

SAUL CENTERS INC  
Form 10-Q  
August 06, 2012  
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**United States**  
**Securities and Exchange Commission**  
Washington, D.C. 20549

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the**  
**Securities Exchange Act of 1934**

For The Quarterly Period Ended June 30, 2012

Commission File Number 1-12254

**SAUL CENTERS, INC.**

(Exact name of registrant as specified in its charter)

Maryland  
(State or other jurisdiction of incorporation or organization)

52-1833074  
(I.R.S. Employer Identification No.)

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7501 Wisconsin Avenue, Bethesda, Maryland 20814

(Address of principal executive office) (Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

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 July 31, 2012: 19.8 million.

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**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**Basis of Presentation**

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments necessary for the fair presentation of the financial position and results of operations of Saul Centers, Inc. for the interim periods have been included. 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, 2011, 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.

**Table of Contents****Saul Centers, Inc.****CONSOLIDATED BALANCE SHEETS***(Dollars in thousands,**except per share amounts)*

	<b>June 30, 2012 (Unaudited)</b>	<b>December 31, 2011</b>
<b>Assets</b>		
Real estate investments		
Land	\$ 324,190	\$ 324,183
Buildings and equipment	1,097,208	1,092,533
Construction in progress	1,150	1,129
	1,422,548	1,417,845
Accumulated depreciation	(340,579)	(326,397)
	1,081,969	1,091,448
Cash and cash equivalents	37,251	12,323
Accounts receivable and accrued income, net	38,671	39,094
Deferred leasing costs, net	26,074	25,876
Prepaid expenses, net	1,437	3,868
Deferred debt costs, net	8,267	7,090
Other assets	7,401	12,870
<b>Total assets</b>	<b>\$ 1,201,070</b>	<b>\$ 1,192,569</b>
<b>Liabilities</b>		
Mortgage notes payable	\$ 833,095	\$ 823,871
Revolving credit facility payable		8,000
Dividends and distributions payable	13,335	13,219
Accounts payable, accrued expenses and other liabilities	26,712	22,992
Deferred income	31,156	31,281
<b>Total liabilities</b>	<b>904,298</b>	<b>899,363</b>
<b>Stockholders' equity</b>		
Preferred stock, 1,000,000 shares authorized:		
Series A Cumulative Redeemable, 40,000 shares issued and outstanding	100,000	100,000
Series B Cumulative Redeemable, 31,731 shares issued and outstanding	79,328	79,328
Common stock, \$0.01 par value, 30,000,000 shares authorized, 19,614,717 and 19,291,845 shares issued and outstanding, respectively	196	193
Additional paid-in capital	230,002	217,829
Accumulated deficit	(150,351)	(144,659)
Accumulated other comprehensive loss	(3,536)	(2,863)
<b>Total Saul Centers, Inc. stockholders' equity</b>	<b>255,639</b>	<b>249,828</b>
Noncontrolling interest	41,133	43,378
<b>Total stockholders' equity</b>	<b>296,772</b>	<b>293,206</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 1,201,070</b>	<b>\$ 1,192,569</b>

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The Notes to Financial Statements are an integral part of these statements.

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Saul Centers, Inc.

**CONSOLIDATED STATEMENTS OF OPERATIONS***(Unaudited)**(Dollars in thousands,**except per share amounts)*

	<b>For The Three Months Ended June 30,</b>		<b>For The Six Months Ended June 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
<b>Revenue</b>				
Base rent	\$ 38,100	\$ 34,193	\$ 75,688	\$ 66,890
Expense recoveries	7,456	6,791	15,165	14,217
Percentage rent	453	453	859	828
Other	1,511	1,342	2,912	2,577
<b>Total revenue</b>	<b>47,520</b>	<b>42,779</b>	<b>94,624</b>	<b>84,512</b>
<b>Operating expenses</b>				
Property operating expenses	6,009	5,827	11,798	12,460
Provision for credit losses	241	518	593	1,033
Real estate taxes	5,538	4,656	11,382	9,138
Interest expense and amortization of deferred debt costs	12,567	11,170	25,338	21,464
Depreciation and amortization of deferred leasing costs	9,770	8,472	19,548	16,796
General and administrative	3,784	3,943	7,031	7,109
<b>Total operating expenses</b>	<b>37,909</b>	<b>34,586</b>	<b>75,690</b>	<b>68,000</b>
<b>Operating income</b>	<b>9,611</b>	<b>8,193</b>	<b>18,934</b>	<b>16,512</b>
Change in fair value of derivatives	(16)	(1,244)	(19)	(1,157)
Acquisition related costs				(74)
Gain on casualty settlement		198		198
<b>Net income</b>	<b>9,595</b>	<b>7,147</b>	<b>18,915</b>	<b>15,479</b>
<b>Noncontrolling interest</b>				
Income attributable to noncontrolling interests	(1,516)	(749)	(2,972)	(1,772)
<b>Net income attributable to Saul Centers, Inc.</b>	<b>8,079</b>	<b>6,398</b>	<b>15,943</b>	<b>13,707</b>
Preferred dividends	(3,785)	(3,785)	(7,570)	(7,570)
<b>Net income available to common stockholders</b>	<b>\$ 4,294</b>	<b>\$ 2,613</b>	<b>\$ 8,373</b>	<b>\$ 6,137</b>
<b>Per share net income available to common stockholders</b>				
Basic and diluted:	\$ 0.22	\$ 0.14	\$ 0.43	\$ 0.33
<b>Dividends declared per common share outstanding</b>	<b>\$ 0.36</b>	<b>\$ 0.36</b>	<b>\$ 0.72</b>	<b>\$ 0.72</b>

