

SAUL CENTERS INC  
Form 10-K  
March 14, 2007  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

\_\_\_\_\_  
**FORM 10-K**  
\_\_\_\_\_

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

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)

7501 Wisconsin Avenue, Suite 1500, Bethesda, Maryland 20814-6522

(Address of principal executive offices) (Zip Code)

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

52-1833074  
(I.R.S. Employer

Identification No.)

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Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, Par Value \$0.01 Per Share	New York Stock Exchange
Depository Shares each representing 1/100 <sup>th</sup> of a share of 8% Series A Cumulative Redeemable Preferred Stock, Par Value, \$0.01 Per Share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: N/A

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No .

Indicate by check mark whether 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 requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in the definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 Act). Yes  No .

The number of shares of Common Stock, \$0.01 par value, outstanding as of March 9, 2007 was 17,450,000.

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the closing price of the registrant's Common Stock on the New York Stock Exchange on June 30, 2006 was \$404,857,000.

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**PART I**

**Cautionary Statement Regarding Forward-Looking Statements**

*Certain statements contained herein constitute forward-looking statements as such term is defined in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are not guarantees of performance. Our future results, financial condition and business may differ materially from those expressed in these forward-looking statements. You can find many of these statements by looking for words such as plans, intends, estimates, anticipates, expects, believes or similar expressions in this Form 10-K. These forward-looking statements are subject to numerous assumptions, risks and uncertainties. Many of the factors that will determine these items are beyond our ability to control or predict. For further discussion of these factors, see Item 1A. Risk Factors in this Form 10-K.*

*For these statements, we claim the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. You are cautioned not to place undue reliance on our forward-looking statements, which speak only as of the date of this Form 10-K or the date of any document incorporated by reference. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We do not undertake any obligation to release publicly any revisions to our forward-looking statements to reflect events or circumstances after the date of this Form 10-K.*

**Item 1. Business**

**General**

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.

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

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.

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The following lists the properties developed and acquired by the Company since 2004. All of the following properties are operating shopping centers ( Shopping Centers ).

<b>Name of Property</b>	<b>Location</b>	<b>Square Footage</b>	<b>Date of Acquisition/Development</b>
<i>Acquisitions</i>			
Boca Valley Plaza	Boca Raton, FL	121,000	2004
Countryside	Sterling, VA	142,000	2004
Cruse MarketPlace	Cumming, GA	79,000	2004
Briggs Chaney MarketPlace	Silver Spring, MD	197,000	2004
Palm Springs Center	Altamonte Springs, FL	126,000	2005
Jamestown Place	Altamonte Springs, FL	96,000	2005
Seabreeze Plaza	Palm Harbor, FL	147,000	2005
Smallwood Village Center	Waldorf, MD	198,000	2006
Hunt Club Corners	Apopka, FL	101,000	2006
<i>Developments</i>			
Shops at Monocacy	Frederick, MD	109,000	2004
Broadlands Village Phase I	Ashburn, VA	107,000	2003
Broadlands Village Phase II	Ashburn, VA	30,000	2004
Kentlands Place	Gaithersburg, MD	41,000	2005
Broadlands Village Phase III	Ashburn, VA	22,000	2006
Lansdowne Town Center	Leesburg, VA	188,000	2006/7

As of December 31, 2006, the Company's properties (the Current Portfolio Properties) consisted of 42 Shopping Centers, five predominantly office operating properties (the Office Properties) and four (non-operating) development properties.

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

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The following diagram depicts the Company's organizational and equity ownership structure, as of December 31, 2006.

**Management of the Current Portfolio Properties**

The Partnerships manage the Current Portfolio Properties and will manage any subsequently acquired properties. The management of the properties includes performing property management, leasing, design, renovation, development and accounting duties for each property. The Partnerships provide each property with a fully integrated property management capability, with approximately 60 employees and with an extensive and mature network of relationships with tenants and potential tenants as well as with members of the brokerage and property owners communities. The Company currently does not, and does not intend to, retain third party managers or provide management services to third parties.

The Company augments its property management capabilities by sharing with The Saul Organization certain ancillary functions, at cost, such as computer and payroll services, benefits administration and in-house legal services. The Company also shares insurance administration expenses on a pro rata basis with The Saul Organization. Management believes that these arrangements result in lower costs than could be obtained by contracting with third parties. These arrangements permit the Company to capture greater economies of scale in purchasing from third party vendors than would otherwise be available to the Company alone and to capture internal economies of scale by avoiding payments representing profits with respect to functions provided internally. The terms of all sharing arrangements with The Saul Organization, including payments related thereto, are specified in a written agreement and are reviewed annually by the Audit Committee of the Company's Board of Directors.

The Company's corporate headquarters lease commenced in March 2002 and is a sublease of office space from The Saul Organization at the Company's share of the cost. A discussion of the lease terms are provided in Note 7, Long Term Lease Obligations, of the Notes to Consolidated Financial Statements.

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### Principal Offices

The principal offices of the Company are located at 7501 Wisconsin Avenue, Suite 1500, Bethesda, Maryland 20814-6522, and the Company's telephone number is (301) 986-6200. The Company's internet web address is [www.saulcenters.com](http://www.saulcenters.com).

### Policies with Respect to Certain Activities

The following is a discussion of the Company's operating strategy and certain of its investment, financing and other policies. These strategies and policies have been determined by the Board of Directors and, in general, may be amended or revised from time to time by the Board of Directors without a vote of the Company's stockholders.

### Operating Strategies

The Company's primary operating strategy is to focus on its community and neighborhood shopping center business and to operate its properties to achieve both cash flow growth and capital appreciation. Community and neighborhood shopping centers typically provide reliable cash flow and steady long-term growth potential. Management intends to actively manage its property portfolio by engaging in strategic leasing activities, tenant selection, lease negotiation and shopping center expansion and reconfiguration. The Company seeks to optimize tenant mix by selecting tenants for its shopping centers that provide a broad spectrum of goods and services, consistent with the role of community and neighborhood shopping centers as the source for day-to-day necessities. Management believes that such a synergistic tenanting approach results in increased cash flow from existing tenants by providing the Shopping Centers with consistent traffic and a desirable mix of shoppers, resulting in increased sales and, therefore, increased cash flows.

Management believes there is potential for growth in cash flow as existing leases for space in the Shopping Centers expire and are renewed, or newly available or vacant space is leased. The Company intends to renegotiate leases where possible and seek new tenants for available space in order to maximize this potential for increased cash flow. As leases expire, management expects to revise rental rates, lease terms and conditions, relocate existing tenants, reconfigure tenant spaces and introduce new tenants with the goal of increasing cash flow. In those circumstances in which leases are not otherwise expiring, management selectively attempts to increase cash flow through a variety of means, or in connection with renovations or relocations, recapturing leases with below market rents and re-leasing at market rates, as well as replacing financially troubled tenants. When possible, management also will seek to include scheduled increases in base rent, as well as percentage rental provisions, in its leases.

The Shopping Centers contain undeveloped parcels within the centers which are suitable for development as free-standing retail facilities, such as restaurants, banks or auto centers. Management will continue to seek desirable tenants for facilities to be developed on these sites and to develop and lease these sites in a manner that complements the Shopping Centers in which they are located.

The Company will also seek growth opportunities in its Washington, DC metropolitan area office portfolio, primarily through development and redevelopment. Management also intends to negotiate lease renewals or to re-lease available space in the Office Properties, while considering the strategic balance of optimizing short-term cash flow and long-term asset value.

It is management's intention to hold properties for long-term investment and to place strong emphasis on regular maintenance, periodic renovation and capital improvement. Management believes that such characteristics as cleanliness, lighting and security are particularly important in community and neighborhood shopping centers, which are frequently visited by shoppers during hours outside of the normal work-day. Management believes that the Shopping Centers and Office Properties generally are attractive and well maintained. The Shopping Centers and Office Properties will undergo expansion, renovation, reconfiguration and modernization from time to time when

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management believes that such action is warranted by opportunities or changes in the competitive environment of a property. Several of the Shopping Centers have been renovated recently. During 2006 and 2005, the Company was involved in development and/or redevelopment of twelve of its operating properties. The Company will continue its practice of expanding existing properties by undertaking new construction on outparcels suitable for development as free standing retail or office facilities.

**Investment in Real Estate or Interests in Real Estate**

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

Management believes that attractive acquisition and development opportunities for investment in existing and new shopping center properties will continue to be available. Management believes that the Company will be well situated to take advantage of these opportunities because of its access to capital markets, as evidenced by; (1) the Company's 2005 expansion and extension of its \$150 million Revolving Credit Facility, recent years' long-term fixed-rate mortgage financing activity and successful \$100 million preferred stock offering in November 2003, (2) the Company's ability to acquire properties or undeveloped land, either for cash or securities (including Operating Partnership interests in tax advantaged transactions), and (3) because of management's experience in seeking out, identifying and evaluating potential acquisitions. In addition, management believes its shopping center expertise should permit it to optimize the performance of shopping centers once they have been acquired.

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

In evaluating a particular redevelopment, renovation, acquisition, or development, management will consider a variety of factors, including (i) the location and accessibility of the property; (ii) the geographic area (with an emphasis on the Washington, DC/Baltimore metropolitan area and the southeastern region of the United States) and demographic characteristics of the community, as well as the local real estate market, including potential for growth and potential regulatory impediments to development; (iii) the size of the property; (iv) the purchase price; (v) the non-financial terms of the proposed acquisition; (vi) the availability of funds or other consideration for the proposed acquisition and the cost thereof; (vii) the fit of the property with the Company's existing portfolio; (viii) the potential for, and current extent of, any environmental problems; (ix) the current and historical occupancy rates of the property or any comparable or competing properties in the same market; (x) the quality of construction and design and the current physical condition of the property; (xi) the financial and other characteristics of existing tenants and the terms of existing leases; and (xii) the potential for capital appreciation.

Although it is management's present intention to concentrate future acquisition and development activities on community and neighborhood shopping centers and office properties in the Washington, DC/Baltimore metropolitan area and the southeastern region of the United States, the Company may, in the future, also acquire other types of real estate in other areas of the country as opportunities present themselves. While the Company may diversify in terms of property locations, size and market, the Company does not set any limit on the amount or percentage of Company assets that may be invested in any one property or any one geographic area.

The Company intends to engage in such future investment or development activities in a manner that is consistent with the maintenance of its status as a REIT for federal income tax purposes and that will not make the Company an investment company under the Investment Company Act of 1940, as amended. Equity investments in acquired properties may be subject to existing mortgage financings and other indebtedness or to new indebtedness which may be incurred in connection with acquiring or refinancing these investments.



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### Investments in Real Estate Mortgages

While the Company's current portfolio of, and its business objectives emphasize, equity investments in commercial and neighborhood shopping centers and office properties, the Company may, at the discretion of the Board of Directors, invest in mortgages, participating or convertible mortgages, deeds of trust and other types of real estate interests consistent with its qualification as a REIT. However, the Company does not presently intend to invest in real estate mortgages.

### Investments in Securities of or Interests in Persons Engaged in Real Estate Activities and Other Issues

Subject to the tests necessary for REIT qualification, the Company may invest in securities of other REITs, other entities engaged in real estate activities or securities of other issuers, including for the purpose of exercising control over such entities.

### Dispositions

The Company does not currently intend to dispose of any of its properties, although the Company reserves the right to do so if, based upon management's periodic review of the Company's portfolio, the Board of Directors determines that such action would be in the best interest of the Company's stockholders. Any decision to dispose of a property will be made by the Board of Directors.

### Capital Policies

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 is below 50% as of December 31, 2006.

The organizational documents of the Company do not limit the absolute amount or percentage of indebtedness that it may incur. The Board of Directors may, from time to time, reevaluate the Company's debt capitalization policy in light of current economic conditions, relative costs of capital, market values of the Company property portfolio, opportunities for acquisition, development or expansion, and such other factors as the Board of Directors then deems relevant. The Board of Directors may modify the Company's debt capitalization policy based on such a reevaluation without shareholder approval and consequently, may increase or decrease the Company's debt to total asset ratio above or below 50% or may waive the policy for certain periods of time. The Company selectively continues to refinance or renegotiate the terms of its outstanding debt in order to achieve longer maturities, and obtain generally more favorable loan terms, whenever management determines the financing environment is favorable.

The Company intends to finance future acquisitions and developments and to make debt repayments by utilizing the sources of capital then deemed to be most advantageous. Such sources may include undistributed operating cash flow, secured or unsecured bank and institutional borrowings, proceeds from the Company's Dividend Reinvestment and Stock Purchase Plan, proceeds from the sale of properties and private and public offerings of debt or equity securities. Borrowings may be at the Operating Partnership or Subsidiary Partnerships' level and securities offerings may include (subject to certain limitations) the issuance of Operating Partnership interests convertible into common stock or other equity securities.

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### Other Policies

The Company has authority to offer equity or debt securities in exchange for property and to repurchase or otherwise acquire its common stock or other securities in the open market or otherwise, and may engage in such activities in the future. The Company expects, but is not obligated, to issue common stock to holders of units of the Partnership upon exercise of their redemption rights. The Company has not engaged in trading, underwriting or agency distribution or sale of securities of other issues other than the Partnership and does not intend to do so. The Company has not made any loans to third parties, although the Company may in the future make loans to third parties.

### Competition

As an owner of, or investor in, community and neighborhood shopping centers and office properties, the Company is subject to competition from an indeterminate number of companies in connection with the acquisition, development, ownership and leasing of similar properties. These investors include investors with access to significant capital, such as domestic and foreign corporations and financial institutions, publicly traded and privately held REITs, private institutional investment funds, investment banking firms, life insurance companies and pension funds.

With respect to acquisitions and developments, this competition may reduce properties available for acquisition or development or increase prices for raw land or developed properties of the type in which the Company invests. The Company faces competition in providing leases to prospective tenants and in re-letting space to current tenants upon expiration of their respective leases. If the Company's tenants decide not to renew or extend their leases upon expiration, the Company may not be able to re-let the space. Even if the tenants do renew or the Company can re-let the space, the terms of renewal or re-letting, including the cost of required renovations, may be less favorable than current lease terms or than expectations for the space. This risk may be magnified if the properties owned by our competitors have lower occupancy rates than the Company's properties. As a result, these competitors may be willing to make space available at lower prices than the space in the Current Portfolio Properties.

Management believes that success in the competition for ownership and leasing property is dependent in part upon the geographic location of the property, the tenant mix, the performance of property managers, the amount of new construction in the area and the maintenance and appearance of the property. Additional competitive factors impacting the Company's properties include the ease of access to the properties, the adequacy of related facilities such as parking, and the demographic characteristics in the markets in which the properties compete. Overall economic circumstances and trends and new properties in the vicinity of each of the Current Portfolio Properties are also competitive factors.

Finally, retailers at our Shopping Centers face increasing competition from outlet stores, discount shopping clubs and other forms of marketing of goods, such as direct mail, internet marketing and telemarketing. This competition may reduce percentage rents payable to us and may contribute to lease defaults or insolvency of tenants.

### Environmental Matters

The Current Portfolio Properties are subject to various laws and regulations relating to environmental and pollution controls. The impact upon the Company of the application of such laws and regulations either prospectively or retrospectively is not expected to have a materially adverse effect on the Company's property operations. As a matter of policy, the Company requires an environmental study be performed with respect to a property that may be subject to possible environmental hazards prior to its acquisition to ascertain that there are no material environmental hazards associated with such property.

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**Employees**

As of March 9, 2007, the Company employed approximately 60 persons, including six leasing officers. None of the Company's employees are covered by collective bargaining agreements. Management believes that its relationship with employees is good.

**Recent Developments**

A significant contributor to the Company's recent growth in its shopping center portfolio has been its land acquisitions and subsequent development, redevelopment of existing centers and operating property acquisition activities. Redevelopment activities reposition the Company's centers to be competitive in the current retailing environment. These redevelopments typically include an update of the facade, site improvements and reconfiguring tenant spaces to accommodate tenant size requirements and merchandising evolution. Since 2002, the Company has acquired seven land parcels located in the Washington, DC metropolitan area and developed neighborhood shopping centers on four of the parcels. Pre-construction development activity is proceeding at two of the parcels. The final land parcel is expected to be a part of an assemblage of parcels held for future development of a neighborhood shopping center. Since 2002, eleven operating grocery-anchored neighborhood shopping center properties have been acquired, two of which have been redeveloped. Six of the Company's operating centers owned prior to 2002 have been redeveloped. In summary, since year end 2002, the Company's leasable area has grown by approximately 25% (1.6 million square feet), from 6.3 million square feet to over 7.9 million square feet.

*2006/2005 Acquisitions, Developments and Redevelopments*

*Olde Forte Village*

In July 2003, the Company acquired Olde Forte Village, a 161,000 square foot neighborhood shopping center located in Fort Washington, Maryland. The center is anchored by the then newly constructed 58,000 square foot Safeway supermarket which opened in March 2003, relocating from a smaller store within the center. The center then contained approximately 50,000 square feet of vacant space, consisting primarily of the former Safeway space, which the Company redeveloped in 2005. The reconfigured shopping center now totals 143,000 square feet of leasable space. The Company's total redevelopment costs, including the initial property acquisition cost, were approximately \$22 million. The center was 93% leased at December 31, 2006.

*Broadlands Village*

The Company purchased 24 acres of undeveloped land in the Broadlands section of the Dulles Technology Corridor of Loudoun County, Virginia in April 2002. Broadlands is a 1,500 acre planned community consisting of 3,500 residences, approximately half of which are constructed and currently occupied. In October 2003, the Company completed construction of the first phase of the Broadlands Village shopping center. The 58,000 square foot Safeway supermarket opened in October 2003 with a pad building and many in-line small shops also opening in the fourth quarter of 2003. Construction of a 30,000 square foot second phase was substantially completed in 2004. The Company's total development costs of both phases, including the land acquisition, were approximately \$22 million. The center was 100% leased at December 31, 2006. During the fourth quarter of 2005, the Company commenced construction of a third phase of this development, totaling approximately 22,000 square feet of shop space and two pad site locations. Construction was substantially completed in June 2006. Development costs for this phase totaled approximately \$7.5 million. All of the new space was leased and all tenants were in occupancy at December 31, 2006.

*The Glen*

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

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### *Kentlands Place*

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

### *Briggs Chaney MarketPlace*

In April 2004, the Company acquired Briggs Chaney MarketPlace in Silver Spring, Maryland. Briggs Chaney MarketPlace is a 194,000 square foot neighborhood shopping center on Route 29 in Montgomery County, Maryland. The center, constructed in 1983, was 100% leased at December 31, 2006 and is anchored by a 45,000 square foot Safeway supermarket and a 28,000 square foot Ross Dress For Less. The property was acquired for \$27.3 million. During 2005, the Company completed interior construction to reconfigure a portion of space vacant at acquisition, totaling approximately 11,000 square feet of leasable area, and completed construction of a façade renovation of the shopping center. Redevelopment costs totaled approximately \$1.9 million.

### *Ashland Square*

On December 15, 2004, the Company acquired a 19.3 acre parcel of land in Dumfries, Prince William County, Virginia for a purchase price of \$6.3 million. The Company has plans to develop the parcel into a grocery-anchored neighborhood shopping center. The Company received site plan approval from Prince William County during the third quarter of 2006 to develop approximately 125,000 square feet of retail space. Approvals for an additional 35,000 square feet of commercial space are expected to be received in 2007. During the third quarter of 2006, the Company commenced site work consisting primarily of clearing, grading and site utility construction. A lease has been executed with Chevy Chase Bank for a branch to be built on a pad site, with construction expected to be completed in mid-2007. The balance of the space is being marketed to grocers and other retail businesses, with a development timetable yet to be finalized.

### *Palm Springs Center*

On March 3, 2005, the Company completed the acquisition of the 126,000 square foot Albertson's anchored Palm Springs Center located in Altamonte Springs, Florida (metropolitan Orlando). The center was 100% leased at December 31, 2006 and was acquired for a purchase price of \$17.5 million.

### *New Market*

On March 3, 2005, the Company acquired a 7.1 acre parcel of land located in New Market, Maryland for a purchase price of \$500,000. On September 8, 2005, the Company acquired a 28.4 acre contiguous parcel for a purchase price of \$1.5 million. Together, these parcels will accommodate a neighborhood shopping center development in excess of 120,000 square feet of leasable space. The Company has contracted to purchase one additional parcel with the intent to assemble additional acreage for further retail development near this I-70 interchange, east of Frederick, Maryland.

### *Lansdowne Town Center*

During the first quarter of 2005, the Company received approval of a zoning submission to Loudoun County which allowed the development of a neighborhood shopping center named Lansdowne Town Center, within the Lansdowne Community in northern Virginia. On March 29, 2005, the Company finalized the acquisition of an additional 4.5 acres of land to bring the total acreage of the development parcel to 23.4 acres (including the 18.9 acres acquired in 2002). The additional purchase price was approximately \$1.0 million. In November 2005, the Company commenced construction of an approximately 188,000 square foot retail center. A lease was executed with Harris Teeter for a 55,000 square foot grocery store, which opened in November 2006. Construction was substantially completed during the fourth quarter of 2006, with project costs expected to total approximately \$41.5 million. The project was 85% leased as of December 31, 2006 and 45% of the space was in operation at that time.

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(approximately 85,000 square feet of retail space). The remaining retail space (65,000 square feet) is expected to be operational by spring 2007, while the second floor office space is expected to be fully operational by fall 2007 (38,000 square feet).

### *Jamestown Place*

On November 17, 2005, the Company completed the acquisition of the 96,000 square foot Publix-anchored Jamestown Place located in Altamonte Springs, Florida (metropolitan Orlando). The center was 100% leased at December 31, 2006 and was acquired for a purchase price of \$14.8 million.

### *Seabreeze Plaza*

On November 30, 2005, the Company completed the acquisition of the 147,000 square foot Publix-anchored Seabreeze Plaza located in Palm Harbor, Florida (metropolitan Tampa). The center was 91% leased at December 31, 2006 and was acquired for a purchase price of \$25.9 million subject to the assumption of a \$13.6 million mortgage loan.

### *Smallwood Village Center*

On January 27, 2006, the Company acquired the 198,000 square foot Smallwood Village Center, located on 25 acres within the St. Charles planned community of Waldorf, Maryland, a suburb of metropolitan Washington, DC, through a wholly-owned subsidiary of its operating partnership. The center was 84% leased at December 31, 2006 and was acquired for a purchase price of \$17.5 million subject to the assumption of an \$11.3 million mortgage loan. The Company is planning and will seek permits for a capital improvement project to improve access to the center, reconfigure the center and upgrade the center's façade. A construction timetable has yet to be established.

### *Ravenwood*

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

### *Lexington Center*

On September 29, 2005, the Company announced the resolution of a land use dispute at Lexington Mall, allowing increased flexibility in future development rights for its property. The Company and the land owner of the adjacent 16 acre site, have resolved a dispute arising from a reciprocal easement agreement governing land use between the two owners. The parties have now executed a new land use agreement which grants each other the flexibility to improve its property. The Company also reached an agreement with Dillard's to terminate its lease, without consideration exchanged by either party. The Dillard's store closed during October 2005. The departure of Dillard's now leaves the mall vacant and combined with the new land use agreement, expands potential redevelopment options. The Company has engaged land planners and architects to prepare conceptual designs for the shopping center's development and marketing to prospective retailers.

### *Hunt Club Corners*

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

### *Ashburn Village-Phase V*

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

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*Clarendon Center*

The Company owns an assemblage of land parcels (including its Clarendon and Clarendon Station operating properties) totaling approximately 1.5 acres adjacent to the Clarendon Metro Station in Arlington, Virginia. In June 2006, the Company obtained zoning approvals for a mixed-use development project to include up to approximately 50,000 square feet of retail space, 170,000 square feet of office space and 244 residential units. The Company has engaged architects and engineers and is proceeding with construction documents. A development timetable has not yet been finalized.

