4.(c) to Registration Statement No. 333-41436, is hereby incorporated by reference. The Sixth Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Holdings Limited Partnership filed as Exhibit 10.(a) of the September 30, 2003 Quarterly Report of the Company on Form 10-Q is hereby incorporated by reference. The Seventh Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Holdings Limited Partnership filed as Exhibit 10.(a) of the December 31, 2003 Annual Report of the Company on Form 10-K is hereby incorporated by reference.
- (b) First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary I Limited Partnership and Amendment No. 1 thereto filed as Exhibit 10.2 to Registration Statement No. 33-64562 are hereby incorporated by reference. The Second Amendment to the First Amended

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and Restated Agreement of Limited Partnership of Saul Subsidiary I Limited Partnership, the Third Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary I Limited Partnership and the Fourth Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary I Limited Partnership as filed as Exhibit 10.(b) of the 1997 Annual Report of the Company on Form 10-K are hereby incorporated by reference.

- (c) First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary II Limited Partnership and Amendment No. 1 thereto filed as Exhibit 10.3 to Registration Statement No. 33-64562 are hereby incorporated by reference. The Second Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary II Limited Partnership filed as Exhibit 10.(c) of the June 30, 2001 Quarterly Report of the Company is hereby incorporated by reference.
- (d) Property Conveyance Agreement filed as Exhibit 10.4 to Registration Statement No. 33-64562 is hereby incorporated by reference.
- (e) Management Functions Conveyance Agreement filed as Exhibit 10.5 to Registration Statement No. 33-64562 is hereby incorporated by reference.
- (f) Registration Rights and Lock-Up Agreement filed as Exhibit 10.6 to Registration Statement No. 33-64562 is hereby incorporated by reference.
- (g) Exclusivity and Right of First Refusal Agreement filed as Exhibit 10.7 to Registration Statement No. 33-64562 is hereby incorporated by reference.
- (h) Agreement of Assumption dated as of August 26, 1993 executed by Saul Holdings Limited Partnership and filed as Exhibit 10.(i) of the 1993 Annual Report of the Company on Form 10-K is hereby incorporated by reference.
- (i) Deferred Compensation Plan for Directors, dated as of April 23, 2004 and filed as Exhibit 10.(k) of the June 30, 2004 Quarterly Report of the Company is hereby incorporated by reference.
- (j) Loan Agreement dated as of November 7, 1996 by and among Saul Holdings Limited Partnership, Saul Subsidiary II Limited Partnership and PFL Life Insurance Company, c/o AEGON USA Realty Advisors, Inc., filed as Exhibit 10.(t) of the March 31, 1997 Quarterly Report of the Company, is hereby incorporated by reference.
- (k) Promissory Note dated as of January 10, 1997 by and between Saul Subsidiary II Limited Partnership and The Northwestern Mutual Life Insurance Company, filed as Exhibit 10.(z) of the March 31, 1997 Quarterly Report of the Company, is hereby incorporated by reference.

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- (l) Loan Agreement dated as of October 1, 1997 between Saul Subsidiary I Limited Partnership as Borrower and Nomura Asset Capital Corporation as Lender filed as Exhibit 10.(p) of the 1997 Annual Report of the Company on Form 10-K is hereby incorporated by reference.
  - (m) Guaranty dated as of August 30, 2002 by and between Saul Centers, Inc. as Guarantor and U.S. Bank National Association, as administrative agent and sole lead arranger for itself and other financial institutions, the Lenders, as filed as Exhibit 10.(p) of the September 30, 2002 Quarterly Report of the Company, is hereby incorporated by reference.
  - (n) Amended and Restated Promissory Note dated January 13, 2003 by and between Saul Holdings Limited Partnership as Borrower and Metropolitan Life Insurance Company as lender, as filed as Exhibit 10.(p) of the December 31, 2002 Annual Report of the Company on Form 10-K, is hereby incorporated by reference.
  - (o) Revolving Credit Agreement, dated as of January 28, 2005, by and among Saul Holdings Limited Partnership as Borrower; U.S. Bank National Association, as Administrative Agent and Sole Lead Arranger; Wells Fargo Bank, National Association, as Syndication Agent; and U.S. Bank National Association, Wells Fargo Bank, National Association, Compass Bank, Sovereign Bank and First Horizon Bank, as Lenders, as filed as Exhibit 10.(q) of the Current Report of the Company on Form 8-K filed with the Commission on February 9, 2005, is hereby incorporated by reference.
  - (p) Guaranty, dated as of February 1, 2005, by and between Saul Centers, Inc., as Guarantor, and U.S. Bank National Association, as Administrative Agent and Sole Lead Arranger for itself and other financial institutions as Lenders, as filed as Exhibit 10.(r) of the Current Report of the Company on Form 8-K filed with the Commission on February 9, 2005, is hereby incorporated by reference.
  - (q) The Saul Centers, Inc. 2004 Stock Plan, as filed as Annex A to the Proxy Statement of the Company for its 2004 Annual Meeting of Stockholders, is hereby incorporated by reference.
  - (r) Form of Director Stock Option Agreements, as filed as Exhibit 10.(j) of the September 30, 2004 Quarterly Report of the Company, is hereby incorporated by reference.
  - (s) Form of Officer Stock Option Grant Agreements, as filed as Exhibit 10.(k) of the September 30, 2004 Quarterly Report of the Company, is hereby incorporated by reference.
31. Rule 13a-14(a)/15d-14(a) Certifications of Chief Executive Officer and Chief Financial Officer (filed herewith)

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32. Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer (filed herewith).  
99. Schedule of Portfolio Properties

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SAUL CENTERS, INC.  
(Registrant)

Date: November 9, 2006

/s/ B. Francis Saul III  
B. Francis Saul III, President

Date: November 9, 2006

/s/ Scott V. Schneider  
Scott V. Schneider  
Senior Vice President, Chief Financial Officer  
(principal financial officer)

Date: November 9, 2006

/s/ Kenneth D. Shoop  
Kenneth D. Shoop  
Vice President, Chief Accounting Officer  
(principal accounting officer)