The Notes to Financial Statements are an integral part of these statements.

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Saul Centers, Inc.

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME***(Unaudited)*

<i>(Dollars in thousands)</i>	<b>For The Three Months Ended June 30,</b>		<b>For The Six Months Ended June 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
<b>Net income</b>	\$ 9,595	\$ 7,147	\$ 18,915	\$ 15,479
<b>Other comprehensive income</b>				
Change in unrealized gain (loss) on cash flow hedge	(1,466)	(26)	(912)	543
<b>Total comprehensive income</b>	8,129	7,121	18,003	16,022
Comprehensive income attributable to noncontrolling interests	(1,142)	(741)	(2,744)	(1,893)
<b>Total comprehensive income attributable to Saul Centers, Inc.</b>	6,987	6,380	15,259	14,129
Preferred dividends	(3,785)	(3,785)	(7,570)	(7,570)
<b>Total comprehensive income available to common stockholders</b>	\$ 3,202	\$ 2,595	\$ 7,689	\$ 6,559

The Notes to Financial Statements are an integral part of these statements.



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Saul Centers, Inc.

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY***(Unaudited)*

*(Dollars in thousands, except per share amounts)*

	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive (Loss)	Total Saul Centers, Inc.	Noncontrolling Interest	Total
Balance, December 31, 2011	\$ 179,328	\$ 193	\$ 217,829	\$ (144,659)	\$ (2,863)	\$ 249,828	\$ 43,378	\$ 293,206
Issuance of 322,872 shares of common stock:								
308,547 shares pursuant to dividend reinvestment plan		3	11,272			11,275		11,275
14,325 shares due to exercise of employee stock options and issuance of directors' deferred stock			901			901		901
Net income				15,943		15,943	2,972	18,915
Unrealized loss on cash flow hedge					(673)	(673)	(239)	(912)
Preferred stock distributions:								
Series A				(4,000)		(4,000)		(4,000)
Series B				(3,570)		(3,570)		(3,570)
Common stock distributions				(14,065)		(14,065)	(4,978)	(19,043)
Balance, June 30, 2012	\$ 179,328	\$ 196	\$ 230,002	\$ (150,351)	\$ (3,536)	\$ 255,639	\$ 41,133	\$ 296,772

The Notes to Financial Statements are an integral part of these statements.

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Saul Centers, Inc.

**CONSOLIDATED STATEMENTS OF CASH FLOWS***(Unaudited)*

	For The Six Months	
	Ended June 30,	
	2012	2011
<i>(Dollars in thousands)</i>		
<b>Cash flows from operating activities:</b>		
Net income	\$ 18,915	\$ 15,479
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in fair value of derivatives	19	1,157
Depreciation and amortization of deferred leasing costs	19,548	16,796
Amortization of deferred debt costs	901	760
Non cash compensation costs of stock grants and options	679	656
Provision for credit losses	593	1,033
Increase in accounts receivable and accrued income	(170)	(1,337)
Increase in deferred leasing costs	(2,980)	(2,417)
Decrease in prepaid expenses	2,431	1,738
(Increase) decrease in other assets	5,469	(7,976)
Increase in accounts payable, accrued expenses and other liabilities	2,774	2,221
Decrease in deferred income	(125)	(1,252)
<b>Net cash provided by operating activities</b>	<b>48,054</b>	<b>26,858</b>
<b>Cash flows from investing activities:</b>		
Acquisitions of real estate investments		(1,600)
Additions to real estate investments	(5,448)	(5,530)
Additions to development and redevelopment projects	(1,824)	(17,984)
<b>Net cash used in investing activities</b>	<b>(7,272)</b>	<b>(25,114)</b>
<b>Cash flows from financing activities:</b>		
Proceeds from mortgage notes payable	83,500	125,000
Repayments on mortgage notes payable	(74,276)	(8,472)
Proceeds from construction loans payable		13,410
Repayments on construction loans payable		(108,465)
Repayments on revolving credit facility	(8,000)	
Additions to deferred debt costs	(2,078)	(482)
Proceeds from the issuance of:		
Common stock	11,497	10,293
Distributions to:		
Series A preferred stockholders	(4,000)	(4,000)
Series B preferred stockholders	(3,570)	(3,570)
Common stockholders	(13,949)	(13,423)
Noncontrolling interest	(4,978)	(3,900)
<b>Net cash provided by (used in) financing activities</b>	<b>(15,854)</b>	<b>6,391</b>
<b>Net increase in cash and cash equivalents</b>	<b>24,928</b>	<b>8,135</b>
<b>Cash and cash equivalents, beginning of period</b>	<b>12,323</b>	<b>12,968</b>