*Westview Village*

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

**Item 1A. Risk Factors**

**RISK FACTORS**

Before investing in our securities, you should consider carefully the risks described in this prospectus, together with the other information incorporated by reference into this prospectus. If any of the following risks actually occur, our business, financial condition and operating results could be materially adversely affected.

***Revenue from our properties may be reduced or limited if the retail operations of our tenants are not successful.***

Revenue from our properties depends primarily on the ability of our tenants to pay the full amount of rent due under their leases on a timely basis. Some of our leases provide for the payment, in addition to base rent, of additional rent above the base amount according to a specified percentage of the gross sales generated by the tenants. The amount of rent we receive from our tenants generally will depend in part on the success of our tenants' retail operations, making us vulnerable to general economic downturns and other conditions affecting the retail industry. Any reduction in our tenants' ability to pay base rent or percentage rent may adversely affect our financial condition and results of operations.

***Our ability to increase our net income depends on the success and continued presence of our shopping center anchor tenants and other significant tenants.***

Our net income could be adversely affected in the event of a downturn in the business, or the bankruptcy or insolvency, of any anchor store or anchor tenant. Our largest shopping center anchor tenant is Giant Food, which accounted for 4.9% of our total revenue for the year ended December 31, 2006. The closing of one or more anchor stores prior to the expiration of the lease of that store or the termination of a lease by one or more of a property's anchor tenants could adversely affect that property and result in lease terminations by, or reductions in rent from, other tenants whose leases may permit termination or rent reduction in those circumstances or whose own operations may suffer as a result. This could reduce our net income.

***We may experience difficulty or delay in renewing leases or re-leasing space.***

We derive most of our revenue directly or indirectly from rent received from our tenants. We are subject to the risks that, upon expiration, leases for space in our properties may not be renewed, the space may not be re-leased, or the terms of renewal or re-lease, including the cost of required renovations or concessions to tenants, may be less favorable than current lease terms. As a result, our results of operations and our net income could be reduced.

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*We have substantial relationships with members of The Saul Organization whose interests could conflict with the interests of other stockholders.*

*Influence of Officers, Directors and Significant Stockholders.*

Two of our officers, Mr. Saul II and his son and our President, B. Francis Saul III, are members of The Saul Organization, and persons associated with The Saul Organization constitute four of the 12 members of our Board of Directors. In addition, as of December 31, 2006, Mr. Saul beneficially owned, for purposes of SEC reporting, 7,396,000 shares of our common stock representing 43.1% of our issued and outstanding shares of common stock. Mr. Saul also beneficially owned, as of December 31, 2006, 5,416,000 units of the Partnership. In general, these units are convertible into shares of our common stock on a one-for-one basis. The ownership limitation set forth in our articles of incorporation is 39.9% in value of our issued and outstanding equity securities (which includes both common and preferred stock). As calculated under the articles of incorporation, Mr. Saul beneficially owns approximately 32.2% of our issued and outstanding equity securities.

As a result of these relationships, members of The Saul Organization will be in a position to exercise significant influence over our affairs, which influence might not be consistent with the interests of some, or a majority, of our stockholders.

*Management Time.*

Our Chief Executive Officer, President, Vice President-Chief Accounting Officer and Senior Vice President-General Counsel are also officers of various members of The Saul Organization. Although we believe that these officers spend sufficient management time to meet their responsibilities as our officers, the amount of management time devoted to us will depend on our specific circumstances at any given point in time. As a result, in a given period, these officers may spend less than a majority of their management time on our matters. Over extended periods of time, we believe that our Chief Executive Officer will spend less than a majority of his management time on Company matters, while our President, Vice President-Chief Accounting Officer and Senior Vice President-General Counsel may or may not spend less than a majority of their time on our matters.

*Exclusivity and Right of First Refusal Agreements.*

We will acquire, develop, own and manage shopping center properties and will own and manage other commercial properties, and, subject to certain exclusivity agreements and rights of first refusal to which we are a party, The Saul Organization will continue to develop, acquire, own and manage commercial properties and own land suitable for development as, among other things, shopping centers and other commercial properties. Therefore, conflicts could develop in the allocation of acquisition and development opportunities with respect to commercial properties other than shopping centers and with respect to development sites, as well as potential tenants and other matters, between us and The Saul Organization. The agreement relating to exclusivity and the right of first refusal between us and The Saul Organization (other than Chevy Chase Bank, F.S.B.) generally requires The Saul Organization to conduct its shopping center business exclusively through us and to grant us a right of first refusal to purchase commercial properties and development sites in certain market areas that become available to The Saul Organization. The Saul Organization has granted the right of first refusal to us, acting through our independent directors, in order to minimize potential conflicts with respect to commercial properties and development sites. We and The Saul Organization have entered into this agreement in order to minimize conflicts with respect to shopping centers and certain of our commercial properties.

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*Shared Services.*

We share with The Saul Organization certain ancillary functions, such as computer and payroll services, benefits administration and in-house legal services. The terms of all sharing arrangements, including payments related thereto, are reviewed periodically by our audit committee, which is comprised solely of independent directors. Included in our general and administrative expenses for the year ended December 31, 2006 are charges totaling \$3,963,000, related to such shared services, which included rental payments for the Company's headquarters lease, which were billed by The Saul Organization. Although we believe that the amounts allocated to us for such shared services represent a fair allocation between us and The Saul Organization, we have not obtained a third party appraisal of the value of these services.

*Related Party Rents.*

Chevy Chase Bank leases space in 16 of the properties owned by us. The total rental income from Chevy Chase Bank for the year ended December 31, 2006 was \$2,220,000, representing approximately 1.6% of our total revenue for such period. Although we believe that these leases have comparable terms to leases we have entered into with third-party tenants, the terms of these leases were not set as a result of arm's-length negotiation. In addition, because Chevy Chase Bank is a member of The Saul Organization, we may be less inclined to take an action or the timing of any action could be influenced if there is a default. The terms of any lease with Chevy Chase Bank are approved in advance by our audit committee, which is comprised solely of independent directors.

In addition, the lease for our corporate headquarters, which commenced in March 2002, is with a member of The Saul Organization. The Company's corporate headquarters lease is leased by a member of The Saul Organization. The 10-year lease provides for base rent escalated at 3% per year, with payment of a pro-rata share of operating expenses over a base year amount. The Company and The Saul Organization entered into a Shared Services Agreement whereby each party pays an allocation of total rental payments on a percentage proportionate to the number of employees employed by each party. The Company's rent payment for the year ended December 31, 2006 was \$726,000. Although the Company believes that this lease has comparable terms to what would have been obtained from a third party landlord, it did not seek bid proposals from any independent third parties when entering into its new corporate headquarters lease.

*Conflicts Based on Individual Tax Considerations.*

The tax basis of members of The Saul Organization in our portfolio properties which were contributed to certain partnerships at the time of our initial public offering in 1993 was substantially less than the fair market value thereof at the time of their contribution. In the event of our disposition of such properties, a disproportionately large share of the gain for federal income tax purposes would be allocated to members of The Saul Organization. In addition, future reductions of the level of our debt, or future releases of the guarantees or indemnities with respect thereto by members of The Saul Organization, would cause members of The Saul Organization to be considered, for federal income tax purposes, to have received constructive distributions. Depending on the overall level of debt and other factors, these distributions could be in excess of The Saul Organization's bases in their Partnership units, in which case such excess constructive distributions would be taxable.

Consequently, it is in the interests of The Saul Organization that we continue to hold the contributed portfolio properties, that a portion of our debt remains outstanding or is refinanced and that The Saul Organization guarantees and indemnities remain in place, in order to defer the taxable gain to members of The Saul Organization. Therefore, The Saul Organization may seek to cause us to retain the contributed portfolio properties, and to refrain from reducing our debt or releasing The Saul Organization guarantees and indemnities, even when such action may not be in the interests of some, or a majority, of our stockholders. In order to minimize these conflicts, decisions as to sales of the portfolio properties, or any refinancing, repayment or release of guarantees and indemnities with respect to our debt, will be made by the independent directors.

*Ability to Block Certain Actions.*

Under applicable law and the limited partnership agreement of the Partnership, consent of the limited partners is required to permit certain actions, including the sale of all or substantially all of the Partnership's assets. Therefore, members of The Saul Organization, through their status as limited partners in the Partnership, could prevent the taking of any such actions, even if they were in the interests of some, or a majority, of our stockholders.



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***The amount of debt we have and the restrictions imposed by that debt could adversely affect our business and financial condition.***

As of December 31, 2006, we had approximately \$522.4 million of debt outstanding, \$487.4 million of which was long-term fixed rate debt and was secured by 34 of our properties. The remaining \$35.0 million of outstanding debt was borrowed under the revolving credit facility.

We currently have a general policy of limiting our borrowings to 50 percent of asset value, i.e., the value of our portfolio, as determined by our Board of Directors by reference to the aggregate annualized cash flow from our portfolio. Our organizational documents contain no limitation on the amount or percentage of indebtedness which we may incur. Therefore, the Board of Directors could alter or eliminate the current limitation on borrowing at any time. If our debt capitalization policy were changed, we could become more highly leveraged, resulting in an increase in debt service that could adversely affect our operating cash flow and our ability to make expected distributions to stockholders, and in an increased risk of default on our obligations.

We have established our debt capitalization policy relative to asset value, which is computed by reference to the aggregate annualized cash flow from the properties in our portfolio rather than relative to book value. We have used a measure tied to cash flow because we believe that the book value of our portfolio properties, which is the depreciated historical cost of the properties, does not accurately reflect our ability to borrow. Asset value, however, is somewhat more variable than book value, and may not at all times reflect the fair market value of the underlying properties.

The amount of our debt outstanding from time to time could have important consequences to our stockholders. For example, it could:

require us to dedicate a substantial portion of our cash flow from operations to payments on our debt, thereby reducing funds available for operations, property acquisitions and other appropriate business opportunities that may arise in the future;

limit our ability to obtain any additional financing we may need in the future for working capital, debt refinancing, capital expenditures, acquisitions, development or other general corporate purposes;

make it difficult to satisfy our debt service requirements;

limit our ability to make distributions on our outstanding common and preferred stock;

require us to dedicate increased amounts of our cash flow from operations to payments on our variable rate, unhedged debt if interest rates rise;

limit our flexibility in planning for, or reacting to, changes in our business and the factors that affect the profitability of our business, which may place us at a disadvantage compared to competitors with less debt or debt with less restrictive terms; and

limit our ability to obtain any additional financing we may need in the future for working capital, debt refinancing, capital expenditures, acquisitions, development or other general corporate purposes.

Our ability to make scheduled payments of the principal of, to pay interest on, or to refinance, our indebtedness will depend primarily on our future performance, which to a certain extent is subject to economic, financial, competitive and other factors described in this section. If we are unable to generate sufficient cash flow from our business in the future to service our debt or meet our other cash needs, we may be required to refinance all or a portion of our existing debt, sell assets or obtain additional financing to meet our debt obligations and other cash needs. Our ability to refinance, sell assets or obtain additional financing may not be possible on terms that we would find acceptable.

***We are obligated to comply with financial and other covenants in our debt that could restrict our operating activities, and the failure to comply could result in defaults that accelerate the payment under our debt.***

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Our secured debt generally contains customary covenants, including, among others, provisions:

relating to the maintenance of the property securing the debt;

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restricting our ability to assign or further encumber the properties securing the debt; and

restricting our ability to enter into certain new leases or to amend or modify certain existing leases without obtaining consent of the lenders.

Our unsecured debt generally contains various restrictive covenants. The covenants in our unsecured debt include, among others, provisions restricting our ability to:

incur additional unsecured debt;

guarantee additional debt;

make certain distributions, investments and other restricted payments, including distribution payments on our outstanding stock;

create certain liens;

increase our overall secured and unsecured borrowing beyond certain levels; and

consolidate, merge or sell all or substantially all of our assets.

Our ability to meet some of the covenants in our debt, including covenants related to the condition of the property or payment of real estate taxes, may be dependent on the performance by our tenants under their leases. In addition, our line of credit requires us and our subsidiaries to satisfy financial covenants. The material financial covenants require us, on a consolidated basis, to:

limit the amount of debt so as to maintain a gross asset value, as defined in the loan agreement, in excess of liabilities of at least \$400 million plus 90% of our future net equity proceeds;

limit the amount of debt as a percentage of gross asset value (leverage ratio) to 60% or less;

limit the amount of debt so that interest expense coverage is not less than 2.1 to 1 on a trailing four quarter basis;

limit the amount of debt so that interest, scheduled principal amortization and preferred dividend coverage is not less than 1.55 to 1 on a trailing four quarter basis; and

limit the amount of variable rate debt and debt with initial loan terms of less than 5 years to no more than 40% of total debt.

As of December 31, 2006, we were in compliance with all such covenants. If we were to breach any of our debt covenants and did not cure the breach within any applicable cure period, our lenders could require us to repay the debt immediately, and, if the debt is secured, could immediately begin proceedings to take possession of the property securing the loan. Some of our debt arrangements are cross-defaulted, which means that the lenders under those debt arrangements can put us in default and require immediate repayment of their debt if we breach and fail to cure a covenant under certain of our other debt obligations. As a result, any default under our debt covenants could have an adverse effect on our financial condition, our results of operations, our ability to meet our obligations and the market value of our shares.

*Our development activities are inherently risky.*

The ground-up development of improvements on real property, as opposed to the renovation and redevelopment of existing improvements, presents substantial risks. In addition to the risks associated with real estate investment in general as described elsewhere, the risks associated with our remaining development activities include:

significant time lag between commencement and completion subjects us to greater risks due to fluctuation in the general economy;

failure or inability to obtain construction or permanent financing on favorable terms;

expenditure of money and time on projects that may never be completed;

inability to achieve projected rental rates or anticipated pace of lease-up;

higher-than-estimated construction costs, including labor and material costs; and

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possible delay in completion of the project because of a number of factors, including weather, labor disruptions, construction delays or delays in receipt of zoning or other regulatory approvals, or acts of God (such as fires, earthquakes or floods).

***Redevelopments and acquisitions may fail to perform as expected.***

Our investment strategy includes the redevelopment and acquisition of community and neighborhood shopping centers that are anchored by supermarkets, drugstores or high volume, value-oriented retailers that provide consumer necessities. The redevelopment and acquisition of properties entails risks that include the following, any of which could adversely affect our results of operations and our ability to meet our obligations:

our estimate of the costs to improve, reposition or redevelop a property may prove to be too low, and, as a result, the property may fail to achieve the returns we have projected, either temporarily or for a longer time;

we may not be able to identify suitable properties to acquire or may be unable to complete the acquisition of the properties we identify;

we may not be able to integrate new developments or acquisitions into our existing operations successfully;

properties we redevelop or acquire may fail to achieve the occupancy or rental rates we project at the time we make the decision to invest, which may result in the properties' failure to achieve the returns we projected;

our pre-acquisition evaluation of the physical condition of each new investment may not detect certain defects or identify necessary repairs until after the property is acquired, which could significantly increase our total acquisition costs; and

our investigation of a property or building prior to our acquisition, and any representations we may receive from the seller, may fail to reveal various liabilities, which could reduce the cash flow from the property or increase our acquisition cost.

***Our ability to grow will be limited if we cannot obtain additional capital.***

Our growth strategy includes the redevelopment of properties we already own and the acquisition of additional properties. Because we are required to distribute to our stockholders at least 90% of our taxable income each year to continue to qualify as a real estate investment trust, or REIT, for federal income tax purposes, in addition to our undistributed operating cash flow, we rely upon the availability of debt or equity capital to fund our growth, which financing may or may not be available on favorable terms or at all. The debt could include mortgage loans from third parties or the sale of debt securities. Equity capital could include our common stock or preferred stock. Additional financing, refinancing or other capital may not be available in the amounts we desire or on favorable terms. Our access to debt or equity capital depends on a number of factors, including the market's perception of our growth potential, our ability to pay dividends, and our current and potential future earnings. Depending on the outcome of these factors, we could experience delay or difficulty in implementing our growth strategy on satisfactory terms, or be unable to implement this strategy.

***Our performance and value are subject to general risks associated with the real estate industry.***

Our economic performance and the value of our real estate assets, and, consequently, the value of our investments, are subject to the risk that if our properties do not generate revenue sufficient to meet our operating expenses, including debt service and capital expenditures, our cash flow and ability to pay distributions to our stockholders will be adversely affected. As a real estate company, we are susceptible to the following real estate industry risks:

economic downturns in the areas where our properties are located;

adverse changes in local real estate market conditions, such as oversupply or reduction in demand;

changes in tenant preferences that reduce the attractiveness of our properties to tenants;

zoning or regulatory restrictions;

decreases in market rental rates;

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weather conditions that may increase energy costs and other operating expenses;

costs associated with the need to periodically repair, renovate and re-lease space; and

increases in the cost of adequate maintenance, insurance and other operating costs, including real estate taxes, associated with one or more properties, which may occur even when circumstances such as market factors and competition cause a reduction in revenue from one or more properties, although real estate taxes typically do not increase upon a reduction in such revenue.

***Many real estate costs are fixed, even if income from our properties decreases.***

Our financial results depend primarily on leasing space in our properties to tenants on terms favorable to us. Costs associated with real estate investment, such as real estate taxes and maintenance costs, generally are not reduced even when a property is not fully occupied, rental rates decrease, or other circumstances cause a reduction in income from the investment. As a result, cash flow from the operations of our properties may be reduced if a tenant does not pay its rent or we are unable to rent our properties on favorable terms. Under those circumstances, we might not be able to enforce our rights as landlord without delays, and may incur substantial legal costs. Additionally, new properties that we may acquire or develop may not produce any significant revenue immediately, and the cash flow from existing operations may be insufficient to pay the operating expenses and debt service associated with that property until the property is fully leased.

***Competition may limit our ability to purchase new properties and generate sufficient income from tenants.***

Numerous commercial developers and real estate companies compete with us in seeking tenants for properties and properties for acquisition. This competition may:

reduce properties available for acquisition;

increase the cost of properties available for acquisition;

reduce rents payable to us;

interfere with our ability to attract and retain tenants;

lead to increased vacancy rates at our properties; and

adversely affect our ability to minimize expenses of operation.

Retailers at our shopping center properties also face increasing competition from outlet stores, discount shopping clubs, and other forms of marketing of goods, such as direct mail, internet marketing and telemarketing. This competition may reduce percentage rents payable to us and may contribute to lease defaults and insolvency of tenants. If we are unable to continue to attract appropriate retail tenants to our properties, or to purchase new properties in our geographic markets, it could materially affect our ability to generate net income, service our debt and make distributions to our stockholders.

***We may be unable to sell properties when appropriate because real estate investments are illiquid.***

Real estate investments generally cannot be sold quickly. In addition, there are some limitations under federal income tax laws applicable to real estate and to REITs in particular that may limit our ability to sell our assets. We may not be able to alter our portfolio promptly in response to changes in economic or other conditions. Our inability to respond quickly to adverse changes in the performance of our investments could have an adverse effect on our ability to meet our obligations and make distributions to our stockholders.

*Our insurance coverage on our properties may be inadequate.*

We carry comprehensive insurance on all of our properties, including insurance for liability, fire, flood, terrorism and rental loss. These policies contain coverage limitations. We believe this coverage is of the type and amount customarily obtained for or by an owner of real property assets. We intend to obtain similar insurance coverage on subsequently acquired properties.

As a consequence of the September 11, 2001 terrorist attacks and other significant losses incurred by the insurance industry, the availability of insurance coverage has decreased and the prices for insurance have increased.



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As a result, we may be unable to renew or duplicate our current insurance coverage in adequate amounts or at reasonable prices. In addition, insurance companies may no longer offer coverage against certain types of losses, such as losses due to terrorist acts and toxic mold, or, if offered, the expense of obtaining these types of insurance may not be justified. We therefore may cease to have insurance coverage against certain types of losses and/or there may be decreases in the limits of insurance available. If an uninsured loss or a loss in excess of our insured limits occurs, we could lose all or a portion of the capital we have invested in a property, as well as the anticipated future revenue from the property, but still remain obligated for any mortgage debt or other financial obligations related to the property. Material losses in excess of insurance proceeds may occur in the future. Also, due to inflation, changes in codes and ordinances, environmental considerations and other factors, it may not be feasible to use insurance proceeds to replace a building after it has been damaged or destroyed. Events such as these could adversely affect our results of operations and our ability to meet our obligations, including distributions to our stockholders.

***Environmental laws and regulations could reduce the value or profitability of our properties.***

All real property and the operations conducted on real property are subject to federal, state and local laws, ordinances and regulations relating to hazardous materials, environmental protection and human health and safety. Under various federal, state and local laws, ordinances and regulations, we and our tenants may be required to investigate and clean up certain hazardous or toxic substances released on or in properties we own or operate, and also may be required to pay other costs relating to hazardous or toxic substances. This liability may be imposed without regard to whether we or our tenants knew about the release of these types of substances or were responsible for their release. The presence of contamination or the failure to properly remediate contamination at any of our properties may adversely affect our ability to sell or lease those properties or to borrow using those properties as collateral. The costs or liabilities could exceed the value of the affected real estate. We are not aware of any environmental condition with respect to any of our properties that management believes would have a material adverse effect on our business, assets or results of operations taken as a whole. The uses of any of our properties prior to our acquisition of the property and the building materials used at the property are among the property-specific factors that will affect how the environmental laws are applied to our properties. If we are subject to any material environmental liabilities, the liabilities could adversely affect our results of operations and our ability to meet our obligations.

We cannot predict what other environmental legislation or regulations will be enacted in the future, how existing or future laws or regulations will be administered or interpreted or what environmental conditions may be found to exist on the properties in the future. Compliance with existing and new laws and regulations may require us or our tenants to spend funds to remedy environmental problems. Our tenants, like many of their competitors, have incurred, and will continue to incur, capital and operating expenditures and other costs associated with complying with these laws and regulations, which will adversely affect their potential profitability. Generally, our tenants must comply with environmental laws and meet remediation requirements. Our leases typically impose obligations on our tenants to indemnify us from any compliance costs we may incur as a result of the environmental conditions on the property caused by the tenant. If a tenant fails to or cannot comply, we could be forced to pay these costs. If not addressed, environmental conditions could impair our ability to sell or re-lease the affected properties in the future or result in lower sales prices or rent payments.

***The Americans with Disabilities Act of 1990 could require us to take remedial steps with respect to newly acquired properties.***

The properties, as commercial facilities, are required to comply with Title III of the Americans with Disabilities Act of 1990. Investigation of a property may reveal non-compliance with this Act. The requirements of the Act, or of other federal, state or local laws, also may change in the future and restrict further renovations of our properties with respect to access for disabled persons. Future compliance with the Act may require expensive changes to the properties.

***The revenue generated by our tenants could be negatively affected by various federal, state and local laws to which they are subject.***

We and our tenants are subject to a wide range of federal, state and local laws and regulations, such as local licensing requirements, consumer protection laws and state and local fire, life-safety and similar requirements that affect the use of the properties. The leases typically require that each tenant comply with all regulations. Failure to

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comply could result in fines by governmental authorities, awards of damages to private litigants, or restrictions on the ability to conduct business on such properties. Non-compliance of this sort could reduce our revenue from a tenant, could require us to pay penalties or fines relating to any non-compliance, and could adversely affect our ability to sell or lease a property.