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Cash and cash equivalents, end of period	\$ 37,251	\$ 21,103
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The Notes to Financial Statements are an integral part of these statements.

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## Notes to Consolidated Financial Statements (Unaudited)

**1. Organization, Formation and Structure**

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). A REIT is required to annually distribute at least 90% of its REIT taxable income (excluding net capital gains) to its stockholders and meet 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 and certain other affiliated entities, each of which is currently 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 mixed-use properties, and the management functions related to the transferred properties. Since its formation, the Company has developed and purchased additional properties.

The following table lists the properties acquired and/or developed by the Company since December 31, 2010.

	<b>Name of Property</b>	<b>Location</b>	<b>Type</b>	<b>Date of Acquisition/Development</b>
<i>Acquisitions</i>				
	4469 Connecticut Ave	Washington, DC	Mixed-Use	2011
	Kentlands Square II	Gaithersburg, MD	Shopping Center	2011
	Severna Park MarketPlace	Severna Park, MD	Shopping Center	2011
	Cranberry Square	Westminster, MD	Shopping Center	2011
<i>Developments</i>				
	Clarendon Center North	Arlington, VA	Mixed-Use	2011
	Clarendon Center South	Arlington, VA	Mixed-Use	2011

As of June 30, 2012, the Company's properties (the Current Portfolio Properties) consisted of 51 operating shopping center properties (the Shopping Centers), seven mixed-use properties which are comprised of office, retail and multi-family residential uses (the Mixed-Use Properties) and two (non-operating) development properties.

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Notes to Consolidated Financial Statements (Unaudited)

**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 mixed-use 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 June 30, 2012, 34 of the Shopping Centers were anchored by a grocery store and offer primarily day-to-day necessities and services. Two retail tenants, Giant Food (5.1%), a tenant at ten Shopping Centers, and Safeway (2.8%), a tenant at eight Shopping Centers, individually accounted for 2.5% or more of the Company's total revenue for the six months ended June 30, 2012.

**Principles of Consolidation**

The accompanying consolidated financial statements of the Company include the accounts of Saul Centers and its subsidiaries, including 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**

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments necessary for the fair presentation of the financial position and results of operations of Saul Centers, Inc. for the interim periods have been included. 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, 2011, 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.

**Use of Estimates**

The preparation of financial statements in conformity with GAAP 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.

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### Notes to Consolidated Financial Statements (Unaudited)

#### **Accounts Receivable, Accrued Income and Allowance for Doubtful Accounts**

Accounts receivable primarily represents amounts currently due from tenants in accordance with the terms of the respective leases. Receivables are reviewed monthly and reserves are established with a charge to current period operations when, in the opinion of management, collection of the receivable is doubtful. Accounts receivable in the accompanying financial statements are shown net of an allowance for doubtful accounts of approximately \$817,000 and \$671,000 at June 30, 2012 and December 31, 2011, respectively.

In addition to rents due currently, accounts receivable includes approximately \$33.2 million and \$31.0 million, at June 30, 2012 and December 31, 2011, respectively, net of allowance for doubtful accounts totaling \$206,000 and \$63,000 respectively, representing minimum rental income accrued on a straight-line basis to be paid by tenants over the remaining term of their respective leases.

#### **Assets Held for Sale**

The Company considers properties to be assets held for sale when all of the following criteria are met:

management commits to a plan to sell a property;

it is unlikely that the disposal plan will be significantly modified or discontinued;

the property is available for immediate sale in its present condition;

actions required to complete the sale of the property have been initiated;

sale of the property is probable and the Company expects the completed sale will occur within one year; and

the property is actively being marketed for sale at a price that is reasonable given its current market value.