***Failure to qualify as a REIT for federal income tax purposes would cause us to be taxed as a corporation, which would substantially reduce funds available for payment of distributions.***

We believe that we are organized and qualified as a REIT, and currently intend to operate in a manner that will allow us to continue to qualify as a REIT for federal income tax purposes under the Code. However, the IRS could successfully assert that we are not qualified as such. In addition, we may not remain qualified as a REIT in the future. Qualification as a REIT involves the application of highly technical and complex Code provisions. The complexity of these provisions and of the applicable income tax regulations that have been issued under the Code by the United States Department of Treasury is greater in the case of a REIT that holds its assets in partnership form. Certain facts and circumstances not entirely within our control may affect our ability to qualify as a REIT. For example, in order to qualify as a REIT, at least 95% of our gross income in any year must be derived from qualifying rents and other income. Satisfying this requirement could be difficult, for example, if defaults by tenants were to reduce the amount of income from qualifying rents. Also, we must make annual distributions to stockholders of at least 90% of our net taxable income (excluding capital gains). In addition, new legislation, new regulations, new administrative interpretations or new court decisions may significantly change the tax laws with respect to qualification as a REIT or the federal income tax consequences of such qualification. If we fail to qualify as a REIT:

we would not be allowed a deduction for dividend distributions to stockholders in computing taxable income;

we would be subject to federal income tax at regular corporate rates;

we could be subject to the federal alternative minimum tax;

unless we are entitled to relief under specific statutory provisions, we could not elect to be taxed as a REIT for four taxable years following the year during which we were disqualified;

we could be required to pay significant income taxes, which would substantially reduce the funds available for investment and for distribution to our stockholders for each year in which we failed to qualify; and

we would no longer be required by law to make any distributions to our stockholders.

We believe that the Partnership is treated as a partnership, and not as a corporation, for federal income tax purposes. If the IRS were to challenge successfully the status of the Partnership as a partnership for federal income tax purposes:

the Partnership would be taxed as a corporation;

we would cease to qualify as a REIT for federal income tax purposes; and

the amount of cash available for distribution to our stockholders would be substantially reduced.

***We may be required to incur additional debt to qualify as a REIT.***

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As a REIT, we must make annual distributions to stockholders of at least 90% of our REIT taxable income. We are subject to income tax on amounts of undistributed REIT taxable income and net capital gain. In addition, we would be subject to a 4% excise tax if we fail to distribute sufficient income to meet a minimum distribution test based on our ordinary income, capital gain and aggregate undistributed income from prior years.

We intend to make distributions to stockholders to comply with the Code's distribution provisions and to avoid federal income and excise tax. We may need to borrow funds to meet our distribution requirements because:

our income may not be matched by our related expenses at the time the income is considered received for purposes of determining taxable income; and

non-deductible capital expenditures or debt service requirements may reduce available cash but not taxable income.

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In these circumstances, we might have to borrow funds on unfavorable terms and even if our management believes the market conditions make borrowing financially unattractive.

***The structure of our leases may jeopardize our ability to qualify as a REIT.***

If the IRS were to challenge successfully the characterization of one or more of our leases of properties as leases for federal income tax purposes, the Partnership would not be treated as the owner of the related property or properties for federal income tax purposes. As a result, the Partnership would lose tax depreciation and cost recovery deductions with respect to one or more of our properties, which in turn could cause us to fail to qualify as a REIT. Although we will use our best efforts to structure any leasing transaction for properties acquired in the future so the lease will be characterized as a lease and the Partnership will be treated as the owner of the property for federal income tax purposes, we will not seek an advance ruling from the IRS and do not intend to seek an opinion of counsel that the Partnership will be treated as the owner of any leased properties for federal income tax purposes. Thus, the IRS could successfully assert that future leases will not be treated as leases for federal income tax purposes, which could adversely affect our financial condition and results of operations.

***To maintain our status as a REIT, we limit the amount of shares any one stockholder can own.***

The Code imposes certain limitations on the ownership of the stock of a REIT. For example, not more than 50% in value of our outstanding shares of capital stock may be owned, actually or constructively, by five or fewer individuals (as defined in the Code). To protect our REIT status, our articles of incorporation restrict beneficial and constructive ownership (defined by reference to various Code provisions) to no more than 2.5% in value of our issued and outstanding equity securities by any single stockholder with the exception of members of The Saul Organization, who are restricted to beneficial and constructive ownership of no more than 39.9% in value of our issued and outstanding equity securities.

The constructive ownership rules are complex. Shares of our capital stock owned, actually or constructively, by a group of related individuals and/or entities may be treated as constructively owned by one of those individuals or entities. As a result, the acquisition of less than 2.5% or 39.9% in value of our issued and outstanding equity securities, by an individual or entity could cause that individual or entity (or another) to own constructively more than 2.5% or 39.9% in value of the outstanding stock. If that happened, either the transfer or ownership would be void or the shares would be transferred to a charitable trust and then sold to someone who can own those shares without violating the respective ownership limit.

The Board of Directors may waive these restrictions on a case-by-case basis. The Board has granted waivers to look-through entities, such as mutual funds, in which shares of equity stock owned by the entity are treated as owned proportionally by individuals who are the beneficial owners of the entity. Even though these entities owned stock in excess of the 2.5% ownership limit, no individual beneficially or constructively owned more than 2.5%. In addition, in September 1999, our Board of Directors agreed to waive the ownership limit with respect to Wells Fargo Bank, National Association and U.S. Bank National Association, the pledges of certain shares of our common stock and units issued by the Partnership and held by members of The Saul Organization.

The ownership restrictions may delay, defer or prevent a transaction or a change of our control that might involve a premium price for our equity stock or otherwise be in the stockholders' best interest.

***The lower tax rate on dividends of regular corporations may cause investors to prefer to hold stock of regular corporations instead of REITs.***

On May 28, 2003, the President signed into law the Jobs and Growth Tax Relief Reconciliation Act of 2003 (which we will refer to as the Act). Under the Act, the maximum tax rate on the long-term capital gains of non-corporate taxpayers is 15% (applicable to sales occurring from May 7, 2003 through December 31, 2008). The Act also reduced the tax rate on qualified dividend income to the maximum capital gains rate. Because, as a REIT, we are not generally subject to tax on the portion of our REIT taxable income or capital gains distributed to our stockholders, our distributions are not generally eligible for this new tax rate on dividends. As a result, our ordinary REIT dividends generally continue to be taxed at the higher tax rates applicable to ordinary income. Without further legislation, the maximum tax rate on long-term capital gains will revert to 20% in 2009, and dividends will again be subject to tax at ordinary rates.

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*We cannot assure you we will continue to pay dividends at historical rates.*

Our ability to continue to pay dividends on our common stock at historical rates or to increase our common stock dividend rate will depend on a number of factors, including, among others, the following:

our financial condition and results of future operations;

the performance of lease terms by tenants;

the terms of our loan covenants; and

our ability to acquire, finance, develop or redevelop and lease additional properties at attractive rates.

If we do not maintain or increase the dividend rate on our common stock, it could have an adverse effect on the market price of our common stock and other securities. Payment of dividends on our common stock may be subject to payment in full of the dividends on any preferred stock or depositary shares and payment of interest on any debt securities we may offer.

*Certain tax and anti-takeover provisions of our articles of incorporation and bylaws may inhibit a change of our control.*

Certain provisions contained in our articles of incorporation and bylaws and the Maryland General Corporation Law may discourage a third party from making a tender offer or acquisition proposal to us. If this were to happen, it could delay, deter or prevent a change in control or the removal of existing management. These provisions also may delay or prevent the stockholders from receiving a premium for their stock over then-prevailing market prices. These provisions include:

the REIT ownership limit described above;

authorization of the issuance of our preferred stock with powers, preferences or rights to be determined by the Board of Directors;

a staggered, fixed-size Board of Directors consisting of three classes of directors;

special meetings of our stockholders may be called only by the Chairman of the Board, the president, by a majority of the directors or by stockholders possessing no less than 25% of all the votes entitled to be cast at the meeting;

the Board of Directors, without a stockholder vote, can classify or reclassify unissued shares of preferred stock;

a member of the Board of Directors may be removed only for cause upon the affirmative vote of 75% of the Board of Directors or 75% of the then-outstanding capital stock;

advance notice requirements for proposals to be presented at stockholder meetings; and

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the terms of our articles of incorporation regarding business combinations and control share acquisitions.

***We may amend or revise our business policies without your approval.***

Our Board of Directors may amend or revise our operating policies without stockholder approval. Our investment, financing and borrowing policies and policies with respect to all other activities, such as growth, debt, capitalization and operations, are determined by the Board of Directors or those committees or officers to whom the Board of Directors has delegated that authority. The Board of Directors may amend or revise these policies at any time and from time to time at its discretion. A change in these policies could adversely affect our financial condition and results of operations, and the market price of our securities.

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**Item 1B. Unresolved Staff Comments**

We have received no written comments from the Securities and Exchange Commission staff regarding our periodic or current reports in the 180 days preceding December 31, 2006 that remain unresolved.

**Item 2. Properties**

**Overview**

The Company is the owner and operator of a real estate portfolio composed of 47 operating properties totaling approximately 7,914,000 square feet of gross leasable area ( GLA ) and four development parcels as of December 31, 2006. The properties are located primarily in the Washington, DC/Baltimore metropolitan area. The portfolio is composed of 42 neighborhood and community Shopping Centers, and five predominantly Office Properties totaling approximately 6,708,000 and 1,206,000 square feet of GLA, respectively. A majority of the Shopping Centers are anchored by several major tenants. Twenty-eight of the Shopping Centers were anchored by a grocery store and offer primarily day-to-day necessities and services. No single property accounted for more than 7.2% of the total gross leasable area. Only two retail tenants, Giant Food (4.9%), a tenant at nine Shopping Centers and Safeway (3.2%), a tenant at seven Shopping Centers and one office tenant, the United States Government (3.0%), a tenant at six properties, individually accounted for more than 2.5% of the Company's total revenue for the year ended December 31, 2006.

The Company's Current Portfolio Properties primarily consists of seasoned properties that have been owned and managed by The Saul Organization for 20 years or more. The Company expects to hold its properties as long-term investments, and it has no maximum period for retention of any investment. It plans to selectively acquire additional income-producing properties and to expand, renovate, and improve its properties when circumstances warrant. See Item 1. Business Operating Strategies and Business Capital Policies.

**The Shopping Centers**

Community and neighborhood shopping centers typically are anchored by one or more supermarkets, discount department stores or drug stores. These anchors offer day-to-day necessities rather than apparel and luxury goods and, therefore, generate consistent local traffic. By contrast, regional malls generally are larger and typically are anchored by one or more full-service department stores.

The Shopping Centers (typically) are seasoned community and neighborhood shopping centers located in well established, highly developed, densely populated, middle and upper income areas. The 2006 average estimated population within a one and three-mile radius of the Shopping Centers is approximately 16,000 and 100,000, respectively. The 2006 average household income within the one and three-mile radius of the Shopping Centers is approximately \$91,100 and \$95,300, respectively, compared to a national average of \$71,100. Because the Shopping Centers generally are located in highly developed areas, management believes that there is little likelihood that significant numbers of competing centers will be developed in the future.

The Shopping Centers range in size from 12,000 to 567,000 square feet of GLA, with six in excess of 300,000 square feet, and an average of approximately 159,000 square feet. A majority of the Shopping Centers are anchored by several major tenants and other tenants offering primarily day-to-day necessities and services. Twenty-eight of the 42 Shopping Centers are anchored by a grocery store.

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The Office Properties

Four of the five Office Properties are located in the Washington, DC metropolitan area and contain an aggregate GLA of approximately 1,009,000 square feet, comprised of 922,000 and 87,000 square feet of office and retail space, respectively. The fifth Office Property is located in Tulsa, Oklahoma and contains GLA of 197,000 square feet. The Office Properties represent three distinct styles of facilities, are located in differing commercial environments with distinctive demographic characteristics, and are geographically removed from one another. As a consequence, management believes that the Washington, DC area office properties compete for tenants in different commercial and geographic sub-markets of the metropolitan Washington, DC market and do not compete with one another.

Management believes that the Washington, DC office market is one of the strongest and most stable leasing markets in the nation, with relatively low vacancy rates in comparison to other major metropolitan areas. Management believes that the long-term stability of this market is attributable to the status of Washington, DC as the nation's capital and to the presence of the Federal government, international agencies, and an expanding private sector job market. 601 Pennsylvania Avenue is a nine-story, 227,000 square foot Class A office building (with a small amount of street level retail space) built in 1986 and located in a prime location in downtown Washington, DC. Van Ness Square is a six-story, 156,000 square foot office/retail building which was redeveloped in 1990. Van Ness Square is located in a highly developed commercial area of Northwest Washington, DC which offers extensive retail and restaurant amenities. Washington Square at Old Town is a 235,000 square foot Class A mixed-use office/retail complex completed in 2000 and located on a two-acre site along Alexandria's main street, North Washington Street, in historic Old Town Alexandria, Virginia. Avenel Business Park is a 391,000 square foot research park located in the suburban Maryland, I-270 biotech corridor. The business park consists of twelve one-story buildings built in six phases, completed in 1981, 1985, 1989, 1998, 1999 and 2000.

Crosstown Business Center is a 197,000 square foot flex office/warehouse property located in Tulsa, Oklahoma. The property is located in close proximity to Tulsa's international airport and major roadways and has attracted tenants requiring light industrial and distribution facilities.

The following table sets forth, at the dates indicated, certain information regarding the Current Portfolio Properties:



**Table of Contents****Saul Centers, Inc.****Schedule of Current Portfolio Properties****December 31, 2006**

Property	Location	Leasable Area (Square Feet)	Year Developed or Acquired (Renovated)	Land Area (Acres)	Percentage Leased		Anchor / Significant Tenants
					Dec-06	Dec-05	
<b>Shopping Centers</b>							
Ashburn Village	Ashburn, VA	221,687	1994/00/01/02/06	26.4	99%	99%	Giant Food, Ruby Tuesday, Hallmark Cards
Beacon Center	Alexandria, VA	356,115	1972 (1993/99)	32.3	100%	98%	Lowe's, Giant Food, Office Depot, Outback Steakhouse, Marshalls, Hancock Fabrics, Party Depot, Panera Bread
Belvedere	Baltimore, MD	54,941	1972	4.8	41%	98%	Family Dollar
Boca Valley Plaza	Boca Raton, FL	121,269	2004	12.7	97%	91%	Publix, Wachovia Bank
Boulevard	Fairfax, VA	56,350	1994 (1999)	5.0	100%	100%	Panera Bread, Party City, Petco
Briggs Chaney MarketPlace	Silver Spring, MD	194,347	2004	18.2	100%	98%	Safeway, Ross Dress For Less, Chuck E Cheese, Family Dollar
Broadlands Village I & II	Ashburn, VA	137,479	2003/4	18.5	100%	100%	Safeway, The Original Steakhouse and Sports Theatre, Bonefish Grill
Broadlands Village III	Ashburn, VA	22,255	2006	5.5	100%	N/A	
Clarendon/Clarendon Station	Arlington, VA	11,808	1973/1996	0.6	70%	100%	
Countryside	Sterling, VA	141,696	2004	16.0	96%	96%	Safeway, CVS Pharmacy
Cruse MarketPlace	Cumming, GA	78,686	2004	10.6	97%	97%	Publix
Flagship Center	Rockville, MD	21,500	1972, 1989	0.5	100%	100%	
French Market	Oklahoma City, OK	244,724	1974 (1984/98)	13.8	93%	94%	Burlington Coat Factory, Bed Bath & Beyond, Famous Footwear, Lakeshore Learning Center, BridesMart, Staples, Dollar Tree
Germantown	Germantown, MD	27,241	1992	2.7	92%	92%	Total Health Medical Center
Giant	Baltimore, MD	70,040	1972 (1990)	5.0	100%	100%	Giant Food
The Glen	Lake Ridge, VA	134,317	1994	14.7	98%	100%	Safeway Marketplace, The Original Steakhouse and Sports Theatre
Great Eastern	District Heights, MD	254,448	1972 (1995)	23.9	100%	99%	Giant Food, Pep Boys, Big Lots, Capital Sports Complex

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Hampshire Langley	Takoma Park, MD	131,700	1972 (1979)	9.9	100%	100%	Safeway
Hunt Club Corners	Apopka, FL	101,454	2006	13.1	94%	N/A	Publix
Jamestown Place	Altamonte Springs, FL	96,372	2005	10.9	100%	N/A	Publix, Carrabas
Kentlands Square	Gaithersburg, MD	114,381	2002	11.5	100%	100%	Lowe s, Chipotle
Kentlands Place	Gaithersburg, MD	40,648	2005	3.4	100%	100%	Elizabeth Arden s Red Door Salon, Bonefish Grill

**Table of Contents****Saul Centers, Inc.****Schedule of Current Portfolio Properties****December 31, 2006**

Property	Location	Leasable Area		Land Area (Acres)	Percentage Leased		Anchor / Significant Tenants
		(Square Feet)	Year Developed or Acquired (Renovated)		Dec-06	Dec-05	
<b>Shopping Centers (continued)</b>							
Lowme Town Center	Leesburg, VA	188,346	2006	23.4	(A)	N/A	Harris Teeter, CVS Pharmacy, Panera Bread, Not Your Average Joes
Leesburg Pike	Baileys Crossroads, VA	97,752	1966(1982/95)	9.4	100%	100%	Party Depot, CVS Pharmacy, FedEx Kinkadee, Hollywood Video
Lexington Pads	Lexington, KY	13,646	1974	4.1	100%	100%	
Lumberton Plaza	Lumberton, NJ	193,044	1975(1992/96)	23.3	98%	99%	SuperFresh, Rite Aid, Ace Hardware
Monocacy Commons	Frederick, MD	109,144	2004	13.0	100%	100%	Giant Food, Panera Bread
Fort Washington Village	Ft. Washington, MD	143,062	2003	16.0	93%	90%	Safeway
Olney	Olney, MD	53,765	1975(1990)	3.7	97%	97%	Rite Aid
Altamonte Springs Center	Altamonte Springs, FL	126,446	2005	12.0	100%	100%	Albertsons, Office Depot, Mimi's Cafe, Toojay's Deli
Baltimore	Baltimore, MD	93,328	1972	8.0	100%	97%	Giant Food, Hollywood Video
Palm Harbor Plaza	Palm Harbor, FL	146,673	2005	18.4	91%	N/A	Publix, Palm Harbor Health Food, World Gym
Falls Church Corners	Falls Church, VA	567,291	1973 (1994-7)	31.6	100%	100%	The Home Depot, Shoppers Club, Michaels, Barnes & Noble, Ross Dress For Less, Circuit City, Street Fabric, Off-Broadway Shoes, The Room Store, Dress Barn
Fairfax Commons	Fairfax, VA	68,743	1975(1993/99)	6.7	100%	100%	Super H Mart
Waldorf Village Center	Waldorf, MD	197,861	2006	25.1	84%	N/A	Safeway, CVS
Glen Burnie	Glen Burnie, MD	484,115	1972(1986)	39.6	100%	99%	Giant Food, The Home Depot, Circuit City, Michaels, Marshalls, PetSmart, Value City Furniture, Athletic Warehouse
Richmond Side Plaza	Richmond, VA	373,651	1972	32.8	96%	95%	Farmers Foods, Maxway, Citi Trends, City of Richmond
Atlanta Dekalb Plaza	Atlanta, GA	163,418	1976	14.6	95%	90%	Pep Boys, Maxway, Consolidated Stores
Winston-Salem	Winston-Salem, NC	354,726	1972(1997)	30.5	93%	93%	Harris Teeter, Fresh Market, Borders Books & Music, Bed Bath & Beyond, Stein Mart, Eckerd, JoS. A. Banks, Bonefish Grill, Chico's, Taylor, New Balance, Aveda Salon, Christies Hallmark
Centreville	Centreville, VA	143,109	1990	17.2	97%	99%	Giant Food, Tuesday Morning, Blockbuster
Oklahoma City Park	Oklahoma City, OK	76,610	1975	11.2	19%	54%	Family Dollar

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e Oak	Silver Spring, MD	480,156	1972(1993)	28.5	100%	100%	Giant Food, Sears, Rite Aid
	Total Shopping Centers	6,708,344		629.1	96.1%	97.2%	

**Table of Contents****Saul Centers, Inc.****Schedule of Current Portfolio Properties****December 31, 2006**

<b>Property</b>	<b>Location</b>	<b>Leasable Area (Square Feet)</b>	<b>Year Developed or Acquired (Renovated)</b>	<b>Land Area (Acres)</b>	<b>Percentage Leased Dec-06</b>	<b>Dec-05</b>	<b>Anchor /Significant Tenants</b>
<b>Office Properties</b>							
Avenel Business Park	Gaithersburg, MD	390,579	1981-2000	37.1	99%	97%	General Services Administration, VIRxSYS, Broadsoft, Quanta Systems, SeraCare Life Sciences, Panacos Pharmaceutical
Crosstown Business Center	Tulsa, OK	197,135	1975(2000)	22.4	88%	90%	Compass Group, Roxtec, Outdoor Innovations, Auto Panels Plus, Gofit, Freedom Express
601 Pennsylvania Ave.	Washington, DC	226,604	1973(1986)	1.0	100%	100%	National Gallery of Art, American Assn. of Health Plans, Credit Union National Assn., Southern Company, HQ Global, Pharmaceutical Care Management Assn., Freedom Forum, Capital Grille
Van Ness Square	Washington, DC	156,493	1973(1990)	1.2	97%	95%	Team Video Intl, Office Depot, Pier 1
Washington Square	Alexandria, VA	235,042	1975(2000)	2.0	100%	99%	Vanderweil Engineering, World Wide Retail Exchange, EarthTech, Thales, Cooper Carry, Bank of America, Trader Joe's, Kinko's, Talbot's, Blockbuster
	<b>Total Office Properties</b>	<b>1,205,853</b>		<b>63.7</b>	<b>97.3%</b>	<b>96.6%</b>	
	<b>Total Portfolio</b>	<b>7,914,197</b>		<b>692.8</b>	<b>96.3%</b>	<b>97.1%</b>	

**Development Parcels**

Clarendon Center	Arlington, VA		2002	1.3	Obtained zoning approvals from Arlington County, June 2006. Architects and engineers drafting construction documents.		
Ashland Square	Dumfries, VA		2004	19.3	Site plan approval received from Prince William County for 125,000 SF shopping center development. Site work commenced during the 3rd quarter 2006.		
Lexington Center	Lexington, KY		1974	26.0	Subsequent to the execution of a new land use agreement, redevelopment commenced for approximately 26 of the property's 30 acres in		

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				September 2005, with site planning and conceptual designs underway.
New Market	New Market, MD	2005	35.5	Parcel will accommodate retail development in excess of 120,000 SF near I-70, east of Frederick, Maryland.
	Total Development Properties		82.1	

(A) Lansdowne Town Center was 85% leased at December 31, 2006, but only 45% of the space was in operation at year end.

**Table of Contents****Item 3. Legal Proceedings**

In the normal course of business, the Company is involved in litigation, including litigation arising out of the collection of rents, the enforcement or defense of the priority of its security interests, and the continued development and marketing of certain of its real estate properties. In the opinion of management, litigation that is currently pending should not have a material adverse impact on the financial condition or future operations of the Company.

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

None.

**PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities****Market Information**

Shares of Saul Centers common stock are listed on the New York Stock Exchange under the symbol "BFS". The composite high and low closing sale prices for the shares of common stock as reported by the New York Stock Exchange for each quarter of 2006 and 2005 were as follows:

Period	Share Price	
	High	Low
October 1, 2006 - December 31, 2006	\$ 56.99	\$ 44.99
July 1, 2006 - September 30, 2006	\$ 45.55	\$ 38.37
April 1, 2006 - June 30, 2006	\$ 42.35	\$ 35.67
January 1, 2006 - March 31, 2006	\$ 43.96	\$ 36.04
October 1, 2005 - December 31, 2005	\$ 38.46	\$ 33.82
July 1, 2005 - September 30, 2005	\$ 39.48	\$ 35.10
April 1, 2005 - June 30, 2005	\$ 36.41	\$ 31.80
January 1, 2005 - March 31, 2005	\$ 37.25	\$ 32.00

On March 9, 2007, the closing price was \$60.25.