Upon designation as an asset held for sale, the Company records the carrying value of each property at the lower of its carrying value or its estimated fair value, less estimated costs to sell, and the Company ceases depreciation. As of June 30, 2012, no properties were classified as held for sale.

#### **Cash and Cash Equivalents**

Cash and cash equivalents include short-term investments. Short-term investments include money market accounts and other investments which generally mature within three months, measured from the acquisition date, and/or are readily convertible to cash.

#### **Construction In Progress**

Construction in progress includes preconstruction and development costs of active projects. Preconstruction costs 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 totaled \$1.2 million and \$1.1 million as of June 30, 2012 and December 31, 2011, respectively.



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Notes to Consolidated Financial Statements (Unaudited)

**Deferred Debt Costs**

Deferred debt costs consist of fees and costs incurred to obtain long-term financing, construction financing and the revolving line of credit. These fees and costs are being amortized on a straight-line basis over the terms of the respective loans or agreements, which approximates the effective interest method. Deferred debt costs totaled \$8.3 million and \$7.1 million, net of accumulated amortization of \$3.6 million and \$6.9 million, at June 30, 2012 and December 31, 2011, 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, including tenant prepayment of rent for future periods, real estate taxes when the taxing jurisdiction has a fiscal year differing from the calendar year, reimbursements specified in the lease agreement and tenant construction work provided by the Company. In addition, deferred income includes the fair value of certain below market leases.

**Deferred Leasing Costs**

Deferred leasing costs consist of commissions paid to third-party leasing agents, internal direct costs such as employee compensation and payroll-related fringe benefits directly related to time spent performing leasing-related activities for successful commercial leases and amounts attributed to in place leases associated with acquired properties. Leasing related 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. Unamortized deferred costs are charged to expense if the applicable lease is terminated prior to expiration of the initial lease term. Deferred leasing costs are amortized over the term of the lease or remaining term of acquired leases. Collectively, deferred leasing costs totaled \$26.1 million and \$25.9 million, net of accumulated amortization of \$15.7 million and \$14.7 million, as of June 30, 2012 and December 31, 2011, respectively. Amortization expense, included in depreciation and amortization in the consolidated statements of operations, totaled \$2.8 million and \$2.3 million for the six months ended June 30, 2012 and 2011, respectively.

**Derivative Financial Instruments**

The Company may, when appropriate, employ derivative instruments, such as interest-rate swaps, to mitigate the risk of interest rate fluctuations. The Company does not enter into derivative or other financial instruments for trading or speculative purposes. Derivative financial instruments are carried at fair value as either assets or liabilities on the consolidated balance sheets. For those derivative instruments that qualify and are designated as hedging instruments, the Company designates the hedging instrument, based upon the exposure being hedged, as a fair value hedge or a cash flow hedge. For derivative instruments that do not meet the criteria for hedge accounting, changes in fair value are immediately recognized in earnings. For those derivative instruments that qualify for hedge accounting, the effective portion of the gain or loss on the hedge instruments is reported as a component of accumulated other comprehensive income (loss) and recognized in earnings within the same line item associated with the forecasted transaction in the same period or periods during which the hedged transaction affects earnings. Any ineffective portion of the change in fair value of a derivative instrument is immediately recognized in earnings.



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Notes to Consolidated Financial Statements (Unaudited)

Derivative financial instruments expose us to credit risk in the event of non-performance by the counterparties under the terms of the derivative instrument. The Company minimizes its credit risk on these transactions by dealing with major, creditworthy financial institutions as determined by management, and therefore, it believes that the likelihood of realizing losses from counterparty non-performance is remote.

**Income Taxes**

The Company made an election to be treated, and intends to continue operating so as to qualify, as a REIT under the Code, commencing with its taxable year ended December 31, 1993. A REIT generally will not be subject to federal income taxation, provided that distributions to its stockholders equal or exceed its REIT taxable income and it complies with certain other requirements. Therefore, no provision has been made for federal income taxes in the accompanying consolidated financial statements.

**Legal Contingencies**

The Company is subject to various legal proceedings and claims that arise in the ordinary course of business, which 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 its financial position or the results of operations. Once it has been determined that a loss is probable to occur and the amount of the loss can be reasonably estimated, 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.

**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, based on the 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 by 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 taking into consideration the remaining contractual lease period, renewal periods, and the likelihood of the tenant exercising its renewal options. The fair value of a below market lease component is recorded as deferred income and accreted as additional 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 revenue over the remaining contractual lease term. The Company determines the fair value of at-market in-place leases considering the cost of acquiring similar leases, the foregone rents associated with the lease-up period and carrying costs associated with the lease-up period. Intangible assets associated with at-market in-place leases are amortized as additional expense over the remaining

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Notes to Consolidated Financial Statements (Unaudited)

contractual lease term. To the extent customer relationship intangibles are present in an acquisition, the fair values of the intangibles are amortized over the lives of the customer relationships. The Company has never recorded a customer relationship intangible asset. The Company expenses acquisition-related costs as they are incurred.