**Holdings**

The approximate number of holders of record of the common stock was 300 as of March 9, 2007.

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### Dividends and Distributions

Under the Code, REITs are subject to numerous organizational and operating requirements, including the requirement to distribute at least 90% of REIT taxable income. The Company distributed amounts greater than the required amount in 2006 and 2005. Distributions by the Company to common stockholders and holders of limited partnership units in the Operating Partnership were \$37,611,000 in 2006 and \$34,887,000 in 2005. Distributions to preferred stockholders were \$8,000,000 in both 2006 and 2005. See Notes to Financial Statements, No. 14, Distributions. The Company may or may not elect to distribute in excess of 90% of REIT taxable income in future years.

The Company's estimate of cash flow available for distributions is believed to be based on reasonable assumptions and represents a reasonable basis for setting distributions. However, the actual results of operations of the Company will be affected by a variety of factors, including actual rental revenue, operating expenses of the Company, interest expense, general economic conditions, federal, state and local taxes (if any), unanticipated capital expenditures, the adequacy of reserves and preferred dividends. While the Company intends to continue paying regular quarterly distributions, any future payments will be determined solely by the Board of Directors and will depend on a number of factors, including cash flow of the Company, its financial condition and capital requirements, the annual distribution requirements required to maintain its status as a REIT under the Code, and such other factors as the Board of Directors deems relevant. We are obligated to pay regular quarterly distributions to holders of depositary shares of Series A preferred stock at the rate of \$2.00 per annum per depositary share, prior to distributions on the common stock.

The Company paid four quarterly distributions totaling \$1.68, \$1.60 and \$1.56, per common share during each of the years ended December 31, 2006, 2005 and 2004, respectively. The annual distribution amounts paid by the Company exceed the distribution amounts required for tax purposes. Distributions to the extent of our current and accumulated earnings and profits for federal income tax purposes generally will be taxable to a stockholder as ordinary dividend income. Distributions in excess of current and accumulated earnings and profits will be treated as a nontaxable reduction of the stockholder's basis in such stockholder's shares, to the extent thereof, and thereafter as taxable gain. Distributions that are treated as a reduction of the stockholder's basis in its shares will have the effect of deferring taxation until the sale of the stockholder's shares. The Company has determined that 86.0% of the total \$1.68 per common share paid in calendar year 2006 represents currently taxable dividend income to the stockholders, while the balance of 14.0% is considered return of capital. The Company has determined that for the \$1.60 per common share dividend paid in 2005, 95.0% was taxable dividend income and 5.0% was considered return of capital and for the \$1.56 per common share dividend paid in 2004, 80.0% was taxable dividend income and 20.0% was considered return of capital. No assurance can be given regarding what portion, if any, of distributions in 2007 or subsequent years will constitute a return of capital for federal income tax purposes. All of the preferred stock dividends paid are considered ordinary dividend income.

### Issuer Repurchases of Equity Securities

Through participation in the Company's Dividend Reinvestment Plan, B. Francis Saul II, the Company's Chairman of the Board and Chief Executive Officer, and B. F. Saul Real Estate Investment Trust, B.F. Saul Company and Van Ness Square Corporation, for each of which Mr. Saul II is either President or Chairman; B.F. Saul Property Company and Dearborn, L.L.C., which are wholly-owned subsidiaries of B. F. Saul Company and B. F. Saul Real Estate Investment Trust, respectively; and the B. F. Saul Company Employees' Profit Sharing Retirement Trust acquired an aggregate of 105,199 shares at a weighted average price of \$47.14 per share, for the October 31, 2006 dividend distribution. In addition, 162,200 shares were acquired in open market purchases at a weighted average price of \$55.24 per share during the fourth quarter of 2006 (November 9 through December 29). For the year ended December 31, 2006, Mr. Saul II and The Saul Organization acquired an aggregate of 269,269 shares at a weighted average price of \$41.88 per share, by reinvesting dividends. In addition, 264,100 shares were acquired in open market purchases at a weighted average price of \$50.08 per share for the year ended December 31, 2006.



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**Performance Graph**

Rules promulgated under the Exchange Act require the Company to present a graph comparing the cumulative total stockholder return on its Common Stock with the cumulative total stockholder return of (i) a broad equity market index, and (ii) a published industry index or peer group. The graph compares the cumulative total stockholder return of the Company's Common Stock, based on the market price of the Common Stock and assuming reinvestment of dividends, with the National Association of Real Estate Investment Trust Equity Index ( NAREIT Equity ), the S&P 500 Index ( S&P 500 ) and the Russell 2000 Index ( Russell 2000 ). The graph assumes the investment of \$100 on January 1, 2002.

**Item 6. Selected Financial Data**

The selected financial data of the Company contained herein has been derived from the consolidated financial statements of the Company. The data should be read in conjunction with Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements included elsewhere in this report. The historical selected financial data have been derived from audited financial statements for all periods.

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Saul Centers, Inc.

**SELECTED FINANCIAL DATA***(In thousands, except per share data)*

	Years Ended December 31,				
	2006	2005	2004	2003	2002
<b>Operating Data:</b>					
Total revenue	\$ 137,978	\$ 127,015	\$ 112,842	\$ 97,884	\$ 93,963
Operating expenses	97,505	89,990	79,135	70,738	67,753
Operating income	40,473	37,025	33,707	27,146	26,210
Non-operating income (loss)					
Gain on sale of property			572	182	1,426
Income before minority interests	40,473	37,025	34,279	27,328	27,636
Minority interests	(7,793)	(7,798)	(8,105)	(8,086)	(8,070)
Net income	32,680	29,227	26,174	19,242	19,566
Preferred dividends	(8,000)	(8,000)	(8,000)	(1,244)	
Net income available to common stockholders	\$ 24,680	\$ 21,227	\$ 18,174	\$ 17,998	\$ 19,566
<b>Per Share Data (diluted):</b>					
Net income available to common stockholders	\$ 1.43	\$ 1.27	\$ 1.12	\$ 1.15	\$ 1.31
Basic and Diluted Shares Outstanding					
Weighted average common shares - basic	17,075	16,663	16,154	15,591	14,865
Effect of dilutive options	158	107	57	17	22
Weighted average common shares - diluted	17,233	16,770	16,211	15,608	14,887
Weighted average convertible limited partnership units	5,395	5,233	5,194	5,182	5,172
Weighted average common shares and fully converted limited partnership units - diluted	22,628	22,003	21,405	20,790	20,059
<b>Dividends Paid:</b>					
Cash dividends to common stockholders (1)	\$ 28,579	\$ 26,542	\$ 25,061	\$ 24,171	\$ 23,030
Cash dividends per share	\$ 1.68	\$ 1.60	\$ 1.56	\$ 1.56	\$ 1.56
<b>Balance Sheet Data:</b>					
Real Estate Investments (net of accumulated depreciation)	\$ 627,651	\$ 567,417	\$ 501,388	\$ 387,292	\$ 353,628
Total assets	700,537	631,469	583,396	471,616	388,687
Total debt, including accrued interest	525,125	484,902	455,925	359,051	382,619
Preferred stock	100,000	100,000	100,000	100,000	

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Total stockholders' equity (deficit)	132,091	111,414	100,964	92,643	(13,267)
<b>Other Data</b>					
Cash flow provided by (used in):					
Operating activities	\$ 62,174	\$ 58,401	\$ 50,686	\$ 37,716	\$ 36,369
Investing activities	\$ (65,699)	\$ (73,805)	\$ (113,467)	\$ (49,121)	\$ (40,169)
Financing activities	\$ 3,579	\$ (10,150)	\$ 51,098	\$ 55,340	\$ 3,304
Funds from operations (2)					
Net income	\$ 32,680	\$ 29,227	\$ 26,174	\$ 19,242	\$ 19,566
Minority Interests	7,793	7,798	8,105	8,086	8,070
Real estate depreciation and amortization	25,648	24,197	21,324	17,838	17,821
Gain on sale of property			(572)	(182)	(1,426)
Funds from operations	66,121	61,222	55,031	44,984	44,031
Preferred dividends	(8,000)	(8,000)	(8,000)	(1,244)	
Funds from operations available to common shareholders	\$ 58,121	\$ 53,222	\$ 47,031	\$ 43,740	\$ 44,031

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- (1) For the years 2006, 2005, 2004, 2003 and 2002, shareholders reinvested \$14,842, \$15,330, \$13,774, \$13,349 and \$12,882, in newly issued common stock by operation of the Company's dividend reinvestment plan, respectively.
- (2) Funds From Operations (FFO) is a non-GAAP financial measure. For a definition of FFO, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations-Funds From Operations.

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**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) begins with the Company's primary business strategy to give the reader an overview of the goals of the Company's business. This is followed by a discussion of the critical accounting policies that the Company believes are important to understanding the assumptions and judgments incorporated in the Company's reported financial results. The next section, beginning on page 37, discusses the Company's results of operations for the past two years. Beginning on page 42, the Company provides an analysis of its liquidity and capital resources, including discussions of its cash flows, debt arrangements, sources of capital and financial commitments. Finally, on page 49, the Company discusses funds from operations, or FFO, which is a relative non-GAAP financial measure of performance of an equity REIT used by the REIT industry.

The MD&A should be read in conjunction with the other sections of this Annual Report on Form 10-K, including the consolidated financial statements and notes thereto appearing in Item 8 of this report. Historical results set forth in Selected Financial Information, the Financial Statements and Supplemental Data included in Item 6 and Item 8 and this section should not be taken as indicative of the Company's future operations.

**Overview**

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

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

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

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

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

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Although it is management's present intention to concentrate future acquisition and development activities on community and neighborhood shopping centers and office properties in the Washington, DC/Baltimore metropolitan area and the southeastern region of the United States, the Company may, in the future, also acquire other types of real estate in other areas of the country as opportunities present themselves. While the Company may diversify in terms of property locations, size and market, the Company does not set any limit on the amount or percentage of Company assets that may be invested in any one property or any one geographic area. In addition to investing in properties in the Washington, DC/Baltimore metropolitan area, during 2004, 2005 and 2006, the Company also acquired five grocery-anchored neighborhood shopping centers in Florida, totaling 592,000 square feet and another grocery-anchored neighborhood shopping center in Georgia totaling 79,000 square feet.

## Critical Accounting Policies

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

### *Real Estate Investments*

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

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

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

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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.

### *Lease Acquisition Costs*

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

### *Revenue Recognition*

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

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

Accounts receivable primarily represent amounts accrued and unpaid from tenants in accordance with the terms of the respective leases, subject to the Company's revenue recognition policy. Receivables are reviewed monthly and reserves are established with a charge to current period operations when, in the opinion of management, collection of the receivable is doubtful. In addition to rents due currently, accounts receivable include amounts representing minimum rental income accrued on a straight-line basis to be paid by tenants over the remaining term of their respective leases. Reserves are established with a charge to income for tenants whose rent payment history or financial condition casts doubt upon the tenant's ability to perform under its lease obligations.

### *Legal Contingencies*

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

**Table of Contents**Results of Operations

Revenue (Dollars in thousands)	For the year ended December 31,			Percentage Change	
	2006	2005	2004	2006 to 2005	2005 to 2004
Base rent	\$ 110,121	\$ 99,448	\$ 91,125	10.7%	9.1%
Expense recoveries	22,636	20,027	16,712	13.0%	19.8%
Percentage rent	1,767	2,057	1,635	-14.1%	25.8%
Other	3,454	5,483	3,370	-37.0%	62.7%
<b>Total revenue</b>	<b>\$ 137,978</b>	<b>\$ 127,015</b>	<b>\$ 112,842</b>	<b>8.6%</b>	<b>12.6%</b>

Total revenue increased 8.6% for the 2006 year compared to 2005 primarily due to (1) the contribution of operating revenue from two development properties (Broadlands Village III and Lansdowne Town Center) and two acquisition properties (Smallwood Village Center and Hunt Club Corners) placed in service during 2006 and four operating properties developed or acquired during 2005, (Kentlands Place, Palm Springs, Jamestown Place and Seabreeze Plaza) together defined as the 2006/2005 Development and Acquisition Properties whose operating results are included in 2006's operating income but not fully in the previous year's results, which was offset in part by (2) the payment related to resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall included in 2005 other revenue. The 2006/2005 Development and Acquisition Properties contributed \$8,184,000 or 74.7% of the increase in revenue. The increase in revenue from 2005 to 2006 was offset by the net payment related to the resolution of the Lexington Mall land use dispute of \$1,801,000 included in 2005 revenue (-16.4% of the change in revenue). Also contributing to the 2006 revenue increase were rents earned at the Company's Great Eastern Plaza, Shops at Monocacy, The Glen (impacted by a 22,000 square foot expansion completed November 2005) and Southside Plaza shopping centers, which provided increased revenue of \$736,000 or 6.7%, \$691,000 or 6.3%, \$562,000 or 5.1% and \$493,000 or 4.5%, respectively.

Total revenue increased 12.6% for the 2005 year compared to 2004 primarily due to (1) the contribution of operating revenue from three development properties (Shops at Monocacy, Kentlands Place and Broadlands Village II) and three acquisition properties (Palm Springs, Jamestown Place and Seabreeze Plaza) placed in service during 2005 and four operating properties acquired during the first half of 2004, (Boca Valley Plaza, Countryside, Cruse MarketPlace and Briggs Chaney MarketPlace) together defined as the 2005/2004 Development and Acquisition Properties whose operating results are included in 2005's operating income but not fully in the previous year's results and (2) the payment related to resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall. The 2005/2004 Development and Acquisition Properties contributed \$8,414,000 or 59.4% of the increase in revenue. The net payment related to the resolution of the Lexington Mall land use dispute contributed \$1,801,000 or 12.7% of the increase in revenue. 601 Pennsylvania Avenue also contributed \$768,000 or 5.4% of the increase due to both a collection of a lease termination fee and increased rental income because all of its rentable area was producing rent during 2005 while a portion of the area was being prepared for occupancy during the 2004. Also contributing to the 2005 revenue increase were rents earned at the Company's Thruway (resulting from a 15,725 square foot expansion completed in April 2004), The Glen (impacted by a 22,000 square foot expansion completed November 2005) and Southdale shopping centers, which provided increased revenue of \$533,000 or 3.8%, \$392,000 or 2.8% and \$376,000 or 2.7%, respectively. A discussion of the components of revenue follows.

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*Base rent*

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

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

*Expense recoveries*

Expense recoveries represent a portion of property operating expenses billable to tenants, including common area maintenance, real estate taxes and other recoverable costs. The majority of the \$2,609,000 increase in expense recovery income from 2005 to 2006 was contributed by the 2006/2005 Development and Acquisition Properties (65.4% or approximately \$1,707,000). Increased expense recovery income was provided by the leasing of a large space at Great Eastern Plaza, which was not contributing expense recovery income in 2005 (10.2% or approximately \$265,000). Increased real estate taxes, insurance, repairs and utilities expenses at several of the Company's other properties were incurred and recovered from tenants.

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

*Percentage rent*

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

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

*Other revenue*

Other revenue consists primarily of parking revenue at three of the Office Properties, temporary lease rental income, payments associated with early termination of leases and interest income from the investment of cash balances. Other revenue decreased \$2,029,000 during 2006 versus 2005 as a result of \$1,801,000 (88.8% of decrease) related to resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall and decreased interest income from short-term investments (16.1% or \$327,000). Other revenue was also impacted by the collection of a lease termination fee and settlement of a rent dispute in 2005 with two former tenants at 601 Pennsylvania Avenue (12.9% or \$262,000), the negative impact of which was more than offset by



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increased parking revenue in the office portfolio (16.6% or \$336,000), primarily at 601 Pennsylvania Avenue where parking revenues increased compared to the prior year, when spaces were temporarily placed out of service during scheduled maintenance.

Other revenue increased \$2,113,000 during 2005 versus 2004 as a result of \$1,801,000 (85.2 % of increase) related to resolution of a land use dispute with a property owner adjacent to the Company's Lexington Mall and increased interest income from short-term investments (19.1% or \$404,000). Also contributing to the other revenue increase was the collection of a lease termination fee and settlement of a rent dispute with two former tenants at 601 Pennsylvania Avenue (12.4% or \$262,000). The other revenue increases were offset in part by reduced parking revenue in the office portfolio (7.0% or \$147,000), primarily at 601 Pennsylvania Avenue where parking spaces were temporarily placed out of service while the parking deck was being refurbished, and lower overall lease termination fees received in 2005 compared to 2004.

**Operating expenses***(Dollars in thousands)*

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

*Property operating expenses*

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

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

**Table of Contents***Provision for credit losses*

The provision for credit losses represents the Company's estimation that amounts previously included in income and owed by tenants may not be collectible. The provision for credit losses increased \$163,000 for 2006 versus 2005 due primarily to the absence of significant credit losses experienced during 2005. The provision for credit losses is less than three tenths of one percent (0.3%) of total revenue for each period, a reflection of the relative credit quality of the Company's tenants.

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

*Real estate taxes*

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

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

*Interest and amortization of deferred debt*

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

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

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### *Depreciation and amortization*

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

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

### *General and administrative*

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

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

### Gain on Sale of Property

The Company recognized a gain on the sale of real estate of \$572,000 in 2004. There were no property dispositions in 2006 and 2005. The 2004 gain resulted from the State of Maryland's condemnation and taking of a small strip of unimproved land for a road widening project at White Oak shopping center.

### Impact of Inflation

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

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

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

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

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

*Operating Activities*

Cash provided by operating activities increased \$3,500,000 to \$62,174,000 for the year ended December 31, 2006 compared to \$58,674,000 for the year ended December 31, 2005 primarily reflecting increased operating income of the 2006/2005 Development and Acquisition Properties. Cash provided by operating activities represents, in each year, cash received primarily from rental income, plus other income, less property operating expenses, normal recurring general and administrative expenses and interest payments on debt outstanding.

*Investing Activities*

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

*Financing Activities*

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

amounts borrowed from the revolving credit facility totaling \$31,000,000;

proceeds received from two new mortgage notes payable totaling \$17,500,000; and

\$21,054,000 of proceeds received from the issuance of common stock under the dividend reinvestment program and from the exercise of stock options, and from the issuance of convertible limited partnership interests in the Operating Partnership;

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which was partially offset by:

the scheduled repayment (amortization) of mortgage notes payable totaling \$13,322,000;

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

distributions made to common stockholders and holders of convertible limited partnership units in the Operating Partnership during the year totaling \$37,611,000;

distributions made to preferred stockholders during the year totaling \$8,000,000; and

payments of \$542,000 for financing costs of two new mortgage loans during 2006.

Cash used by financing activities for the year ended December 31, 2005 primarily reflects:

the repayment of borrowings on mortgage notes payable totaling \$20,794,000;

distributions made to common stockholders and holders of convertible limited partnership units in the Operating Partnership during the year totaling \$34,887,000;

distributions made to preferred stockholders during the year totaling \$8,000,000; and

payments of \$2,025,000 for financing costs of the revolving credit facility and two mortgage loans during 2005.

which was partially offset by:

\$25,500,000 of proceeds received from mortgage notes payable incurred during the year;

amounts borrowed from the revolving credit facility totaling \$10,500,000; and

\$19,283,000 of proceeds received from the issuance of common stock under the dividend reinvestment program and from the exercise of stock options, and from the issuance of convertible limited partnership interests in the Operating Partnership;

*Liquidity Requirements*

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

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

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

redevelop certain of the Current Portfolio Properties,

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develop additional freestanding outparcels or expansions within certain of the Shopping Centers,

acquire existing neighborhood and community shopping centers and/or office properties, and

develop new shopping center or office sites.

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

*Contractual Payment Obligations*

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

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

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

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

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Management believes that the Company's capital resources, which at December 31, 2006 included cash balances of \$8.1 million and borrowing availability of \$113.4 million on its revolving line of credit (\$50.4 million for general corporate use and \$63.0 million for qualified future acquisitions), will be sufficient to meet its liquidity needs for the foreseeable future.

*Preferred Stock Issue*

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

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

*Dividend Reinvestments*

In December 1995, the Company established a Dividend Reinvestment Plan (the "Plan") to allow its common stockholders and holders of limited partnership interests an opportunity to buy additional shares of common stock by reinvesting all or a portion of their dividends or distributions. The Plan provides for investing in newly issued shares of common stock at a 3% discount from market price without payment of any brokerage commissions, service charges or other expenses. All expenses of the Plan are paid by the Company. The Company issued 358,563 and 455,494 shares under the Plan at a weighted average discounted price of \$41.43 and \$33.66 per share during the years ended December 31, 2006 and 2005, respectively.

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

**Capital Strategy and Financing Activity**

As a general policy, the Company intends to maintain a ratio of its total debt to total asset value of 50% or less and to actively manage the Company's leverage and debt expense on an ongoing basis in order to maintain prudent coverage of fixed charges. Asset value is the aggregate fair market value of the Current Portfolio Properties and any subsequently acquired properties as reasonably determined by management by reference to the properties' aggregate cash flow. Given the Company's current debt level, it is management's belief that the ratio of the Company's debt to total asset value was below 50% as of December 31, 2006.

The organizational documents of the Company do not limit the absolute amount or percentage of indebtedness that it may incur. The Board of Directors may, from time to time, reevaluate the Company's debt capitalization policy in light of current economic conditions, relative costs of capital, market values of the Company property portfolio, opportunities for acquisition, development or expansion, and such other factors as the Board of Directors then deems relevant. The Board of Directors may modify the Company's debt capitalization policy based on such a reevaluation without shareholder approval and consequently, may increase or decrease the Company's debt to total asset ratio above or below 50% or may waive the policy for certain periods of time. The Company



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selectively continues to refinance or renegotiate the terms of its outstanding debt in order to achieve longer maturities, and obtain generally more favorable loan terms, whenever management determines the financing environment is favorable. The following is a summary of notes payable as of December 31, 2006 and 2005:

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

- \* Interest rate and scheduled maturity data presented as of December 31, 2006. Totals computed using weighted averages.
- (a) The loan is collateralized by Avenel Business Park, Van Ness Square, Ashburn Village, Leesburg Pike, Lumberton Plaza and Village Center. The loan has been increased on four occasions since its inception in 1997. The 8.00% blended interest rate is the weighted average of the initial loan rate and additional borrowing rates. The loan requires equal monthly principal and interest payments of \$920,000 based upon a weighted average 23-year amortization schedule and a final payment of \$63,153,000 at loan maturity. Principal of \$3,896,000 was amortized during 2006.
- (b) The loan is collateralized by nine shopping centers (Seven Corners, Thruway, White Oak, Hampshire Langley, Great Eastern, Southside Plaza, Belvedere, Giant and Ravenwood) and requires equal monthly principal and interest payments of \$1,103,000 based upon a 25-year amortization schedule and a final payment of \$97,403,000 at loan maturity. Principal of \$3,507,000 was amortized during 2006.

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- (c) The loan is collateralized by Smallwood Village Center and requires equal monthly principal and interest payments of \$71,000 based upon a 30 year amortization schedule and a final payment of \$10,071,000 at loan maturity. Principal of \$146,000 was amortized during 2006.
- (d) The loan is collateralized by 601 Pennsylvania Avenue and requires equal monthly principal and interest payments of \$294,000 based upon a 25-year amortization schedule and a final payment of \$22,961,000 at loan maturity. Principal of \$1,030,000 was amortized during 2006.
- (e) The loan is collateralized by Cruse MarketPlace and requires equal monthly principal and interest payments of \$56,000 based upon an amortization schedule of approximately 24 years and a final payment of \$6,830,000 at loan maturity. Principal of \$189,000 was amortized during 2006.
- (f) The loan is collateralized by Seabreeze Plaza and requires equal monthly principal and interest payments of \$84,000 based upon a 25-year amortization schedule and a final payment of \$10,531,000 at loan maturity. Principal of \$301,000 was amortized during 2006.
- (g) The loan is collateralized by Shops at Fairfax and Boulevard shopping centers and requires monthly principal and interest payments of \$118,000 based upon a 22-year amortization schedule and a final payment of \$7,630,000 at loan maturity. Principal of \$375,000 was amortized during 2006.
- (h) The loan is collateralized by Washington Square and requires equal monthly principal and interest payments of \$264,000 based upon a 27.5-year amortization schedule and a final payment of \$28,012,000 at loan maturity. Principal of \$741,000 was amortized during 2006.
- (i) The loan, consisting of two notes dated December 2003 and two notes dated February and December 2004, is currently collateralized by three shopping centers, Broadlands Village (Phases I, II & III), The Glen and Kentlands Square, and requires equal monthly principal and interest payments of \$306,000 based upon a 25-year amortization schedule and a final payment of \$28,393,000 at loan maturity. Principal of \$963,000 was amortized during 2006.
- (j) The loan is collateralized by Olde Forte Village and requires equal monthly principal and interest payments of \$98,000 based upon a 25-year amortization schedule and a final payment of \$8,985,000 at loan maturity. Principal of \$314,000 was amortized during 2006.
- (k) The loan is collateralized by Countryside and requires equal monthly principal and interest payments of \$133,000 based upon a 25-year amortization schedule and a final payment of \$12,288,000 at loan maturity. Principal of \$436,000 was amortized during 2006.
- (l) The loan is collateralized by Briggs Chaney MarketPlace and requires equal monthly principal and interest payments of \$133,000 based upon a 25-year amortization schedule and a final payment of \$12,192,000 at loan maturity. Principal of \$414,000 was amortized during 2006.
- (m) The loan is collateralized by Shops at Monocacy and requires equal monthly principal and interest payments of \$112,000 based upon a 25-year amortization schedule and a final payment of \$10,568,000 at loan maturity. Principal of \$392,000 was amortized during 2006.
- (n) The loan is collateralized by Boca Valley Plaza and requires equal monthly principal and interest payments of \$75,000 based upon a 30-year amortization schedule and a final payment of \$9,149,000 at loan maturity. Principal of \$178,000 was amortized during 2006.
- (o) The loan is collateralized by Palm Springs Center and requires equal monthly principal and interest payments of \$75,000 based upon a 25-year amortization schedule and a final payment of \$7,075,000 at loan maturity. Principal of \$253,000 was amortized during 2006.
- (p) The loan is collateralized by Jamestown Place and requires equal monthly principal and interest payments of \$66,000 based upon a 25-year amortization schedule and a final payment of \$6,102,000 at loan maturity. Principal of \$159,000 was amortized during 2006.

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- (q) The loan is collateralized by Hunt Club Corners and requires equal monthly principal and interest payments of \$42,000 based upon a 30-year amortization schedule and a final payment of \$5,018,000 at loan maturity. Principal of \$28,000 was amortized during 2006.
- (r) The loan is an unsecured revolving credit facility totaling \$150,000,000. Loan availability for working capital and general corporate uses is determined by operating income from the Company's unencumbered properties, with a portion available only for funding qualified operating property acquisitions. Interest expense is calculated based upon the 1,2,3 or 6 month LIBOR rate plus a spread of 1.40% to 1.625% (determined by certain debt service coverage and leverage tests) or upon the bank's reference rate at the Company's option. The line may be extended one year with payment of a fee of 1/4% at the Company's option. Monthly payments, if applicable, are interest only and will vary depending upon the amount outstanding and the applicable interest rate for any given month.

The December 31, 2006 and 2005 depreciation adjusted cost of properties collateralizing the mortgage notes payable totaled \$508,236,000 and \$467,015,000, respectively. Notes payable at December 31, 2006 and 2005, totaling \$189,285,000 and \$169,322,000, respectively, are guaranteed by members of The Saul Organization. The Company's credit facility requires the Company and its subsidiaries to maintain certain financial covenants. As of December 31, 2006, the material covenants required the Company, on a consolidated basis, to:

limit the amount of debt so as to maintain a gross asset value, as defined in the loan agreement, in excess of liabilities of at least \$400 million plus 90% of our future net equity proceeds;

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

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

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

limit the amount of variable rate debt and debt with initial loan terms of less than 5 years to no more than 40% of total debt. As of December 31, 2006, the Company was in compliance with all such covenants.

*2006 Financing Activity*

The Company obtained two new fixed-rate, non-recourse financings during the first quarter of 2006. On January 10, 2006, the Company closed on a new fixed-rate mortgage financing in the amount of \$10,500,000, secured by Jamestown Place, acquired in November 2005. The loan matures February 2021, requires equal monthly principal and interest payments of \$66,000, based upon a 5.81% interest rate and 25-year principal amortization, and requires a final payment of \$6,102,000 at maturity. On January 27, 2006, the Company assumed the obligation of a secured mortgage obligation in conjunction with the acquisition of Smallwood Village Center. The outstanding balance on the loan was \$11,334,000 at settlement. The loan matures January 2013, requires equal monthly principal and interest payments of \$71,000, based upon a 6.12% interest rate and 30-year principal amortization, and requires a final payment of \$10,071,000 at maturity. The Company also obtained a new fixed-rate, non-recourse financing on July 12, 2006 when it closed on a new fixed-rate mortgage financing in the amount of \$7,000,000, secured by Hunt Club Corners, acquired June 1, 2006. The loan matures August 11, 2021, requires equal monthly principal and interest payments of \$42,000, based upon a 6.01% interest rate and 30-year principal amortization, and requires a final payment of \$5,018,000 at maturity.

In December 2005, the Company entered into a rate lock agreement and made application for a 15-year, \$40,000,000 fixed-rate mortgage loan to be collateralized by Lansdowne Town Center. The loan application was approved as a commitment in March 2006. The rate lock agreement set the interest rate at 5.62%, contingent upon meeting certain construction and leasing criteria prior to loan funding, projected to occur during the 2007 first quarter. The Company paid a loan deposit fee of \$850,000 which is refundable at closing.

**Table of Contents**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.

Funds From Operations

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

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

<sup>1</sup> The National Association of Real Estate Investment Trusts (NAREIT) developed FFO as a relative non-GAAP financial measure of performance of an equity REIT in order to recognize that income-producing real estate historically has not depreciated on the basis determined under GAAP. FFO is defined by NAREIT as net income, computed in accordance with GAAP, plus minority interests, extraordinary items and real estate depreciation and amortization, excluding gains or losses from property sales. FFO does not represent cash generated from operating activities in accordance with GAAP and is not necessarily indicative of cash available to fund cash needs, which is disclosed in the Company's Consolidated Statements of Cash Flows for the applicable periods. There are no material legal or functional restrictions on the use of FFO. FFO should not be considered as an alternative to net income, its most directly comparable GAAP measure, as 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.

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**Acquisitions, Redevelopments and Renovations**

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

The Company has been selectively involved in acquisition, redevelopment and renovation activities. It continues to evaluate the acquisition of land parcels for retail and office development and acquisitions of operating properties for opportunities to enhance operating income and cash flow growth. The Company also continues to take advantage of redevelopment, renovation and expansion opportunities within the portfolio, as demonstrated by its recent activities at Olde Forte Village, Broadlands Village, Thruway, The Glen, Ravenwood and Lansdowne Town Center. The following describes the acquisitions, redevelopments and renovations which affected the Company's financial position and results of operations in 2006 and 2005.

*Olde Forte Village*

In July 2003, the Company acquired Olde Forte Village, a 161,000 square foot neighborhood shopping center located in Fort Washington, Maryland. The center is anchored by the then newly constructed 58,000 square foot Safeway supermarket which opened in March 2003, relocating from a smaller store within the center. The center then contained approximately 50,000 square feet of vacant space, consisting primarily of the former Safeway space, which the Company redeveloped in 2005. The reconfigured shopping center now totals 143,000 square feet of leasable space. The Company's total redevelopment costs, including the initial property acquisition cost, were approximately \$22 million. The center was 93% leased at December 31, 2006.

*Broadlands Village*

The Company purchased 24 acres of undeveloped land in the Broadlands section of the Dulles Technology Corridor of Loudoun County, Virginia in April 2002. Broadlands is a 1,500 acre planned community consisting of 3,500 residences, approximately half of which are constructed and currently occupied. In October 2003, the Company completed construction of the first phase of the Broadlands Village shopping center. The 58,000 square foot Safeway supermarket opened in October 2003 with a pad building and many in-line small shops also opening in the fourth quarter of 2003. Construction of a 30,000 square foot second phase was substantially completed in 2004. The Company's total development costs of both phases, including the land acquisition, were approximately \$22 million. The center was 100% leased at December 31, 2006. During the fourth quarter of 2005, the Company commenced construction of a third phase of this development, totaling approximately 22,000 square feet of shop space and two pad site locations. Construction was substantially completed in June 2006. Development costs for this phase totaled approximately \$7.5 million. All of the new space was leased and all tenants were in occupancy at December 31, 2006.

*The Glen*

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

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### *Kentlands Place*

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

### *Briggs Chaney MarketPlace*

In April 2004, the Company acquired Briggs Chaney MarketPlace in Silver Spring, Maryland. Briggs Chaney MarketPlace is a 194,000 square foot neighborhood shopping center on Route 29 in Montgomery County, Maryland. The center, constructed in 1983, was 100% leased at December 31, 2006 and is anchored by a 45,000 square foot Safeway supermarket and a 28,000 square foot Ross Dress For Less. The property was acquired for \$27.3 million. During 2005, the Company completed interior construction to reconfigure a portion of space vacant at acquisition, totaling approximately 11,000 square feet of leasable area, and completed construction of a façade renovation of the shopping center. Redevelopment costs totaled approximately \$1.9 million.

### *Ashland Square*

On December 15, 2004, the Company acquired a 19.3 acre parcel of land in Dumfries, Prince William County, Virginia for a purchase price of \$6.3 million. The Company has plans to develop the parcel into a grocery-anchored neighborhood shopping center. The Company received site plan approval from Prince William County during the third quarter of 2006 to develop approximately 125,000 square feet of retail space. Approvals for an additional 35,000 square feet of commercial space are expected to be received in 2007. During the third quarter of 2006, the Company commenced site work consisting primarily of clearing, grading and site utility construction. A lease has been executed with Chevy Chase Bank for a branch to be built on a pad site, with construction expected to be completed in mid-2007. The balance of the space is being marketed to grocers and other retail businesses, with a development timetable yet to be finalized.

### *Palm Springs Center*

On March 3, 2005, the Company completed the acquisition of the 126,000 square foot Albertson's anchored Palm Springs Center located in Altamonte Springs, Florida (metropolitan Orlando). The center was 100% leased at December 31, 2006 and was acquired for a purchase price of \$17.5 million.

### *New Market*

On March 3, 2005, the Company acquired a 7.1 acre parcel of land located in New Market, Maryland for a purchase price of \$500,000. On September 8, 2005, the Company acquired a 28.4 acre contiguous parcel for a purchase price of \$1.5 million. Together, these parcels will accommodate a neighborhood shopping center development in excess of 120,000 square feet of leasable space. The Company has contracted to purchase one additional parcel with the intent to assemble additional acreage for further retail development near this I-70 interchange, east of Frederick, Maryland.

### *Lansdowne Town Center*

During the first quarter of 2005, the Company received approval of a zoning submission to Loudoun County which allowed the development of a neighborhood shopping center named Lansdowne Town Center, within the Lansdowne Community in northern Virginia. On March 29, 2005, the Company finalized the acquisition of an additional 4.5 acres of land to bring the total acreage of the development parcel to 23.4 acres (including the 18.9 acres acquired in 2002). The additional purchase price was approximately \$1.0 million. In November 2005, the Company commenced construction of an approximately 188,000 square foot retail center. A lease was executed with Harris Teeter for a 55,000 square foot grocery store, which opened in November 2006. Construction was

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substantially completed during the fourth quarter of 2006, with project costs expected to total approximately \$41.5 million. The project was 85% leased as of December 31, 2006 and 45% of the space was in operation at that time (approximately 85,000 square feet of retail space). The remaining retail space (65,000 square feet) is expected to be operational by spring 2007, while the second floor office space is expected to be fully operational by fall 2007 (38,000 square feet).

### *Jamestown Place*

On November 17, 2005, the Company completed the acquisition of the 96,000 square foot Publix-anchored Jamestown Place located in Altamonte Springs, Florida (metropolitan Orlando). The center was 100% leased at December 31, 2006 and was acquired for a purchase price of \$14.8 million.

### *Seabreeze Plaza*

On November 30, 2005, the Company completed the acquisition of the 147,000 square foot Publix-anchored Seabreeze Plaza located in Palm Harbor, Florida (metropolitan Tampa). The center was 91% leased at December 31, 2006 and was acquired for a purchase price of \$25.9 million subject to the assumption of a \$13.6 million mortgage loan.

### *Smallwood Village Center*

On January 27, 2006, the Company acquired the 198,000 square foot Smallwood Village Center, located on 25 acres within the St. Charles planned community of Waldorf, Maryland, a suburb of metropolitan Washington, DC, through a wholly-owned subsidiary of its operating partnership. The center was 84% leased at December 31, 2006 and was acquired for a purchase price of \$17.5 million subject to the assumption of an \$11.3 million mortgage loan. The Company is planning and will seek permits for a capital improvement project to improve access to the center, reconfigure the center and upgrade the center's façade. A construction timetable has yet to be established.

### *Ravenwood*

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

### *Lexington Center*

On September 29, 2005, the Company announced the resolution of a land use dispute at Lexington Mall, allowing increased flexibility in future development rights for its property. The Company and the land owner of the adjacent 16 acre site, have resolved a dispute arising from a reciprocal easement agreement governing land use between the two owners. The parties have now executed a new land use agreement which grants each other the flexibility to improve its property. The Company also reached an agreement with Dillard's to terminate its lease, without consideration exchanged by either party. The Dillard's store closed during October 2005. The departure of Dillard's now leaves the mall vacant and combined with the new land use agreement, expands potential redevelopment options. The Company has engaged land planners and architects to prepare conceptual designs for the shopping center's development and marketing to prospective retailers.

### *Hunt Club Corners*

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

### *Ashburn Village-Phase V*

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





**Table of Contents***Clarendon Center*

The Company owns an assemblage of land parcels (including its Clarendon and Clarendon Station operating properties) totaling approximately 1.5 acres adjacent to the Clarendon Metro Station in Arlington, Virginia. In June 2006, the Company obtained zoning approvals for a mixed-use development project to include up to approximately 50,000 square feet of retail space, 170,000 square feet of office space and 244 residential units. The Company has engaged architects and engineers and is proceeding with construction documents. A development timetable has not yet been finalized.

*Westview Village*

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

**Portfolio Leasing Status**

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

As of December 31,	Total Properties		Total Square Footage		Percent Leased	
	Shopping Centers	Office	Shopping Centers	Office	Shopping Centers	Office
2006	42	5	6,698,000	1,206,000	96.1%	97.3%
2005	39	5	6,170,000	1,206,000	97.2%	96.6%
2004	35	5	6,012,000	1,205,000	93.5%	95.9%

The December 31, 2006 leasing percentage excludes the Lansdowne Town Center development property which was 85.0% leased. The 2006 shopping center leasing percentages decreased due to the departure of two local grocery anchors at the Belvedere and West Park shopping centers totaling 59,000 square feet. The increase in the shopping center portfolio's leasing percentage in 2005 resulted primarily from the removal from service of 133,000 square feet of vacant mall space at Lexington Mall which the Company had not leased in 2004 in anticipation of redeveloping the shopping center.

**Item 7A. 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 December 31, 2006, the Company had variable rate indebtedness totaling \$35,000,000. 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 December 31, 2006 had been one percent higher, our annual interest expense relating to

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these debt instruments would have increased by \$350,000, based on those balances. Interest rate fluctuations affect the fair value of the Company's fixed rate debt instruments. As of December 31, 2006, the Company had fixed rate indebtedness totaling \$487,443,000 with a weighted average interest rate of 6.84%. If interest rates on the Company's fixed rate debt instruments at December 31, 2006 had been one percent higher, the fair value of those debt instruments on that date would have decreased by approximately \$25,244,000.

**Item 8. Financial Statements and Supplementary Data**

The financial statements of the Company and its consolidated subsidiaries are included in this report on the pages indicated, and are incorporated herein by reference:

<b>Page</b>	
F-1	(a) <u>Report of Independent Registered Public Accounting Firm - Ernst &amp; Young LLP</u>
F-2	(a) <u>Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting - Ernst &amp; Young LLP</u>
F-3	(b) <u>Consolidated Balance Sheets - December 31, 2006 and 2005</u>
F-4	(c) <u>Consolidated Statements of Operations - Years ended December 31, 2006, 2005 and 2004.</u>
F-5	(d) <u>Consolidated Statements of Stockholders' Equity - Years ended December 31, 2006, 2005 and 2004.</u>
F-6	(e) <u>Consolidated Statements of Cash Flows - Years ended December 31, 2006, 2005 and 2004.</u>
F-7	(f) <u>Notes to Consolidated Financial Statements.</u>

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

*Quarterly Assessment.*

The Company carried out an assessment as of December 31, 2006 of the effectiveness of the design and operation of its disclosure controls and procedures and its internal control over financial reporting. This assessment was done under the supervision and with the participation of management, including 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 as appropriate. Rules adopted by the SEC require that the Company present the conclusions of the Company's Chairman and Chief Executive Officer and its Senior Vice President-Chief Financial Officer, Secretary and Treasurer about the effectiveness of the Company's disclosure controls and procedures and the conclusions of the Company's management about the effectiveness of its internal control over financial reporting as of the end of the period covered by this Annual Report on Form 10-K.

*CEO and CFO Certifications.*

Included as Exhibits 31 to this Annual Report on Form 10-K are forms of Certification of the Company's Chairman and Chief Executive Officer and its Senior Vice President-Chief Financial Officer, Secretary and Treasurer. The forms of Certification are required in accordance with Section 302 of the Sarbanes-Oxley Act of 2003. This section of the Annual Report on Form 10-K that you are currently reading is the information concerning the assessment referred to in the Section 302 certifications and this information should be read in conjunction with the Section 302 certifications for a more complete understanding of the topics presented.

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*Disclosure Controls and Procedures and Internal Control over Financial Reporting.*

Management is responsible for establishing and maintaining adequate disclosure controls and procedures and internal control over financial reporting. Disclosure controls and procedures are designed to provide reasonable assurance that information required to be disclosed in our reports filed or submitted under the Exchange Act, such as this Annual Report on Form 10-K, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures are also designed to provide reasonable assurance that such information is accumulated and communicated to the Company's management, including 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, as appropriate to allow timely decisions regarding required disclosure.

Internal control over financial reporting is a process designed by, or under the supervision of 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, and effected by the Company's Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that:

pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the Company's assets;

provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that the Company's receipts and expenditures are being made only in accordance with authorizations of management or the Company's Board of Directors; and

provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material adverse effect on the Company's financial statements.

*Limitations on the Effectiveness of Controls.*

Management, including 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, does not expect that the Company's disclosure controls and procedures or internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no assessment of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management's override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

*Scope of the Assessments.*

The assessment by 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 of the Company's disclosure controls and procedures and the assessment by the Company's management of the Company's internal control over financial reporting included a review of procedures and discussions with the Company's Disclosure Committee and others in the Company. In the course of the assessments, management sought to identify data errors,

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control problems or acts of fraud and to confirm that appropriate corrective action, including process improvements, were being undertaken. Management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control - Integrated Framework to assess the effectiveness of the Company's internal control over financial reporting. The evaluation of the Company's disclosure controls and procedures and internal control over financial reporting is done on a quarterly basis so that the conclusions concerning controls effectiveness can be reported in the Company's Quarterly Reports on Form 10-Q and Annual Report on Form 10-K.

The Company's internal control over financial reporting is also evaluated on an ongoing basis by management, other personnel in the Company's accounting department and the Company's internal audit function. Management's annual assessment of the Company's internal control over financial reporting is audited by the Company's independent registered public accounting firm. We consider the results of these various assessment activities as we monitor the Company's disclosure controls and procedures and internal control over financial reporting and when deciding to make modifications as necessary. Management's intent in this regard is that the disclosure controls and procedures and the internal control over financial reporting will be maintained and updated (including improvements and corrections) as conditions warrant.

*Assessment of Effectiveness of Disclosure Controls and Procedures*

Based upon the assessments, 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 have concluded that as of December 31, 2006 the Company's disclosure controls and procedures were effective.

*Assessment of Effectiveness of Internal Control Over Financial Reporting.*

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission in Internal Control - Integrated Framework to assess the effectiveness of the Company's internal control over financial reporting. Based upon the assessments, the Company's management has concluded that as of December 31, 2006 the Company's internal control over financial reporting was effective. The Company's independent registered public accounting firm has issued an attestation report on management's assessment of the Company's internal control over financial reporting, which appears on page F-2 of this Annual Report on Form 10-K.

*Changes in Internal Control Over Financial Reporting.*

During the three months ended December 31, 2006, there was no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control for financial reporting.

**Item 9B. Other Information**

None.

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**PART III**

Certain information that Part III requires will be filed in a definitive proxy statement with the SEC pursuant to Regulation 14A for the annual meeting of stockholders to be held on April 28, 2006 (the Proxy Statement ) not later than 120 days after the end of the year covered by this Report, and certain information to be included therein is incorporated herein by reference. Only those sections or pages of the Proxy Statement which specifically address the items set forth herein are incorporated by reference.

The Company's Chairman and Chief Executive Officer, Senior Vice President-Chief Financial Officer, Treasurer and Secretary, Vice President-Chief Accounting Officer are governed by the Company's code of ethics. The code of ethics is available on the Company's website at [www.saulcenters.com](http://www.saulcenters.com).

**Item 10. Directors, Executive Officers and Corporate Governance**

The information this Item requires is incorporated by reference to the information under the captions Election of Directors, Corporate Governance Code of Ethics, Corporate Governance Section 16(a) Beneficial Ownership Reporting Compliance, Corporate Governance Nominating and Corporate Governance Committee Selection of Director Nominees, and Corporate Governance Audit Committee of the Company's Proxy Statement to be filed with the SEC for its annual shareholders meeting to be held on April 27, 2007.

**Item 11. Executive Compensation**

The information this Item requires is incorporated by reference to the information under the captions Corporate Governance Compensation of Directors, Report of the Compensation Committee, and Executive Compensation of the Proxy Statement.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Shareholder Matters**

The information this Item requires is incorporated by reference to the information under the captions Equity Compensation Plan Information and Security Ownership of Certain Beneficial Owners and Management of the Proxy Statement.

**Item 13. Certain Relationships and Related Transactions and Director Independence**

The information this Item requires is incorporated by reference to the information under the captions Certain Relationships and Transactions and Corporate Governance Board of Directors of the Proxy Statement.

**Item 14. Principal Accountant Fees and Services**

The information this Item requires is incorporated by reference to the information contained in the Proxy Statement under the caption 2006 and 2005 Audit Firm Fee Summary and the caption Audit Committee Report of the Proxy Statement.

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**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

(a) The following documents are filed as part of this report:

1. Financial Statements

The following financial statements of the Company and their consolidated subsidiaries are incorporated by reference in Part II, Item 8.