If there is an event or change in circumstance that indicates a potential impairment in the value of a real estate investment property, the Company prepares an analysis to determine whether the carrying value of the real estate investment property exceeds its estimated fair value. The Company considers both quantitative and qualitative factors including recurring operating losses, significant decreases in occupancy, and significant adverse changes in legal factors and business climate. If impairment indicators are present, the Company compares the projected cash flows of the property over its remaining useful life, on an undiscounted basis, to the carrying value of that property. The Company assesses its undiscounted projected cash flows based upon estimated capitalization rates, historic operating results and market conditions that may affect the property. If such carrying value is greater than the undiscounted projected cash flows, the Company would recognize an impairment loss equivalent to an amount required to adjust the carrying amount to its then estimated fair value. The value of any property is sensitive to the actual results of any of the aforementioned estimated factors, either individually or taken as a whole. Should the actual results differ from management's projections, the valuation could be negatively or positively affected. The Company did not recognize an impairment loss on any of its real estate during the six months ended June 30, 2012 and 2011.

Interest, real estate taxes, development-related salary costs and other carrying costs are capitalized on projects under development and construction. Once construction is substantially completed and the assets are placed in service, their rental income, real estate tax expense, property operating expenses (consisting of payroll, repairs and maintenance, utilities, insurance and other property related expenses) and depreciation are included in current operations. Property operating expenses are charged to operations as incurred. Interest expense capitalized totaled \$3.6 million and \$1.3 million for the six months ended June 30, 2012 and 2011, respectively. Commercial development projects are 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. Multi-family residential development projects are considered substantially complete and available for occupancy upon receipt of the certificate of occupancy from the appropriate licensing authority. 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. Leasehold improvements are capitalized when certain criteria are met, including when the Company supervises construction and will own the improvements. Tenant improvements are amortized, over the shorter of the lives of the related leases or the useful life of the improvements, using the straight-line method. The depreciation component included in depreciation and amortization expense in the consolidated statements of operations totaled \$16.8 million and \$14.5 million for the six months ended June 30, 2012 and 2011, respectively. Repairs and maintenance expense, included in property operating expenses, for the six months ended June 30, 2012 and 2011, was \$4.6 million and \$5.5 million, respectively.

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Notes to Consolidated Financial Statements (Unaudited)

**Revenue Recognition**

Rental and interest income are accrued as earned except when doubt exists as to collectability, 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. Expense recoveries represent a portion of property operating expenses billed to tenants, including common area maintenance, real estate taxes and other recoverable costs and are recognized in the period when the expenses are incurred. Rental income based on a tenant's revenue (percentage rent) is accrued when a tenant reports sales that exceed a specified breakpoint, pursuant to the terms of their respective leases.

**Stock-based Employee Compensation, Stock Plan and Deferred Compensation Plan for Directors**

The Company uses the fair value method to value and account for employee stock options. 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 determined using the most recent trading history of the Company's common stock (month-end closing prices) corresponding to the average expected term of the options; (2) Average Expected Term of the options is based on prior exercise history, scheduled vesting and the expiration date; (3) Expected Dividend Yield determined by management 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) a Risk-free Interest Rate 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 has a stock plan, which was originally approved in 2004 and amended in 2008 and which expires in 2018, for the purpose of attracting and retaining executive officers, directors and other key personnel (the Stock Plan). Pursuant to the Stock Plan, the Compensation Committee established a Deferred Compensation Plan for Directors for the benefit of its directors and their beneficiaries, which replaced a previous Deferred Compensation and Stock Plan for Directors. A director may make an annual election 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 June 30, 2012, 236,100 shares had been credited to the directors' deferred fee accounts.

The Compensation Committee has also approved an annual award of shares of the Company's common stock as additional compensation to each director serving on the Board of Directors as of the record date for the Annual Meeting of Stockholders. The shares are awarded as of each Annual Meeting of Shareholders, and their issuance may not be deferred. Each director was issued 200 shares at the 2012 Annual Meeting of Shareholders. The value of these shares was based on the closing stock price on the date the shares were awarded and is included in general and administrative expenses.