- (a) Report of Independent Registered Public Accounting Firm Ernst & Young LLP
- (a) Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting Ernst & Young LLP
- (b) Consolidated Balance Sheets - December 31, 2006 and 2005
- (c) Consolidated Statements of Operations - Years ended December 31, 2006, 2005 and 2004
- (d) Consolidated Statements of Stockholders' Equity (Deficit) - Years ended December 31, 2006, 2005 and 2004
- (e) Consolidated Statements of Cash Flows - Years ended December 31, 2006, 2005 and 2004
- (f) Notes to Consolidated Financial Statements

2. Financial Statement Schedule and Supplementary Data

- (a) Selected Quarterly Financial Data for the Company are incorporated by reference in Part II, Item 8
- (b) Schedule of the Company:

Schedule III - Real Estate and Accumulated Depreciation

All other schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

3. Exhibits

- (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,

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- 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.
  - (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 Depository, and the holders of depository 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 depository 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 and Restated Agreement of Limited Partnership of Saul Subsidiary I Limited Partnership, the Third Amendment to the First Amended and Restated

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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. The Third Amendment to the First Amended and Restated Agreement of Limited Partnership of Saul Subsidiary II Limited Partnership filed herewith.
- (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.
- (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.



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- (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.
- 21. Subsidiaries of Saul Centers, Inc. is filed herewith.
- 23. Consent of Ernst & Young LLP, Independent Public Accountants is filed herewith.
- 24. Power of Attorney (included on signature page).
- 31. Rule 13a-14(a)/15d-14(a) Certifications of Chief Executive Officer and Chief Financial Officer are filed herewith.
- 32. Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer are filed herewith.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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: March 8, 2007

/s/ B. Francis Saul II  
B. Francis Saul II  
Chairman of the Board of Directors

& Chief Executive Officer (Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this Report has been signed below by the following persons in the capacities indicated. Each person whose signature appears below hereby constitutes and appoints each of B. Francis Saul II, B. Francis Saul III and Scott V. Schneider as his attorney-in-fact and agent, with full power of substitution and resubstitution for him in any and all capacities, to sign any or all amendments to this Report and to file same, with exhibits thereto and other documents in connection therewith, granting unto such attorney-in-fact and agent full power and authority to do and perform each and every act and thing requisite and necessary in connection with such matters and hereby ratifying and confirming all that such attorney-in-fact and agent or his substitutes may do or cause to be done by virtue hereof.

Date: March 8, 2007

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

Date: March 8, 2007

/s/ Philip D. Caraci  
Philip D. Caraci, Vice Chairman

Date: March 8, 2007

/s/ Scott V. Schneider  
Scott V. Schneider, Senior Vice President, Treasurer and  
Secretary (Principal Financial Officer)

Date: March 8, 2007

/s/ Kenneth D. Shoop  
Kenneth D. Shoop, Vice President-Chief Accounting Officer  
(Principal Accounting Officer)

Date: March 8, 2007

/s/ John E. Chapoton  
John E. Chapoton, Director

Date: March 8, 2007

/s/ Gilbert M. Grosvenor  
Gilbert M. Grosvenor, Director

Date: March 8, 2007

/s/ Philip C. Jackson Jr.  
Philip C. Jackson Jr., Director

Date: March 8, 2007

/s/ David B. Kay  
David B. Kay, Director

Date: March 8, 2007

/s/ General Paul X. Kelley  
General Paul X. Kelley, Director



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Date: March 8, 2007

/s/ Charles R. Longworth  
Charles R. Longworth, Director

Date: March 8, 2007

/s/ Patrick F. Noonan  
Patrick F. Noonan, Director

Date: March 8, 2007

/s/ James W. Symington  
James W. Symington, Director

Date: March 8, 2007

/s/ John R. Whitmore  
John R. Whitmore, Director

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**REPORT OF INDEPENDENT REGISTERED  
PUBLIC ACCOUNTING FIRM**

Board of Directors and Stockholders

Saul Centers, Inc.

We have audited the accompanying consolidated balance sheets of Saul Centers, Inc. as of December 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Saul Centers, Inc. at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

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

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

Ernst & Young LLP

McLean, Virginia

March 8, 2007

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**REPORT OF INDEPENDENT REGISTERED  
PUBLIC ACCOUNTING FIRM ON  
INTERNAL CONTROL OVER FINANCIAL REPORTING**

Board of Directors and Stockholders

Saul Centers, Inc.

We have audited management's assessment, included in the Assessment of Effectiveness of Internal Control over Financial Reporting section of Item 9A. Controls and Procedures of this Annual Report on Form 10K, that Saul Centers, Inc. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Saul Centers, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

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

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, management's assessment that Saul Centers, Inc. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Saul Centers, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Saul Centers, Inc. as of December 31, 2006 and 2005, the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006 of Saul Centers, Inc. and our report dated March 8, 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP

McLean, Virginia

March 8, 2007

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Saul Centers, Inc.

**CONSOLIDATED BALANCE SHEETS***(Dollars in thousands,*

<i>except per share amounts)</i>	<b>December 31, 2006</b>	<b>December 31, 2005</b>
<b>Assets</b>		
Real estate investments		
Land	\$ 154,047	\$ 139,421
Buildings and equipment	631,797	575,504
Construction in progress	56,017	47,868
	841,861	762,793
Accumulated depreciation	(214,210)	(195,376)
	627,651	567,417
Cash and cash equivalents	8,061	8,007
Accounts receivable and accrued income, net	33,248	23,410
Deferred leasing costs, net	18,137	19,834
Prepaid expenses, net	2,507	2,540
Deferred debt costs, net	5,328	5,875
Other assets	5,605	4,386
Total assets	\$ 700,537	\$ 631,469
<b>Liabilities</b>		
Mortgage notes payable	\$ 487,443	\$ 471,931
Revolving credit facility outstanding	35,000	10,500
Dividends and distributions payable	11,558	11,319
Accounts payable, accrued expenses and other liabilities	16,409	13,679
Deferred income	12,251	9,558
Total liabilities	562,661	516,987
<b>Minority interests</b>	5,785	3,068
<b>Stockholders equity</b>		
Series A Cumulative Redeemable Preferred stock, 1,000,000 shares authorized and 40,000 shares issued and outstanding	100,000	100,000
Common stock, \$0.01 par value, 30,000,000 shares authorized, 17,341,441 and 16,877,244 shares issued and outstanding, respectively	173	169
Additional paid-in capital	141,554	123,339
Accumulated deficit	(109,636)	(112,094)
Total stockholders equity	132,091	111,414
Total liabilities and stockholders equity	\$ 700,537	\$ 631,469

The accompanying notes are an integral part of these statements.





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Saul Centers, Inc.

**CONSOLIDATED STATEMENTS OF OPERATIONS**

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

The accompanying notes are an integral part of these statements.

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Saul Centers, Inc.

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY***(Dollars in thousands,**except per share amounts)*

	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Total
<b>Stockholders' equity:</b>					
Balance, December 31, 2003	\$ 100,000	\$ 159	\$ 91,469	\$ (98,985)	\$ 92,643
Issuance of 538,208 shares of common stock:					
497,282 shares due to dividend reinvestment plan		5	14,077		14,082
40,928 shares due to employee stock options and directors' deferred stock plan and stock option awards			1,340		1,340
Net income				26,174	26,174
Preferred stock distributions				(6,000)	(6,000)
Distributions payable preferred stock (\$50.00 per share)				(2,000)	(2,000)
Common stock distributions				(18,879)	(18,879)
Distributions payable common stock (\$0.39 per share)				(6,396)	(6,396)
Balance, December 31, 2004	100,000	164	106,886	(106,086)	100,964
Issuance of 477,802 shares of common stock:					
455,494 shares due to dividend reinvestment plan		5	15,402		15,407
22,308 shares due to employee stock options and directors' deferred stock plan and stock option awards			1,051		1,051
Net income				29,227	29,227
Preferred stock distributions				(6,000)	(6,000)
Distributions payable preferred stock (\$50.00 per share)				(2,000)	(2,000)
Common stock distributions				(20,146)	(20,146)
Distributions payable common stock (\$0.42 per share)				(7,089)	(7,089)
Balance, December 31, 2005	100,000	169	123,339	(112,094)	111,414
Issuance of 464,197 shares of common stock:					
358,563 shares due to dividend reinvestment plan		4	14,838		14,842
105,634 shares due to employee stock options and directors' deferred stock plan and stock option awards			3,377		3,377
Net income				32,680	32,680
Cumulative effect of SAB 108 adjustment (see Note 2)				6,551	6,551
Preferred stock distributions				(6,000)	(6,000)
Distributions payable preferred stock (\$50.00 per share)				(2,000)	(2,000)
Common stock distributions				(21,490)	(21,490)
Distributions payable common stock (\$0.42 per share)				(7,283)	(7,283)
Balance, December 31, 2006	\$ 100,000	\$ 173	\$ 141,554	\$ (109,636)	\$ 132,091

The accompanying notes are an integral part of these statements.

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Saul Centers, Inc.

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

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

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

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

The 2005 real estate acquisition costs of \$47,745 are presented exclusive of a mortgage loan assumed. On November 30, 2005, the Company paid the \$25,912 acquisition cost of Seabreeze Plaza by assuming a \$13,579 mortgage loan and paying cash of \$12,333.

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

The accompanying notes are an integral part of these statements

**Table of Contents****SAUL CENTERS, INC.****Notes to Consolidated Financial Statements****1. ORGANIZATION, FORMATION, AND BASIS OF PRESENTATION****Organization**

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

**Formation and Structure of Company**

Saul Centers was formed to continue and expand the shopping center business previously owned and conducted by the B.F. Saul Real Estate Investment Trust, the B.F. Saul Company, Chevy Chase Bank, F.S.B. and certain other affiliated entities, each of which is controlled by B. Francis Saul II and his family members (collectively, The Saul Organization). On August 26, 1993, members of The Saul Organization transferred to Saul Holdings Limited Partnership, a newly formed Maryland limited partnership (the Operating Partnership), and two newly formed subsidiary limited partnerships (the Subsidiary Partnerships), and collectively with the Operating Partnership, the Partnerships), shopping center and office properties, and the management functions related to the transferred properties. Since its formation, the Company has developed and purchased additional properties. The Company has developed, purchased and redeveloped several properties in 2004, 2005 and 2006. In November 2004 the Company completed construction of Shops at Monocacy, a grocery anchored shopping center in Frederick, Maryland, the land of which was acquired in November 2003. During the fourth quarter of 2003, the Company completed construction of Broadlands Village Phase I, an in-line retail and retail pad, grocery anchored shopping center. Phase II, a 30,000 square foot addition to the center was completed in 2004 and Phase III, a 22,500 square foot addition was completed in 2006. In 2005 the Company constructed a 41,000 square foot retail/office property known as Kentlands Place on a land parcel adjacent to its Kentlands Square shopping center. During the 4<sup>th</sup> quarter of 2006, the Company substantially completed construction of Lansdowne Town Center, a 188,000 square foot life-style, grocery anchored center, located in Loudoun County, Virginia (45% of the project was in operation as of December 31, 2006). During 2004, 2005 and 2006 the Company acquired nine grocery anchored shopping centers; (1) Boca Valley Plaza, 121,000 square feet, located in Boca Raton, Florida, (2) Countryside, 142,000 square feet located in Loudoun County, Virginia, (3) Cruse MarketPlace, 79,000 square feet, located in Forsyth County, Georgia, (4) Briggs Chaney MarketPlace, 197,000 square feet, located in Silver Spring, Maryland, (5) Palm Springs Center, 126,000 square feet, located in Altamonte Springs, Florida, (6) Jamestown Place, 96,000 square feet, located in Altamonte Springs, Florida, (7) Seabreeze Plaza, 147,000 square feet, located in Palm Harbor, Florida (8) Smallwood Village, 198,000 square feet, located in Waldorf, Maryland and (9) Hunt Club Corners, 101,000 square feet, located in Apopka, FL. As of December 31, 2006, the Company's properties (the Current Portfolio Properties) consisted of 42 operating shopping center properties (the Shopping Centers), five predominantly office operating properties (the Office Properties) and four (non-operating) development properties.

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

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**SAUL CENTERS, INC.**

**Notes to Consolidated Financial Statements**

**Basis of Presentation**

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

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations**

The Company, which conducts all of its activities through its subsidiaries, the Operating Partnership and Subsidiary Partnerships, engages in the ownership, operation, management, leasing, acquisition, renovation, expansion, development and financing of community and neighborhood shopping centers and office properties, primarily in the Washington, DC/Baltimore metropolitan area. Because the properties are located primarily in the Washington, DC/Baltimore metropolitan area, the Company is subject to a concentration of credit risk related to these properties. A majority of the Shopping Centers are anchored by several major tenants. As of December 31, 2006, twenty-eight of the Shopping Centers were anchored by a grocery store and offer primarily day-to-day necessities and services. No single property accounted for more than 7.2% of the total gross leasable area. Only two retail tenants, Giant Food (4.9%), a tenant at nine Shopping Centers and Safeway (3.2%), a tenant at seven Shopping Centers and one office tenant, the United States Government (3.0%), a tenant at six properties, individually accounted for more than 2.5% of the Company's total revenue for the year ended December 31, 2006.

**Principles of Consolidation**

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

**Use of Estimates**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

**Real Estate Investment Properties**

The Company purchases real estate investment properties from time to time and allocates the purchase price to various components, such as land, buildings, and intangibles related to in-place leases and customer relationships in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) 141, Business Combinations. The purchase price is allocated based on the relative fair value of each component. The fair value of buildings is determined as if the buildings were vacant upon acquisition and subsequently leased at market rental rates. As such, the determination of fair value considers the present value of all cash flows expected to be generated from the property including an initial lease up period. The Company determines the fair value of above and below market intangibles associated with in-place leases by assessing the net effective rent and remaining term of the lease relative to market terms for similar leases at acquisition. In the case of below market leases, the Company considers the remaining contractual lease period and renewal periods, taking into consideration the likelihood of the tenant exercising its renewal options. The fair value

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**SAUL CENTERS, INC.**

**Notes to Consolidated Financial Statements**

of a below market lease component is recorded as deferred income and amortized as additional lease revenue over the remaining contractual lease period and any renewal option periods included in the valuation analysis. The fair value of above market lease intangibles is recorded as a deferred asset and is amortized as a reduction of lease revenue over the remaining contractual lease term. The Company determines the fair value of at-market in-place leases considering the cost of acquiring similar leases, the foregone rents associated with the lease-up period and carrying costs associated with the lease-up period. Intangible assets associated with at-market in-place leases are amortized as additional expense over the remaining contractual lease term. To the extent customer relationship intangibles are present in an acquisition, the fair value of the intangibles are amortized over the life of the customer relationship.

Real estate investment properties are reviewed for potential impairment losses quarterly or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If there is an event or change in circumstance indicating the potential for an impairment in the value of a real estate investment property, the Company's policy is to assess potential impairment in value by making a comparison of the current and projected operating cash flows of the property over its remaining useful life, on an undiscounted basis, to the carrying amount or projected carrying amount of that property. If such carrying amount is in excess of the estimated projected operating cash flows of the property, the Company would recognize an impairment loss equivalent to an amount required to adjust the carrying amount to its estimated fair market value. The Company has not recognized an impairment loss in 2006, 2005 or 2004 on any of its real estate.

Interest, real estate taxes and other carrying costs are capitalized on projects under development and construction. Once construction is substantially completed and the assets are placed in service, their rental income, real estate tax expense, property operating expenses (consisting of payroll, repairs and maintenance, utilities, insurance and other property related expenses) and depreciation are included in current operations. Property operating expenses are charged to operations as incurred. Interest expense capitalized totaled \$3,673,000, \$3,258,000 and \$3,227,000, for 2006, 2005 and 2004, respectively. In the initial rental operations of development projects, a project is considered substantially complete and available for occupancy upon completion of tenant improvements, but no later than one year from the cessation of major construction activity. Substantially completed portions of a project are accounted for as separate projects.

Depreciation is calculated using the straight-line method and estimated useful lives of 35 to 50 years for base buildings and up to 20 years for certain other improvements that extend the useful lives. In addition, we capitalize leasehold improvements when certain criteria are met, including when we supervise construction and will own the improvement. Leasehold improvements are amortized, over the shorter of the lives of the related leases or the useful life of the improvement, using the straight-line method. Depreciation expense and amortization of leasehold improvements for the years ended December 31, 2006, 2005 and 2004 was \$20,236,000, \$19,824,000 and \$17,061,000, respectively. Repairs and maintenance expense totaled \$7,364,000, \$6,329,000 and \$4,927,000, for 2006, 2005 and 2004, respectively, and is included in operating expenses in the accompanying consolidated financial statements.

**Deferred Leasing Costs**

Certain initial direct costs incurred by the Company in negotiating and consummating a successful lease are capitalized and amortized over the initial base term of the lease. These costs total \$18,137,000 and \$19,834,000, net of accumulated amortization of \$13,308,000 and \$11,392,000 as of December 31, 2006 and 2005, respectively. Amortization expense, included in depreciation and amortization in the consolidated statements of operations, totaled \$5,412,000, \$4,373,000 and \$4,263,000, for the years ended December 31, 2006, 2005 and 2004, respectively. Capitalized leasing costs consist of commissions paid to third party leasing agents as well as internal direct costs for successful leases such as employee compensation and payroll related fringe benefits directly related to time spent performing leasing related activities. Such activities include evaluating the prospective tenant's

**Table of Contents****SAUL CENTERS, INC.****Notes to Consolidated Financial Statements**

financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating lease terms, preparing lease documents and closing the transaction. The carrying amount of costs are written-off to expense if the applicable lease is terminated prior to expiration of the initial lease term.

**Construction in Progress**

Construction in progress includes preconstruction costs and development costs of active projects. Preconstruction costs associated with these active projects include legal, zoning and permitting costs and other project carrying costs incurred prior to the commencement of construction. Development costs include direct construction costs and indirect costs incurred subsequent to the start of construction such as architectural, engineering, construction management and carrying costs consisting of interest, real estate taxes and insurance. Construction in progress balances as of December 31, 2006 and 2005 are as follows:

**Construction in Progress**

*(In thousands)*

	<b>December 31,</b>	
	<b>2006</b>	<b>2005</b>
Clarendon Center	\$ 20,431	\$ 16,629
Lansdowne Town Center	19,972	10,348
Ashland Square	8,878	7,262
Ashburn Village Phase V	1,846	
Olde Forte Village		5,667
Broadlands Village III		3,638
Lexington Center	2,480	1,972
Ravenwood		607
Other	2,410	1,745
<b>Total</b>	<b>\$ 56,017</b>	<b>\$ 47,868</b>

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



**Table of Contents****SAUL CENTERS, INC.****Notes to Consolidated Financial Statements****Accounts Receivable and Accrued Income**

Accounts receivable primarily represent amounts currently due from tenants in accordance with the terms of the respective leases. Receivables are reviewed monthly and reserves are established with a charge to current period operations when, in the opinion of management, collection of the receivable is doubtful. Accounts receivable in the accompanying consolidated financial statements are shown net of an allowance for doubtful accounts of \$479,000 and \$430,000, at December 31, 2006 and 2005, respectively.

**Allowance for Doubtful Accounts**

*(In thousands)*

	<b>For the Year Ended December 31,</b>	
	<b>2006</b>	<b>2005</b>
Beginning Balance	\$ 430	\$ 1,125
Provision for Credit Losses	400	237
Charge-offs	(351)	(932)
Ending Balance	\$ 479	\$ 430

In addition to rents due currently, accounts receivable include \$23,341,000 and \$14,701,000, at December 31, 2006 and 2005, respectively, representing minimum rental income accrued on a straight-line basis to be paid by tenants over the remaining term of their respective leases. These amounts are presented after netting allowances of \$213,000 and \$64,000, respectively, for tenants whose rent payment history or financial condition cast doubt upon the tenant's ability to perform under its lease obligations. See Recent Accounting Pronouncements-SAB 108 for an explanation for \$6,415,000 of the accounts receivable increase for 2006.

**Cash and Cash Equivalents**

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

**Deferred Debt Costs**

Deferred debt costs consist of fees and costs incurred to obtain long-term financing, construction financing and the revolving line of credit. These fees and costs are being amortized over the terms of the respective loans or agreements, which approximates the effective interest method. Deferred debt costs totaled \$5,328,000 and \$5,875,000, net of accumulated amortization of \$4,244,000 and \$3,155,000, at December 31, 2006 and 2005, respectively. During 2005, \$2,235,000 of fully amortized deferred debt costs was written-off.

**Deferred Income**

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



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**SAUL CENTERS, INC.**

**Notes to Consolidated Financial Statements**

**Revenue Recognition**

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

**Income Taxes**

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

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

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

The Company established a stock option plan in 1993 (the 1993 Plan) for the purpose of attracting and retaining executive officers and other key personnel. The 1993 Plan provides for grants of options to purchase a specified number of shares of common stock. A total of 400,000 shares were made available under the 1993 Plan. The 1993 Plan authorizes the Compensation Committee of the Board of Directors to grant options at an exercise price which may not be less than the market value of the common stock on the date the option is granted. On May 23, 2003, the Compensation Committee granted options to purchase a total of 220,000 shares (80,000 shares from incentive stock options and 140,000 shares from nonqualified stock options) to six Company officers (the 2003 Options). Following the grant of the 2003 Options, no additional shares remained for issuance under the 1993 Plan. The 2003 Options vest 25% per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment. The exercise price of \$24.91 was the closing market price of the Company's common stock on the date of the award.

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**SAUL CENTERS, INC.**

**Notes to Consolidated Financial Statements**

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

Effective April 26, 2004, the Compensation Committee granted options to purchase a total of 152,500 shares (27,500 shares from incentive stock options and 125,000 shares from nonqualified stock options) to eleven Company officers and to the twelve Company directors (the 2004 Options). The officers' 2004 Options vest 25% per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment.

The directors' options were immediately exercisable. The exercise price of \$25.78 was the closing market price of the Company's common stock on the date of the award. Using the Black-Scholes model, the Company determined the total fair value of the 2004 Options to be \$360,000, of which \$293,000 and \$67,000 were the values assigned to the officer options and director options respectively. Because the directors' options vest immediately, the entire \$67,000 was expensed as of the date of grant. The expense of the officers' options is being recognized as compensation expense monthly during the four years the options vest. The 2004 Options are due to expire April 25, 2014.

Effective May 6, 2005, the Compensation Committee granted options to purchase a total of 162,500 shares (35,500 shares from incentive stock options and 127,000 shares from nonqualified stock options) to twelve Company officers and to the twelve Company directors (the 2005 Options). The officers' 2005 Options vest 25% per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment. The directors' options were immediately exercisable. The exercise price of \$33.22 was the closing market price of the Company's common stock on the date of the award. Using the Black-Scholes model, the Company determined the total fair value of the 2005 Options to be \$484,500, of which \$413,400 and \$71,100 were the values assigned to the officer options and director options respectively. Because the directors' options vest immediately, the entire \$71,100 was expensed as of the date of grant. The expense of the officers' options is being recognized as compensation expense monthly during the four years the options vest. The 2005 Options are due to expire May 5, 2015.

Effective May 1, 2006, the Compensation Committee granted options to purchase a total of 30,000 shares (all nonqualified stock options) to the twelve Company directors (the 2006 Options). The options were immediately exercisable. The exercise price of \$40.35 was the closing market price of the Company's common stock on the date of the award. Using the Black-Scholes model, the Company determined the total fair value of the 2006 Options to be \$143,400. Because the directors' options vest immediately, the entire \$143,400 was expensed as of the date of grant. The 2006 Options are due to expire April 30, 2016. (See Note 10. Stock Option Plan)

Pursuant to the 2004 Plan, the Compensation Committee established a Deferred Compensation Plan for Directors for the benefit of its directors and their beneficiaries. This replaces the Company's previous Deferred Compensation and Stock Plan for Directors. A director may elect to defer all or part of his or her director's fees and has the option to have the fees paid in cash, in shares of common stock or in a combination of cash and shares of common stock upon termination from the Board. If the director elects to have fees paid in stock, fees earned during a calendar quarter are aggregated and divided by the common stock's closing market price on the first trading day of the following quarter to determine the number of shares to be allocated to the director. As of December 31, 2006, 203,000 shares had been credited to the directors' deferred fee accounts.