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## Notes to Consolidated Financial Statements (Unaudited)

**Noncontrolling Interest**

Saul Centers is the sole general partner of the Operating Partnership, owning a 73.9% common interest as of June 30, 2012. Noncontrolling interest in the Operating Partnership is comprised of limited partnership units owned by The Saul Organization. Noncontrolling interest as reflected on the accompanying consolidated balance sheets is increased for earnings allocated to limited partnership interests and distributions reinvested in additional units, and is decreased for limited partner distributions. Noncontrolling interest as reflected on the consolidated statements of operations represent earnings allocated to limited partnership interests held by the Saul Organization.

**Per Share Data**

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 non-dilutive. Certain options are dilutive because the average share price of the Company's common stock exceeded the exercise prices. The treasury stock method was used to measure the effect of the dilution. For the three and six months ended June 30, 2012, the stock options issued in 2007, 2008 and 2011 are anti-dilutive and are therefore excluded from this measurement.

**Basic and Diluted Shares Outstanding**

<i>(In thousands)</i>	Three months ended		Six months ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Weighted average common shares outstanding-Basic	19,559	18,770	19,481	18,714
Effect of dilutive options	43	69	45	82
Weighted average common shares outstanding-Diluted	19,602	18,839	19,526	18,796

**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.

**3. Real Estate Acquired***4469 Connecticut Avenue*

In January 2011, the Company purchased 4469 Connecticut Avenue for \$1.6 million, a one retail space property, currently unleased, located adjacent to Van Ness Square in northwest Washington, DC and incurred acquisition costs of \$74,000.

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Notes to Consolidated Financial Statements (Unaudited)

*Kentlands Square II*

In September 2011, the Company purchased for \$74.5 million Kentlands Square II, a retail property located adjacent to the Company's Kentlands Square I and Kentlands Place shopping centers in Gaithersburg, Maryland, and incurred acquisition costs of \$1.1 million.

*Severna Park MarketPlace*

In September 2011, the Company purchased for \$61.0 million Severna Park MarketPlace, a retail property located in Severna Park, Maryland, and incurred acquisition costs of \$0.8 million.

*Cranberry Square*

In September 2011, the Company purchased for \$33.0 million Cranberry Square, a retail property located in Westminster, Maryland, and incurred acquisition costs of \$0.5 million.

**4. Noncontrolling Interest - Holders of Convertible Limited Partnership Units in the Operating Partnership**

The Saul Organization holds a 26.1% limited partnership interest in the Operating Partnership represented by approximately 6.9 million convertible limited partnership units as of June 30, 2012. These 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"). As of June 30, 2012, 1.96 million units were convertible into shares of Saul Centers common stock.

The impact of The Saul Organization's approximately 26.1% limited partnership interest in the Operating Partnership is reflected as Noncontrolling Interest in the accompanying consolidated financial statements. Fully converted partnership units and diluted weighted average shares outstanding for the three months ended June 30, 2012 and 2011, were approximately 26.5 million and 24.3 million, respectively, and for the six months ended June 30, 2012 and 2011, were approximately 26.4 million and 24.2 million, respectively.

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

The Company's outstanding debt totaled approximately \$833.1 million at June 30, 2012, of which approximately \$818.1 million was fixed-rate debt and approximately \$15.0 million was variable rate debt.

At June 30, 2012, the Company had a \$175 million unsecured revolving credit facility, which can be used for working capital, property acquisitions, development projects or letters of credit. The revolving credit facility matures on May 20, 2016, and may be extended by the Company for one additional year subject to the Company's satisfaction of certain conditions. Saul Centers and certain consolidated subsidiaries of the Operating Partnership have guaranteed the payment obligations of the Operating Partnership under the revolving credit facility. Letters of credit may be issued under the revolving credit facility. On June 30, 2012, no amounts were outstanding under the line, approximately \$174.8 million was available under the line and approximately \$224,000 was committed for letters of credit. Loans under the facility bear

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Notes to Consolidated Financial Statements (Unaudited)

interest at a rate equal to the sum of LIBOR and a margin based on the Company's leverage ratio, ranging from 160 basis points to 250 basis points. Based on the leverage ratio as of June 30, 2012, the margin would have been 190 basis points.

Saul Centers is a guarantor of the revolving credit facility, of which the Operating Partnership is the borrower. Saul Centers is also the guarantor of 50% of the Northrock bank term loan (approximately \$7.5 million of the \$15.0 million outstanding at June 30, 2012). The fixed-rate notes payable are all non-recourse debt except for \$3.9 million of the Great Falls Center mortgage, 25% of the Metro Pike Center loan (approximately \$4.0 million of the \$15.9 million outstanding at June 30, 2012) and \$27.6 million of the Clarendon Center mortgage, which will be eliminated upon the achievement of certain leasing and debt service covenants which are guaranteed by Saul Centers.