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The Compensation Committee has also approved an annual award of shares of the Company's common stock as additional compensation to each director serving on the Board of Directors as of the record date for the Annual Meeting of Stockholders. The shares are awarded as of each Annual Meeting of Shareholders, and their issuance may not be deferred. Each director was issued 200 shares, for each of the years ended December 31, 2006, 2005 and 2004. The shares were valued at the closing stock price on the dates the shares were awarded and included in general and administrative expenses in the total amounts of \$97,000, \$80,000, and \$71,000, for the years ended December 31, 2006, 2005 and 2004, respectively.

**Minority Interests**

Saul Centers is the sole general partner of the Operating Partnership, owning a 76.2% common interest as of December 31, 2006. Minority Interests in the Operating Partnership are comprised of limited partnership units owned by The Saul Organization. Minority Interests as reflected on the Balance Sheets are increased for earnings allocated to limited partnership interests, distributions reinvested in additional units and in certain situations for distributions to minority interests in excess of earnings allocated, and are decreased for limited partner distributions. Minority Interests as reflected on the Statements of Operations represent earnings allocated to limited partnership interests. Amounts distributed in excess of the limited partners' share of earnings, net of limited partner reinvestments of distributions, also increase minority interests expense in the respective period and are classified on the Statements of Operations as Distributions in excess of earnings to the extent such distributions in excess of earnings exceed the carrying amount of minority interests.

**Per Share Data**

Per share data is calculated in accordance with SFAS 128, Earnings Per Share. Per share data for net income (basic and diluted) is computed using weighted average shares of common stock. Convertible limited partnership units and employee stock options are the Company's potentially dilutive securities. For all periods presented, the convertible limited partnership units are anti-dilutive. For the years ended December 31, 2006, 2005 and 2004 the options are dilutive because the average share price of the Company's common stock exceeded the exercise prices. The treasury stock method was used to measure the effect of the dilution.

**Basic and Diluted Shares Outstanding**

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

**Reclassifications**

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

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**SAUL CENTERS, INC.**

**Notes to Consolidated Financial Statements**

**Legal Contingencies**

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

**Recent Accounting Pronouncements**

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

In December 2004, the FASB issued FAS No. 123 (revised 2004), Share-Based Payment ( FAS No. 123R ), which is a revision of FAS No. 123, Accounting for Stock-Based Compensation. FAS No. 123R supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees, and amends FAS No. 95, Statement of Cash Flows. Saul Centers adopted FAS No. 123R as required, effective January 1, 2006. FAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recorded as an expense based on their fair values. The grant-date fair value of employee share options and similar instruments will be estimated using an option-pricing model adjusted for any unique characteristics of a particular instrument. If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification. The Company already values stock option awards using the fair value method and expenses the option value over the vesting period of the options, in accordance with FAS No. 123. The Company adopted FAS No. 123R using the modified prospective transition method. The Company has determined that the adoption of FAS No. 123R did not have a material impact upon (1) Income from continuing operations, (2) Net income, (3) Cash flow from operations (4) Cash flow from financing activities and (5) Basic and diluted earnings per share. The adoption of the modified prospective method did not affect the prior year period's financial statements, so there are no restated amounts resulting from the adoption of the modified prospective method.

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

On September 13, 2006 the SEC staff published Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 addresses how the effects of a prior year uncorrected misstatement must be considered in quantifying misstatements in the current year

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**Table of Contents****SAUL CENTERS, INC.****Notes to Consolidated Financial Statements**

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

**3. REAL ESTATE ACQUIRED****Boca Valley Plaza**

On February 13, 2004, the Company acquired Boca Valley Plaza in Boca Raton, Florida. Boca Valley Plaza is a 121,000 square foot neighborhood shopping center on U.S. Highway 1 in South Florida. The center, constructed in 1988, was 97% leased at December 31, 2006 and anchored by a 42,000 square foot Publix supermarket. The property was acquired for a purchase price of \$17.5 million, subject to the assumption of a \$9.2 million mortgage. The mortgage assumption was treated as a non-cash acquisition in the Statement of Cash Flows.

**Countryside**

On February 17, 2004, the Company completed the acquisition of the 142,000 square foot Safeway-anchored Countryside shopping center, its fourth neighborhood shopping center investment in Loudoun County, Virginia. The center was 96% leased at December 31, 2006 and was acquired for a purchase price of \$29.7 million.

**Cruse MarketPlace**

On March 25, 2004, the Company completed the acquisition of the 79,000 square foot Publix-anchored, Cruse MarketPlace located in Forsyth County, Georgia. Cruse MarketPlace was constructed in 2002 and was 97% leased at December 31, 2006. The center was purchased for \$12.6 million subject to the assumption of an \$8.8 million mortgage loan. The mortgage assumption was treated as a non-cash acquisition in the Statement of Cash Flows.

**Briggs Chaney MarketPlace**

On April 23, 2004, the Company completed the acquisition of the 194,000 square foot Safeway-anchored Briggs Chaney MarketPlace shopping center located in Silver Spring, Maryland. The center was 100% leased at December 31, 2006 and was acquired for a purchase price of \$27.3 million.

**Ashland Square**

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





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**SAUL CENTERS, INC.**

**Notes to Consolidated Financial Statements**

**Palm Springs Center**

On March 3, 2005, the Company completed the acquisition of the 126,000 square foot Albertson s-anchored Palm Springs Center located in Altamonte Springs, Florida (metropolitan Orlando). The center was 100% leased at December 31, 2006 and was acquired for a purchase price of \$17.5 million.

**New Market**

On March 3, 2005, the Company acquired a 7.1 acre parcel of land located in New Market, Maryland for a purchase price of \$500,000. On September 8, 2005, the Company acquired a 28.4 acre contiguous parcel for a purchase price of \$1.5 million. Together, these parcels will accommodate a neighborhood shopping center development in excess of 120,000 square feet of leasable space. The Company has contracted to purchase one additional parcel with the intent to assemble additional acreage for further retail development near this I-70 interchange, east of Frederick, Maryland.

**Lansdowne Town Center**

During the first quarter of 2005, the Company received approval of a zoning submission to Loudoun County which allowed the development of a neighborhood shopping center named Lansdowne Town Center, within the Lansdowne Community in northern Virginia. On March 29, 2005, the Company finalized the acquisition of an additional 4.5 acres of land to bring the total acreage of the development parcel to 23.4 acres (including the 18.9 acres acquired in 2002). The additional purchase price was approximately \$1.0 million. In November 2005, the Company commenced construction of an approximately 188,000 square foot retail center. A lease was executed with Harris Teeter for a 55,000 square foot grocery store, which opened in November 2006. Construction was substantially completed during the fourth quarter of 2006, with project costs expected to total approximately \$41.5 million. The project was 85% leased as of December 31, 2006 and 45% of the space was in operation at that time (approximately 85,000 square feet of retail space). The remaining retail space (65,000 square feet) is expected to be operational by spring 2007, while the second floor office space is expected to be fully operational by fall 2007 (38,000 square feet).

**Jamestown Place**

On November 17, 2005, the Company completed the acquisition of the 96,000 square foot Publix-anchored Jamestown Place located in Altamonte Springs, Florida (metropolitan Orlando). The center was 100% leased at December 31, 2006 and was acquired for a purchase price of \$14.8 million.

**Seabreeze Plaza**

On November 30, 2005, the Company completed the acquisition of the 147,000 square foot Publix-anchored Seabreeze Plaza located in Palm Harbor, Florida (metropolitan Tampa). The center was 91% leased at December 31, 2006 and was acquired for a purchase price of \$25.9 million subject to the assumption of a \$13.6 million mortgage loan (See Note 5. Mortgage Notes Payable). The mortgage assumption was treated as a non-cash acquisition in the Statement of Cash Flows.

**Smallwood Village Center**

On January 27, 2006, the Company acquired the 198,000 square foot Smallwood Village Center, located on 25 acres within the St. Charles planned community of Waldorf, Maryland, a suburb of metropolitan Washington, DC, through a wholly-owned subsidiary of its operating partnership. The center was 84% leased at December 31, 2006 and was acquired for a purchase price of \$17.5 million subject to the assumption of an \$11.3 million mortgage loan.

**Hunt Club Corners**

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

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**Table of Contents****SAUL CENTERS, INC.****Notes to Consolidated Financial Statements****Application of SFAS 141, Business Combinations, for Real Estate Acquired**

The Company accounts for the acquisition of operating properties using the purchase method of accounting in accordance with SFAS 141, Business Combinations. The Company allocates the purchase price to various components, such as land, buildings and intangibles related to in-place leases and customer relationships, if applicable, as described in Note 2. Significant Accounting Policies-Real Estate Investment Properties. Of the combined \$28,538,000 total cost of the operating property acquisitions in 2006 and \$58,464,000 in 2005, of which both amounts include the properties purchase price and closing costs, a total of \$1,459,000 and \$3,523,000, was allocated as lease intangible assets and included in lease acquisition costs at December 31, 2006 and December 31, 2005, respectively. Each year's lease intangible assets are being amortized over the remaining periods of the leases acquired, a weighted average term of 22 and 13 years, for 2006 and 2005, respectively. The value of below market leases totaling \$3,211,000 and \$2,203,000, are being amortized over a weighted average term of 30 and 19 years, for 2006 and 2005, respectively, and are included in deferred income. The value of above market leases totaling \$37,000 and \$151,000, are being amortized over a weighted average term of one and 5 years, respectively, and are included as a deferred asset in accounts receivable.

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

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

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

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

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

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**SAUL CENTERS, INC.**

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

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

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

The impact of The Saul Organization's 23.8% limited partnership interest in the Operating Partnership is reflected as minority interests in the accompanying consolidated financial statements. Fully converted partnership units and diluted weighted average shares outstanding for the years ended December 31, 2006, 2005 and 2004, were 22,628,000, 22,003,000, and 21,405,000, respectively.

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

The Company's outstanding debt, including amounts owed under the Company's revolving credit facility, totaled \$522,443,000 at December 31, 2006, of which \$487,443,000 was fixed rate debt and \$35,000,000 was variable rate debt. At the prior year's end, notes payable totaled \$482,431,000 at December 31, 2005, of which \$471,931,000 was fixed rate debt and \$10,500,000 was variable rate debt. At December 31, 2006, the Company had a \$150 million unsecured revolving credit facility with \$35,000,000 outstanding borrowings. The facility is due to mature January 2008 and requires monthly interest payments, if applicable, at a rate of LIBOR plus a spread of 1.40% to 1.625% (determined by certain debt service coverage and leverage tests) or upon the bank's reference rate at the Company's option. Loan availability is determined by operating income from the Company's unencumbered properties. Based upon the terms of the facility as of December 31, 2006, the unencumbered properties support line availability of \$87,000,000, of which \$1,627,000 has been issued under a letter of credit and \$35,000,000 has been borrowed, leaving \$50,373,000 available for working capital uses. An additional \$63,000,000 could become available for funding working capital and operating property acquisitions as unencumbered properties' internal cash flow grows and operating income is provided by future unencumbered acquisitions.

Saul Centers has guaranteed a portion of one of the Partnerships' mortgage notes payable totaling \$4,500,000, the amount of which is considered a recourse obligation to Saul Centers as of December 31, 2006. The guarantee is expected to be released upon the achievement of specified leasing thresholds at a recently redeveloped property. Saul Centers is also a guarantor of the revolving credit facility. The balance of the mortgage notes payable totaling \$482,943,000 are non-recourse.

The Company obtained three new fixed-rate, non-recourse financings during 2006. On January 10, 2006, the Company closed on a new fixed-rate mortgage financing in the amount of \$10,500,000, secured by Jamestown Place, acquired in November 2005. The loan matures February 2021, requires equal monthly principal and interest payments of \$66,000, based upon a 5.81% interest rate and 25-year principal amortization, and requires a final payment of \$6,102,000 at maturity. On January 27, 2006, the Company assumed the obligation of a secured

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**SAUL CENTERS, INC.**

**Notes to Consolidated Financial Statements**

mortgage obligation in conjunction with the acquisition of Smallwood Village Center. The outstanding balance on the loan was \$11,334,000 at settlement. The loan matures January 2013, requires equal monthly principal and interest payments of \$71,000, based upon a 6.12% interest rate and 30-year principal amortization, and requires a final payment of \$10,071,000 at maturity. The Company also obtained a new fixed-rate, non-recourse financing on July 12, 2006 when it closed on a new fixed-rate mortgage financing in the amount of \$7,000,000, secured by Hunt Club Corners, acquired June 1, 2006. The loan matures August 11, 2021, requires equal monthly principal and interest payments of \$42,000, based upon a 6.01% interest rate and 30-year principal amortization, and requires a final payment of \$5,018,000 at maturity.

In December 2005, the Company entered into a rate lock agreement and made application for a 15-year, \$40,000,000 fixed-rate mortgage loan to be collateralized by Lansdowne Town Center. The loan application was approved as a commitment in March 2006. The rate lock agreement set the interest rate at 5.62%, contingent upon meeting certain construction and leasing criteria prior to loan funding, projected to occur during the 2007 first quarter. The Company paid a loan deposit fee of \$850,000 which is refundable at closing.

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

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

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

- (a) The loan is collateralized by Avenel Business Park, Van Ness Square, Ashburn Village, Leesburg Pike, Lumberton Plaza and Village Center. The loan has been increased on four occasions since its inception in 1997. The 8.00% blended interest rate is the weighted average of the initial loan rate and additional borrowing rates. The loan requires equal monthly principal and interest payments of \$920,000 based upon a weighted average 23-year amortization schedule and a final payment of \$63,153,000 at loan maturity. Principal of \$3,896,000 was amortized during 2006.
- (b) The loan is collateralized by nine shopping centers (Seven Corners, Thruway, White Oak, Hampshire Langley, Great Eastern, Southside Plaza, Belvedere, Giant and Ravenwood) and requires equal monthly principal and interest payments of \$1,103,000 based upon a 25-year amortization schedule and a final payment of \$97,403,000 at loan maturity. Principal of \$3,507,000 was amortized during 2006.

**Table of Contents****SAUL CENTERS, INC.****Notes to Consolidated Financial Statements**

- (c) *The loan is collateralized by Smallwood Village Center and requires equal monthly principal and interest payments of \$71,000 based upon a 30 year amortization schedule and a final payment of \$10,071,000 at loan maturity. Principal of \$146,000 was amortized during 2006.*
- (d) *The loan is collateralized by 601 Pennsylvania Avenue and requires equal monthly principal and interest payments of \$294,000 based upon a 25-year amortization schedule and a final payment of \$22,961,000 at loan maturity. Principal of \$1,030,000 was amortized during 2006.*
- (e) *The loan is collateralized by Cruse MarketPlace and requires equal monthly principal and interest payments of \$56,000 based upon an amortization schedule of approximately 24 years and a final payment of \$6,830,000 at loan maturity. Principal of \$189,000 was amortized during 2006.*
- (f) *The loan is collateralized by Seabreeze Plaza and requires equal monthly principal and interest payments of \$84,000 based upon a 25-year amortization schedule and a final payment of \$10,531,000 at loan maturity. Principal of \$301,000 was amortized during 2006.*
- (g) *The loan is collateralized by Shops at Fairfax and Boulevard shopping centers and requires monthly principal and interest payments of \$118,000 based upon a 22-year amortization schedule and a final payment of \$7,630,000 at loan maturity. Principal of \$375,000 was amortized during 2006.*
- (h) *The loan is collateralized by Washington Square and requires equal monthly principal and interest payments of \$264,000 based upon a 27.5-year amortization schedule and a final payment of \$28,012,000 at loan maturity. Principal of \$741,000 was amortized during 2006.*
- (i) *The loan, consisting of two notes dated December 2003 and two notes dated February and December 2004, is currently collateralized by three shopping centers, Broadlands Village (Phases I, II & III), The Glen and Kentlands Square, and requires equal monthly principal and interest payments of \$306,000 based upon a 25-year amortization schedule and a final payment of \$28,393,000 at loan maturity. Principal of \$963,000 was amortized during 2006.*
- (j) *The loan is collateralized by Olde Forte Village and requires equal monthly principal and interest payments of \$98,000 based upon a 25-year amortization schedule and a final payment of \$8,985,000 at loan maturity. Principal of \$314,000 was amortized during 2006.*
- (k) *The loan is collateralized by Countryside and requires equal monthly principal and interest payments of \$133,000 based upon a 25-year amortization schedule and a final payment of \$12,288,000 at loan maturity. Principal of \$436,000 was amortized during 2006.*
- (l) *The loan is collateralized by Briggs Chaney MarketPlace and requires equal monthly principal and interest payments of \$133,000 based upon a 25-year amortization schedule and a final payment of \$12,192,000 at loan maturity. Principal of \$414,000 was amortized during 2006.*
- (m) *The loan is collateralized by Shops at Monocacy and requires equal monthly principal and interest payments of \$112,000 based upon a 25-year amortization schedule and a final payment of \$10,568,000 at loan maturity. Principal of \$392,000 was amortized during 2006.*
- (n) *The loan is collateralized by Boca Valley Plaza and requires equal monthly principal and interest payments of \$75,000 based upon a 30-year amortization schedule and a final payment of \$9,149,000 at loan maturity. Principal of \$178,000 was amortized during 2006.*
- (o) *The loan is collateralized by Palm Springs Center and requires equal monthly principal and interest payments of \$75,000 based upon a 25-year amortization schedule and a final payment of \$7,075,000 at loan maturity. Principal of \$253,000 was amortized during 2006.*
- (p) *The loan is collateralized by Jamestown Place and requires equal monthly principal and interest payments of \$66,000 based upon a 25-year amortization schedule and a final payment of \$6,102,000 at loan maturity. Principal of \$159,000 was amortized during 2006.*

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- (q) *The loan is collateralized by Hunt Club Corners and requires equal monthly principal and interest payments of \$42,000 based upon a 30-year amortization schedule and a final payment of \$5,018,000 at loan maturity. Principal of \$28,000 was amortized during 2006.*
- (r) *The loan is an unsecured revolving credit facility totaling \$150,000,000. Loan availability for working capital and general corporate uses is determined by operating income from the Company's unencumbered properties, with a portion available only for funding qualified operating property acquisitions. Interest expense is calculated based upon the 1,2,3 or 6 month LIBOR rate plus a spread of 1.40% to 1.625% (determined by certain debt service coverage and leverage tests) or upon the bank's reference rate at the Company's option. The line may be extended one year with payment of a fee of 1/4% at the Company's option. Monthly payments, if applicable, are interest only and will vary depending upon the amount outstanding and the applicable interest rate for any given month.*

The December 31, 2006 and 2005 depreciation adjusted cost of properties collateralizing the mortgage notes payable totaled \$508,236,000 and \$467,015,000, respectively. The Company's credit facility requires the Company and its subsidiaries to maintain certain financial covenants. As of December 31, 2006, the material covenants required the Company, on a consolidated basis, to:

limit the amount of debt so as to maintain a gross asset value, as defined in the loan agreement, in excess of liabilities of at least \$400 million plus 90% of our future net equity proceeds;

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

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

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

limit the amount of variable rate debt and debt with initial loan terms of less than 5 years to no more than 40% of total debt. As of December 31, 2006, the Company was in compliance with all such covenants.

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

**Debt Maturity Schedule**

*(In thousands)*

2007	\$ 14,423
2008	50,473
2009	16,663
2010	17,915
2011	81,497
Thereafter	341,472
<b>Total</b>	<b>\$ 522,443</b>





**Table of Contents****SAUL CENTERS, INC.****Notes to Consolidated Financial Statements****Interest Expense and Amortization of Deferred Debt Costs***(In thousands)*

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

**6. LEASE AGREEMENTS**

Lease income includes primarily base rent arising from noncancelable commercial leases. Base rent (including straight-lined rent) for the years ended December 31, 2006, 2005 and 2004, amounted to \$110,121,000, \$99,448,000 and \$91,125,000, respectively. Future contractual payments under noncancelable leases for years ended December 31, (which exclude the effect of straight-lining rents), are as follows:

**Future Contractual Payments***(In thousands)*

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

The majority of the leases also provide for rental increases and expense recoveries based on fixed annual increases or increases in the Consumer Price Index and increases in operating expenses. The expense recoveries generally are payable in equal installments throughout the year based on estimates, with adjustments made in the succeeding year. Expense recoveries for the years ended December 31, 2006, 2005 and 2004 amounted to \$22,636,000, \$20,027,000 and \$16,712,000, respectively. In addition, certain retail leases provide for percentage rent based on sales in excess of the minimum specified in the tenant's lease. Percentage rent amounted to \$1,767,000, \$2,057,000 and \$1,635,000, for the years ended December 31, 2006, 2005 and 2004, respectively.

**7. LONG-TERM LEASE OBLIGATIONS**

Certain properties are subject to noncancelable long-term leases which apply to land underlying the Shopping Centers. Certain of the leases provide for periodic adjustments of the base annual rent and require the payment of real estate taxes on the underlying land. The leases will expire between 2058 and 2068. Reflected in the accompanying consolidated financial statements is minimum ground rent expense of \$164,000

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for each of the years ended December 31, 2006, 2005 and 2004, respectively.

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

**Ground Lease Rental Commitments**

(In thousands)

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

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

The Company's corporate headquarters lease, which commenced in March 2002, is leased by a member of The Saul Organization. The 10-year lease provides for base rent escalated at 3% per year, with payment of a pro-rata share of operating expenses over a base year amount. The Company and The Saul Organization entered into a Shared Services Agreement whereby each party pays an allocation of total rental payments on a percentage proportionate to the number of employees employed by each party. The Company's rent payments for the years ended December 31, 2006, 2005 and 2004 were \$726,000, \$661,000 and \$621,000, respectively. Expenses arising from the lease are included in general and administrative expense (see Note 9 - Related Party Transactions).

**8. STOCKHOLDERS' EQUITY AND MINORITY INTERESTS**

The consolidated statement of operations for the year ended December 31, 2006 includes a charge for minority interests of \$7,793,000, representing The Saul Organization's share of the net income for the year. The charge for the year ended December 31, 2005 was \$7,798,000, consisting of \$6,937,000 related to The Saul Organization's share of the net income for the year and \$861,000 related to distributions to minority interests in excess of allocated net income for the year. The charge for the year ended December 31, 2004 was \$8,105,000, consisting of \$6,386,000 related to The Saul Organization's share of the net income for the year and \$1,719,000 related to distributions to minority interests in excess of allocated net income for the year.

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

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

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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.

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**Notes to Consolidated Financial Statements**

**9. RELATED PARTY TRANSACTIONS**

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

The Company utilizes Chevy Chase Bank for its various checking accounts and as of December 31, 2006 had \$7,884,000 deposited in cash and short-term investment accounts.

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

The Company participates in a multiemployer profit sharing retirement plan with other entities within The Saul Organization which covers those full-time employees who meet the requirements as specified in the plan. Beginning January 1, 2002, only employer contributions are made to the plan. Each participant who is entitled to be credited with at least one hour of service on or after January 1, 2002, shall be 100% vested in his or her employer contribution account and no portion of such account shall be forfeitable. Employer contributions, included in general and administrative expense or property operating expenses in the consolidated statements of operations, at the discretionary amount of up to six percent of the employee's cash compensation, subject to certain limits, were \$289,000, \$266,000 and \$269,000 for 2006, 2005 and 2004, respectively. There are no past service costs associated with the plan since it is of the defined-contribution type.