On April 11, 2012, the Company closed on a \$73.0 million mortgage loan secured by Seven Corners shopping center. Proceeds from this loan were used to pay-off the \$63 million remaining balance of existing debt secured by Seven Corners and six other shopping center properties, which was scheduled to mature in October 2012, and to provide cash of approximately \$10 million. The new 15-year mortgage loan, which matures in May 2027, requires equal monthly principal and interest payments totaling \$463,226 based upon a fixed 5.84% interest rate and 25-year principal amortization and a final payment of \$42.5 million at maturity.

On April 26, 2012, the Company substituted the White Oak shopping center for Van Ness Square as collateral for one of its existing mortgage loans which will allow the Company to analyze the feasibility of repositioning Van Ness Square. The terms of the original loan, including its 8.11% interest rate, are unchanged and, in conjunction with the collateral substitution, the Company borrowed an additional \$10.5 million, also secured by White Oak. The new borrowing requires equal monthly payments based upon a fixed 4.90% interest rate and 25-year principal amortization, and will mature in July 2024, coterminously with the original loan. The consolidated loan has an outstanding balance of \$26.9 million, requires equal monthly payments based upon a blended fixed interest rate of 7.0% and will require a final payment of \$18.5 million at maturity.

At December 31, 2011, the Company's outstanding debt totaled approximately \$831.9 million, of which \$808.8 million was fixed rate debt and \$23.1 million was variable rate debt, including \$8.0 million outstanding on the Company's unsecured revolving credit facility.

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## Notes to Consolidated Financial Statements (Unaudited)

At June 30, 2012, the scheduled maturities of debt, including scheduled principal amortization, for years ending December 31, were as follows:

<i>(In thousands)</i>	Balloon Payments	Scheduled Principal Amortization	Total
July 1 through December 31, 2012	\$	\$ 10,329	\$ 10,329
2013	70,131	19,376	89,507
2014	13,218	19,677	32,895
2015	15,077	20,209	35,286
2016		21,058	21,058
2017		22,311	22,311
Thereafter	472,892	148,817	621,709
	\$ 571,318	\$ 261,777	\$ 833,095

Interest expense and amortization of deferred debt costs for the three and six months ended June 30, 2012 and 2011, were as follows:

<i>(In thousands)</i>	Three months ended June 30,		Six months ended June 30,	
	2012	2011	2012	2011
Interest incurred	\$ 12,076	\$ 11,384	\$ 24,441	\$ 21,978
Amortization of deferred debt costs	495	388	901	760
Capitalized interest	(4)	(602)	(4)	(1,274)
	\$ 12,567	\$ 11,170	\$ 25,338	\$ 21,464

**6. Stockholders' Equity and Noncontrolling Interest**

The consolidated statements of operations for the six months ended June 30, 2012 and 2011 reflect noncontrolling interest of \$3.0 million and \$1.8 million, respectively, representing The Saul Organization's share of net income for each period.

The Company has outstanding 4,000,000 depositary shares, each representing 1/100th of a share of 8% Series A Cumulative Redeemable Preferred Stock. The depositary shares are redeemable, in whole or in part at the Company's option, from time to time, at \$25.00 per share. The depositary shares pay an annual dividend of \$2.00 per share, equivalent to 8% of the \$25.00 per 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.

The Company has outstanding 3,173,115 depositary shares, each representing 1/100th of a share of 9% Series B Cumulative Redeemable Preferred Stock. The depositary shares may be redeemed at the Company's option, on or after March 15, 2013, in whole or in part, at \$25.00 per share. The depositary shares pay an annual dividend of \$2.25 per share, equivalent to 9% of the \$25.00 per share liquidation preference. The Series B preferred stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and is not convertible into any other

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Notes to Consolidated Financial Statements (Unaudited)

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.

**7. Related Party Transactions**

The Chairman and Chief Executive Officer, the President, the Senior Vice President- General Counsel and the Senior 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 Senior 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 401K plan with entities in The Saul Organization which covers those full-time employees who meet the requirements as specified in the plan. Company contributions, which are included in general and administrative expense or property operating expenses in the consolidated statements of operations, at the discretionary amount of up to six percent of the employee's cash compensation, subject to certain limits, were \$170,000 and \$155,000 for the six months ended June 30, 2012 and 2011, respectively. All amounts deferred by employees and the Company are fully vested.

The Company also participates in a multiemployer nonqualified deferred compensation plan with entities in The Saul Organization which covers those full-time employees who meet the requirements as specified in the plan. According to the plan, which can be modified or discontinued at any time, participating employees defer 2% of their compensation in excess of a specified amount. For the six months ended June 30, 2012 and 2011, the Company contributed \$109,000 and \$108,000, respectively, which is three times the amount deferred by employees and is included in general and administrative expense. All amounts deferred by employees and the Company are fully vested. The cumulative unfunded liability under this plan was \$2.0 million and \$1.9 million, at June 30, 2012 and December 31, 2011, respectively, and is included in accounts payable, accrued expenses and other liabilities in the consolidated balance sheets.