The Company also participates in a multiemployer nonqualified deferred plan with entities in The Saul Organization which covers those full-time employees who meet the requirements as specified in the plan. The plan, which can be modified or discontinued at any time, requires participating employees to defer 2% of their compensation over a specified amount. For the years ended December 31, 2006, 2005 and 2004, the Company was required to contribute three times the amount deferred by employees. The Company's expense, included in general and administrative expense, totaled \$106,000, \$118,000 and \$650,000, for the years ended December 31, 2006, 2005 and 2004, respectively. All amounts deferred by employees and the Company are fully vested. The cumulative unfunded liability under this plan was \$709,000 and \$570,000 at December 31, 2006 and 2005, respectively, and is included in accounts payable, accrued expenses and other liabilities in the consolidated balance sheets.

The Company has entered into a shared services agreement (the Agreement) with The Saul Organization that provides for the sharing of certain personnel and ancillary functions such as computer hardware, software, and support services and certain direct and indirect administrative personnel. The method for determining the cost of the shared services is provided for in the Agreement and is based upon head count estimates of usage or estimates of time incurred, as applicable. Senior management has determined that the final allocations of shared costs are reasonable. The terms of the Agreement and the payments made thereunder are reviewed annually by the Audit Committee of the Board of Directors, which consists entirely of independent directors. Billings by The Saul Organization for the Company's share of these ancillary costs and expenses for the years ended December 31, 2006,

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**SAUL CENTERS, INC.**

**Notes to Consolidated Financial Statements**

2005 and 2004, which included rental payments for the Company's headquarters lease (see Note 7. Long Term Lease Obligations), totaled \$3,963,000, \$3,462,000 and \$3,139,000, respectively. The amounts are expensed when incurred and are primarily reported as general and administrative expenses in these consolidated financial statements. As of December 31, 2006 and 2005, accounts payable, accrued expenses and other liabilities included \$255,000 and \$305,000, respectively, represent billings due to The Saul Organization for the Company's share of these ancillary costs and expenses.

On January 12, 2006, the Company agreed to final terms of a contract to purchase a 10.4 acre site in Frederick, Maryland, from a subsidiary of Chevy Chase Bank, a related party, for \$5,000,000. The Company plans to develop this property into a retail center. The purchase price of the property was determined by the average of two independent third party appraisals which were contracted, one on behalf of the Company and one on behalf of Chevy Chase Bank. The parties anticipate closing on the transaction during the summer of 2007.

**10. STOCK OPTION PLAN**

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

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

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

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

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

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Effective May 6, 2005, the Compensation Committee granted options to purchase a total of 162,500 shares (35,500 shares of incentive stock options and 127,000 shares of nonqualified stock options) to twelve Company officers and to the twelve Company directors (the 2005 Options). The officers' 2005 Options vest 25% per year over four years and have a term of ten years, subject to earlier expiration upon termination of employment. The directors' options are exercisable immediately. The exercise price of \$33.22 per share was the market trading price of the Company's common stock at the time of the award. The table below summarizes the status of the 2005, 2004 and 2003 Option grants and the value of the options expensed and included in general and administrative expense in the Consolidated Statements of Operations:

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

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

**Stock Options**

	Officers			Directors			Total
	05/23/2003	04/26/2004	05/06/2005	04/26/2004	05/06/2005	05/01/2006	
Grant date	05/23/2003	04/26/2004	05/06/2005	04/26/2004	05/06/2005	05/01/2006	
Total grant	220,000	122,500	132,500	30,000	30,000	30,000	565,000
Vested	165,000	61,250	33,125	30,000	30,000	30,000	349,375
Exercised	81,422	21,875	5,000				108,297
Forfeited	7,500	7,500	11,250				26,250
Remaining unexercised	131,078	93,125	116,250	30,000	30,000	30,000	430,453
Exercise price	\$ 24.91	\$ 25.78	\$ 33.22	\$ 25.78	\$ 33.22	\$ 40.35	
Volatility	0.175	0.183	0.207	0.183	0.198	0.206	
Expected life (years)	7.0	7.0	8.0	5.0	10.0	9.0	
Assumed yield	7.00%	5.75%	6.37%	5.75%	6.91%	5.93%	
Risk-free rate	4.00%	4.05%	4.15%	3.57%	4.28%	5.11%	
Total value at grant date	\$ 332,200	\$ 292,775	\$ 413,400	\$ 66,600	\$ 71,100	\$ 143,400	\$ 1,319,475
Expensed previous yrs	50,000						50,000
Expensed in 2004	83,000	50,000		66,600			199,600
Expensed in 2005	83,000	73,000	69,000		71,100		296,100
Expensed in 2006	76,444	67,220	95,550			143,400	382,614
Forfeited options	11,325	17,925	35,100				64,350
Future expense	28,431	84,630	213,750				326,811
Weighted average term of future expense							1.9 yrs



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

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

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

**11. NON-OPERATING ITEMS****Gain on Sale of Property**

The gain on sale of property of \$572,000 in 2004 represents the Company s share of the gain recognized as a result of a condemnation of a portion of land at the Company s White Oak shopping center for road improvements. There were no property dispositions in 2006 or 2005.

**12. FAIR VALUE OF FINANCIAL INSTRUMENTS**

Statement of Financial Accounting Standards No. 107, Disclosure about Fair Value of Financial Instruments, requires disclosure about the fair value of financial instruments. The carrying values of cash and cash equivalents, accounts receivable, accounts payable and accrued expenses are reasonable estimates of their fair value. Based upon management s estimate of borrowing rates and loan terms currently available to the Company for fixed rate financing, the fair value of the fixed rate notes payable is in excess of the \$487,443,000 and \$471,931,000 carrying value at December 31, 2006 and 2005, respectively. Management estimates that the fair value of these fixed rate notes payable, assuming long term interest rates of approximately 5.96% and 5.65%, would be approximately \$504,562,000 and \$501,550,000, as of December 31, 2006 and 2005, respectively.

**13. COMMITMENTS AND CONTINGENCIES**

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



**Table of Contents****SAUL CENTERS, INC.****Notes to Consolidated Financial Statements****14. DISTRIBUTIONS**

In December 1995, the Company established a Dividend Reinvestment and Stock Purchase Plan (the Plan), to allow its stockholders and holders of limited partnership interests an opportunity to buy additional shares of common stock by reinvesting all or a portion of their dividends or distributions. The Plan provides for investing in newly issued shares of common stock at a 3% discount from market price without payment of any brokerage commissions, service charges or other expenses. All expenses of the Plan are paid by the Company. The Operating Partnership also maintains a similar dividend reinvestment plan that mirrors the Plan, which allows limited partnership interests the opportunity to buy additional limited partnership units.

The Company paid common stock distributions of \$1.68 per share, \$1.60 per share and \$1.56 per share, during 2006, 2005 and 2004, respectively, and paid preferred stock dividends of \$2.00 per depositary share during each of the years. For the common stock dividends paid, \$1.445, \$1.520 and \$1.248 per share, represented ordinary dividend income and \$0.235, \$0.080 and \$0.312 per share, represented return of capital to the shareholders for the years 2006, 2005 and 2004, respectively. All of the preferred stock dividends paid were considered ordinary dividend income.

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

	Total Distributions to (Dollars in thousands)			Dividend Reinvestments		
	Preferred Stockholders	Common Stockholders	Partnership Unitholders	Common	Units Issued	Discounted Share Price
				Stock Shs Issued		
<b>Distributions during 2006</b>						
October 31	\$ 2,000	\$ 7,219	\$ 2,274	126,054		\$ 47.14
July 28	2,000	7,145	2,274	153,298		38.70
April 28	2,000	7,126	2,254	35,807	50,736	39.66
January 31	2,000	7,089	2,230	43,404	55,421	35.89
Total 2006	\$ 8,000	\$ 28,579	\$ 9,032	358,563	106,157	
<b>Distributions during 2005</b>						
October 31	\$ 2,000	\$ 7,042	\$ 2,207	108,133	57,875	\$ 33.95
July 29	2,000	6,668	2,081	91,353	50,483	36.67
April 29	2,000	6,436	2,029	158,607		32.50
January 31	2,000	6,396	2,028	97,401	2,552	32.40
Total 2005	\$ 8,000	\$ 26,542	\$ 8,345	455,494	110,910	
<b>Distributions during 2004</b>						
October 29	\$ 2,000	\$ 6,342	\$ 2,028	116,006	2,590	\$ 31.53
July 30	2,000	6,296	2,027	117,334	2,769	29.10
April 30	2,000	6,236	2,026	140,253	3,270	24.25
January 30	1,244	6,187	2,024	123,689	2,928	26.69
Total 2004	\$ 7,244	\$ 25,061	\$ 8,105	497,282	11,557	



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In December 2006, 2005 and 2004, the Board of Directors of the Company authorized a distribution of \$0.42, \$0.42 and \$0.39 per common share payable in January 2007, 2006 and 2005, to holders of record on January 17, 2006, January 17, 2005 and January 17, 2004, respectively. As a result, \$7,284,000, \$7,089,000 and \$6,396,000, were paid to common shareholders on January 31, 2007, January 31, 2006 and January 31, 2005, respectively. Also, \$2,275,000, \$2,230,000 and \$2,028,000, were paid to limited partnership unitholders on January 31, 2007, January 31, 2006 and January 31, 2005 (\$0.42, \$0.42 and \$0.39 per Operating Partnership unit), respectively. The Board of Directors authorized preferred stock dividends of \$0.50 per depositary share, to holders of record on January 2, 2007, January 3, 2006 and January 3, 2005, respectively. As a result, \$2,000,000 was paid to preferred shareholders on January 12, 2007, January 13, 2006 and January 14, 2005, respectively. These amounts are reflected as a reduction of stockholders' equity in the case of common stock and preferred stock dividends and minority interests deductions in the case of limited partner distributions and are included in dividends and distributions payable in the accompanying consolidated financial statements.

**15. INTERIM RESULTS (Unaudited)**

The following summary presents the results of operations of the Company for the quarterly periods of calendar years 2006 and 2005.

*(In thousands, except per share amounts)*

	2006			
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Revenue	\$ 33,467	\$ 33,748	\$ 34,860	\$ 35,903
Operating income before minority interests and gain on sale of property	9,509	9,648	10,328	10,988
Net income	7,707	7,797	8,321	8,855
Net income available to common shareholders	5,707	5,797	6,321	6,855
Net income available to common shareholders per share (diluted)	0.33	0.34	0.37	0.39

  

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

**Table of Contents****SAUL CENTERS, INC.****Notes to Consolidated Financial Statements****16. BUSINESS SEGMENTS**

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

*(In thousands)*

	<b>Shopping Centers</b>	<b>Office Properties</b>	<b>Corporate and Other</b>	<b>Consolidated Totals</b>
<b>2006</b>				
Real estate rental operations:				
Revenue	\$ 101,460	\$ 36,184	\$ 334	\$ 137,978
Expenses	(20,172)	(9,009)		(29,181)
Income from real estate	81,288	27,175	334	108,797
Interest expense & amortization of deferred debt			(32,534)	(32,534)
General and administrative			(10,142)	(10,142)
Subtotal	81,288	27,175	(42,342)	66,121
Depreciation and amortization	(17,646)	(8,002)		(25,648)
Minority interests			(7,793)	(7,793)
Net Income	\$ 63,642	\$ 19,173	\$ (50,135)	\$ 32,680
Capital investment	\$ 59,679	\$ 3,109	\$ 2,911	\$ 65,699
Total assets	\$ 539,283	\$ 131,317	\$ 29,937	\$ 700,537
<b>2005</b>				
Real estate rental operations:				
Revenue	\$ 90,592	\$ 35,762	\$ 661	\$ 127,015
Expenses	(17,221)	(8,780)		(26,001)
Income from real estate	73,371	26,982	661	101,014
Interest expense & amortization of deferred debt			(30,207)	(30,207)
General and administrative			(9,585)	(9,585)
Subtotal	73,371	26,982	(39,131)	61,222
Depreciation and amortization	(16,283)	(7,914)		(24,197)
Minority interests			(7,798)	(7,798)
Net income	\$ 57,088	\$ 19,068	\$ (46,929)	\$ 29,227
Capital investment	\$ 70,652	\$ 1,509	\$ 1,644	\$ 73,805
Total assets	\$ 467,687	\$ 135,211	\$ 28,571	\$ 631,469

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<b>2004</b>				
Real estate rental operations:				
Revenue	\$ 77,906	\$ 34,679	\$ 257	\$ 112,842
Expenses	(14,226)	(8,121)		(22,347)
Income from real estate	63,680	26,558	257	90,495
Interest expense & amortization of deferred debt			(27,022)	(27,022)
General and administrative			(8,442)	(8,442)
Subtotal	63,680	26,558	(35,207)	55,031
Depreciation and amortization	(13,758)	(7,566)		(21,324)
Gain on property sale	572			572
Minority interests			(8,105)	(8,105)
Net income	\$ 50,494	\$ 18,992	\$ (43,312)	\$ 26,174
Capital investment	\$ 109,874	\$ 2,658	\$ 1,768	\$ 114,300
Total assets	\$ 394,674	\$ 138,273	\$ 50,449	\$ 583,396

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Schedule III

## SAUL CENTERS, INC.

## Real Estate and Accumulated Depreciation

December 31, 2006

(Dollars in Thousands)

	Costs		Basis at Close of Period				Accumulated Book Value	Related Debt	Date of Construction	Date Acquired	Buildings and Improvements	Lives in Years
	Capitalized Subsequent	to	Land	Improvements	Interests	Total						
	Initial Basis	Acquisition										
<b>Shopping Centers</b>												
Ashburn Village, Ashburn, VA	\$ 11,431	\$ 18,389	\$ 6,764	\$ 23,056	\$	\$ 29,820	\$ 5,347	\$ 24,473	\$ 24,656	1994 & 2000-2	3/94	40
Beacon Center, Alexandria, VA	1,493	17,324		17,723	1,094	18,817	8,368	10,449		1960 & 1974	1/72	40 & 50
Belvedere, Baltimore, MD	932	889	263	1,558		1,821	1,285	536	2,315	1958	1/72	40
Boca Valley Plaza, Boca Raton, FL	16,720	230	5,735	11,215		16,950	788	16,162	12,723		2/04	40
Boulevard, Fairfax, VA	4,883	1,701	3,687	2,897		6,584	845	5,739	4,950	1969	4/94	40
Briggs Chaney MarketPlace, Silver Spring, MD	27,037	2,333	9,789	19,581		29,370	1,327	28,043	20,100		4/04	40
Broadlands Village I & II, Ashburn, VA	4,102	18,552	4,085	18,569		22,654	1,750	20,904	24,182	2002-3 & 2004	3/02	40 & 50
Broadlands Village III, Ashburn, VA	1,214	5,833	1,214	5,833		7,047	44	7,003		2004	3/02	50
Clarendon/Clarendon Station, Arlington, VA	1,219	1,614	1,061	1,772		2,833	193	2,640		1949	7/73 & 1/96	40
Countryside, Sterling, VA	28,912	255	7,532	21,635		29,167	1,522	27,645	20,338		2/04	40
Cruse MarketPlace, Cumming, GA	12,226	65	3,920	8,371		12,291	574	11,717	8,331		3/04	40
Flagship Center, Rockville, MD	160	9	169			169		169		1972	1/72	
French Market, Oklahoma City, OK	5,781	9,898	1,118	14,561		15,679	7,236	8,443		1972 & 2001	3/74	50
Germantown, Germantown, MD	3,576	553	2,034	2,095		4,129	840	3,289		1990	8/93	40
Giant, Baltimore, MD	998	528	422	1,104		1,526	825	701	2,340	1959	1/72	40



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The Glen, Lake Ridge, VA	12,918	6,011	5,300	13,629	18,929	3,225	15,704	11,665	1993	6/94	40
Great Eastern, District Heights, MD	3,472	9,447	2,264	10,655	12,919	5,271	7,648	10,048	1958 & 1960	1/72	40
Hampshire Langley, Takoma Park, MD	3,159	2,835	1,856	4,138	5,994	3,012	2,982	9,211	1960	1/72	40
Hunt Club Corners, Apopka, FL	12,584	21	3,948	8,657	12,605	126	12,479	6,972		6/06	40
Jamestown Place, Altamonte Springs, FL	14,055	90	4,455	9,690	14,145	272	13,873	10,341		11/05	40
Kentlands Square, Gaithersburg, MD	14,379	104	5,006	9,477	14,483	1,018	13,465	9,669	2002	9/02	40
Kentlands Place, Gaithersburg, MD	1,425	6,972	1,425	6,972	8,397	398	7,999			1/04	50
Lansdowne Town Center, Leesburg, VA (A)	6,545	30,007	6,546	30,006	36,552	27	36,525		2002	11/02	50
Leesburg Pike, Baileys Crossroads, VA	2,418	5,511	1,132	6,797	7,929	4,707	3,222	9,067	1965	2/66	40
Lexington Pads, Lexington, KY	4,868	1,348	2,111	4,105	6,216	2,605	3,611		1971 & 1974	3/74	40
Lumberton Plaza, Lumberton, NJ	4,400	9,383	950	12,833	13,783	8,844	4,939	6,396	1975	12/75	40
Shops at Monocacy, Frederick, MD	9,541	13,283	9,260	13,564	22,824	942	21,882	18,015	2003-4	11/03	50
Olde Forte Village, Ft. Washington, MD	15,933	6,058	5,409	16,582	21,991	1,334	20,657	14,726	2003-4	07/03	40
Olney, Olney, MD	1,884	1,418		3,302	3,302	2,467	835		1972	11/75	40
Palm Springs Center, Altamonte Springs, FL	18,365	42	5,739	12,668	18,407	582	17,825	12,125		3/05	40

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Schedule III

## SAUL CENTERS, INC.

## Real Estate and Accumulated Depreciation

December 31, 2006

*(Dollars in Thousands)*

	Costs		Basis at Close of Period					Book Value	Related Debt	Date of Constructor	Date of Acquired	Buildings and Improvements	Depreciable Lives in Years
	Capitalized	Subsequent	Land	Buildings	Leasehold Interests	Total	Accumulated Depreciation						
	Initial Basis	to Acquisition		and									
Ravenwood, Baltimore, MD	1,245	4,013	703	4,555		5,258	1,358	3,900	5,936	1959	1/72	40	
Seabreeze Plaza, Palm Harbor, FL	24,526	(6)	8,665	15,855		24,520	430	24,090	13,253		11/05	40	
Seven Corners, Falls Church, VA	4,848	39,841	4,913	39,776		44,689	18,061	26,628	40,181	1956	7/73	40	
Shops at Fairfax, Fairfax, VA	2,708	9,292	992	11,008		12,000	4,238	7,762	7,387	1975 & 2001	6/75	50	
Smallwood Village Center, Waldorf, MD	17,819	201	6,402	11,618		18,020	269	17,751	11,188		1/06	40	
Southdale, Glen Burnie, MD	3,650	16,854		19,882	622	20,504	15,398	5,106		1962 & 1987	1/72	40	
Southside Plaza, Richmond, VA	6,728	8,475	1,878	13,325		15,203	7,885	7,318	8,891	1958	1/72	40	
South Dekalb Plaza, Atlanta, GA	2,474	3,002	703	4,773		5,476	3,371	2,105		1970	2/76	40	
Thruway, Winston-Salem, NC	4,778	17,417	5,496	16,594	105	22,195	8,621	13,574	22,978	1955 & 1965	5/72	40	
Village Center, Centreville, VA	16,502	886	7,851	9,537		17,388	3,662	13,726	7,134	1990	8/93	40	
West Park, Oklahoma City, OK	1,883	694	485	2,092		2,577	1,324	1,253		1974	9/75	50	
White Oak, Silver Spring, MD	6,277	3,814	4,665	5,426		10,091	4,252	5,839	21,230	1958 & 1967	1/72	40	
Total Shopping Centers	340,068	275,186	145,947	467,486	1,821	615,254	134,643	480,611	376,348				

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<b>Office Properties</b>											
Avenel Business Park, Gaithersburg, MD	21,459	22,136	3,755	39,840	43,595	21,802	21,793	27,184	1984, 1986, 1990, 1998 & 2000	12/84, 8/85, 2/86, 4/98 & 10/2000	35 & 40
Crosstown Business Center, Tulsa, OK	3,454	5,549	604	8,399	9,003	4,662	4,341		1974	10/75	40
501 Pennsylvania Ave., Washington, DC	5,479	55,900	5,667	55,712	61,379	29,276	32,103	31,155	1986	7/73	35
Van Ness Square, Washington, DC	812	29,353	831	29,334	30,165	16,367	13,798	12,870	1990	7/73	35
Washington Square, Alexandria, VA	2,034	48,238	544	49,728	50,272	7,460	42,812	39,886	1952 & 2001	7/73	50
<b>Total Office Properties</b>	<b>33,238</b>	<b>161,176</b>	<b>11,401</b>	<b>183,013</b>	<b>194,414</b>	<b>79,567</b>	<b>114,847</b>	<b>111,095</b>			
<b>Development Land</b>											
Clarendon Center, Arlington, VA	11,534	7,680	11,534	7,680	19,214		19,214				4/02
Ashland Square, Dumfries, VA	6,411	2,466	6,470	2,407	8,877		8,877				12/04
New Market, New Market, MD	2,088	17	2,101	4	2,105		2,105				9/05
Lexington Center, Lexington, KY		655		655	655		655				3/74
<b>Total Development Land</b>	<b>20,033</b>	<b>10,818</b>	<b>20,105</b>	<b>10,746</b>	<b>30,851</b>		<b>30,851</b>				
Westview Village, Frederick, MD		653		653	653		653				
Preacquisition Costs		689		689	689		689				
<b>Total</b>	<b>\$ 393,339</b>	<b>\$ 448,522</b>	<b>\$ 177,453</b>	<b>\$ 662,587</b>	<b>\$ 1,821</b>	<b>\$ 841,861</b>	<b>\$ 214,210</b>	<b>\$ 627,651</b>	<b>\$ 487,443</b>		

(A) Lansdowne Town Center was 85% leased at December 31, 2006, but only 45% of the space was in operation at year end.

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Schedule III

**SAUL CENTERS, INC.****Real Estate and Accumulated Depreciation****December 31, 2006**

Depreciation and amortization related to the real estate investments reflected in the statements of operations is calculated over the estimated useful lives of the assets as follows:

Base building	35 - 50 years
Building components	Up to 20 years
Tenant improvements	The shorter of the term of the lease or the useful life of the improvements

The changes in total real estate investments and related accumulated depreciation for each of the years in the three year period ended December 31, 2006 are summarized as follows.

<b>(In thousands)</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>Total real estate investments:</b>			
Balance, beginning of year	\$ 762,793	\$ 682,808	\$ 552,115
Acquisitions	30,434	60,053	92,733
Improvements	50,036	26,042	38,546
Sales			(122)
Retirements	(1,402)	(6,110)	(464)
<b>Balance, end of year</b>	<b>\$ 841,861</b>	<b>\$ 762,793</b>	<b>\$ 682,808</b>
<b>Total accumulated depreciation:</b>			
Balance, beginning of year	\$ 195,376	\$ 181,420	\$ 164,823
Depreciation expense	20,236	19,824	17,061
Sales			
Retirements	(1,402)	(5,868)	(464)
<b>Balance, end of year</b>	<b>\$ 214,210</b>	<b>\$ 195,376</b>	<b>\$ 181,420</b>

The aggregate remaining net basis of the real estate investments for federal income tax purposes was approximately \$662,700,000 at December 31, 2006. Depreciation and amortization are provided on the declining balance and straight-line methods over the estimated useful lives of the assets.