The Company has entered into a shared services agreement (the Agreement) with The Saul Organization that provides for the sharing of certain personnel and ancillary functions such as computer hardware, software, and support services and certain direct and indirect administrative personnel. The method for determining the cost of the shared services is provided for in the Agreement and is based upon head count, estimates of usage or estimates of time incurred, as applicable. The terms of the Agreement and the payments made thereunder are deemed reasonable by management and 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 six months ended June 30, 2012 and 2011, which included rental expense for the Company's headquarters lease, totaled approximately \$3.1 million and \$3.0 million, respectively. The amounts are expensed as incurred and are primarily reported as general and administrative expenses in the consolidated financial statements. As of June 30, 2012 and December 31, 2011, accounts payable, accrued expenses and other liabilities included approximately \$454,000 and \$560,000, respectively, representing amounts due to The Saul Organization for the Company's share of these ancillary costs and expenses.



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Notes to Consolidated Financial Statements (Unaudited)

The Company's corporate headquarters space is leased by a member of The Saul Organization. The lease commenced in March 2002, was recently extended for five years through March 2017, and provides for base rent increases of 3% per year, with payment of a pro-rata share of operating expenses over a base year amount. The Agreement requires each party to pay an allocation of total rental payments based on a percentage proportionate to the number of employees employed by each party. The Company's rent expense was \$452,000 and \$470,000 for the six months ended June 30, 2012 and 2011, respectively, and is included in general and administrative expense.

The B. F. Saul Insurance Agency of Maryland, Inc., a subsidiary of the B. F. Saul Company and a member of The Saul Organization, is a general insurance agency that receives commissions and fees in connection with the Company's insurance program. Such commissions and fees amounted to \$130,000 and \$116,000 for the six months ended June 30, 2012 and 2011, respectively.

**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.

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## Notes to Consolidated Financial Statements (Unaudited)

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 six months ended June 30, 2012:

Stock options issued

	Directors									
Grant date	04/26/2004	05/06/2005	05/01/2006	04/27/2007	04/25/2008	04/24/2009	05/07/2010	05/13/2011	05/04/2012	Subtotals
Total grant	30,000	30,000	30,000	30,000	30,000	32,500	32,500	32,500	35,000	282,500
Vested	30,000	30,000	30,000	30,000	30,000	32,500	32,500	32,500	35,000	282,500
Exercised	8,700	5,000				5,000				18,700
Forfeited			2,500	2,500	2,500		2,500	2,500		12,500
Exercisable at June 30, 2012	21,300	25,000	27,500	27,500	27,500	27,500	30,000	30,000	35,000	251,300
Remaining unexercised	21,300	25,000	27,500	27,500	27,500	27,500	30,000	30,000	35,000	251,300
Exercise price	\$ 25.78	\$ 33.22	\$ 40.35	\$ 54.17	\$ 50.15	\$ 32.68	\$ 38.76	\$ 41.82	\$ 39.29	
Volatility	0.183	0.198	0.206	0.225	0.237	0.344	0.369	0.358	0.348	
Expected life (years)	5.0	10.0	9.0	8.0	7.0	6.0	5.0	5.0	5.0	
Assumed yield	5.75%	6.91%	5.93%	4.39%	4.09%	4.54%	4.23%	4.16%	4.61%	
Risk-free rate	3.57%	4.28%	5.11%	4.65%	3.49%	2.19%	2.17%	1.86%	0.78%	
Total value at grant date	\$ 66,600	\$ 71,100	\$ 143,400	\$ 285,300	\$ 254,700	\$ 222,950	\$ 287,950	\$ 297,375	\$ 244,388	\$ 1,873,763
Forfeited options										
Expensed in previous years	66,600	71,100	143,400	285,300	254,700	222,950	287,950	297,375		1,629,375
Expensed in 2012									244,388	244,388
Future expense										

	Officers							Subtotals	Grand Totals
Grant date	05/23/2003	04/26/2004	05/06/2005	04/27/2007	05/13/2011	05/04/2012			
Total grant	220,000	122,500	132,500	135,000	162,500	242,500	1,015,000	<b>1,297,500</b>	
Vested	212,500	115,000	118,750	122,500	40,625		609,375	<b>891,875</b>	
Exercised	205,585	51,025	25,125				281,735	<b>300,435</b>	
Forfeited	7,500	7,500	13,750	12,500			41,250		