

SAUL CENTERS INC
Form 10-Q
November 02, 2012
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United States
Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-Q

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

For The Quarterly Period Ended September 30, 2012

Commission File Number 1-12254

SAUL CENTERS, INC.

(Exact name of registrant as specified in its charter)

Maryland
State or other jurisdiction of

52-1833074
(I.R.S. Employer

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incorporation or organization)

Identification No.)

7501 Wisconsin Avenue, Bethesda, Maryland 20814

(Address of principal executive office) (Zip Code)

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

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

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

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Smaller reporting company ☐

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

Number of shares of common stock, par value \$0.01 per share outstanding as of October 31, 2012: 19.9 million.

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Part I. FINANCIAL INFORMATION

Item 1. Financial Statements
Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments necessary for the fair presentation of the financial position and results of operations of Saul Centers, Inc. for the interim periods have been included. All such adjustments are of a normal recurring nature. These consolidated financial statements and the accompanying notes should be read in conjunction with the audited consolidated financial statements of Saul Centers, Inc. for the year ended December 31, 2011, which are included in its Annual Report on Form 10-K. The results of operations for interim periods are not necessarily indicative of results to be expected for the year.

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Saul Centers, Inc.

CONSOLIDATED BALANCE SHEETS*(Dollars in thousands,**except per share amounts)*

	September 30, 2012 <i>(Unaudited)</i>	December 31, 2011
Assets		
Real estate investments		
Land	\$ 323,723	\$ 324,183
Buildings and equipment	1,101,339	1,092,533
Construction in progress	1,422	1,129
	1,426,484	1,417,845
Accumulated depreciation	(346,426)	(326,397)
	1,080,058	1,091,448
Cash and cash equivalents	33,498	12,323
Accounts receivable and accrued income, net	41,916	39,094
Deferred leasing costs, net	25,396	25,876
Prepaid expenses, net	6,367	3,868
Deferred debt costs, net	8,106	7,090
Other assets	5,106	12,870
Total assets	\$ 1,200,447	\$ 1,192,569
Liabilities		
Mortgage notes payable	\$ 827,963	\$ 823,871
Revolving credit facility payable		8,000
Dividends and distributions payable	13,394	13,219
Accounts payable, accrued expenses and other liabilities	30,044	22,992
Deferred income	30,128	31,281
Total liabilities	901,529	899,363
Stockholders' equity		
Preferred stock, 1,000,000 shares authorized:		
Series A Cumulative Redeemable, 40,000 shares issued and outstanding	100,000	100,000
Series B Cumulative Redeemable, 31,731 shares issued and outstanding	79,328	79,328
Common stock, \$0.01 par value, 30,000,000 shares authorized, 19,769,875 and 19,291,845 shares issued and outstanding, respectively	198	193
Additional paid-in capital	236,459	217,829
Accumulated deficit	(153,312)	(144,659)
Accumulated other comprehensive loss	(3,773)	(2,863)
Total Saul Centers, Inc. stockholders' equity	258,900	249,828
Noncontrolling interest	40,018	43,378
Total stockholders' equity	298,918	293,206
Total liabilities and stockholders' equity	\$ 1,200,447	\$ 1,192,569

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

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Saul Centers, Inc.

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

	For The Three Months Ended September 30,		For The Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenue				
Base rent	\$ 38,403	\$ 34,390	\$ 114,091	\$ 101,280
Expense recoveries	7,576	6,994	22,741	21,211
Percentage rent	259	209	1,118	1,037
Other	1,296	1,285	4,208	3,862
Total revenue	47,534	42,878	142,158	127,390
Operating expenses				
Property operating expenses	5,977	5,829	17,775	18,289
Provision for credit losses	168	595	761	1,628
Real estate taxes	5,546	4,743	16,928	13,881
Interest expense and amortization of deferred debt costs	12,322	11,250	37,660	32,714
Depreciation and amortization of deferred leasing costs	10,268	8,512	29,816	25,308
General and administrative	3,272	3,293	10,303	10,402
Predevelopment expenses	1,870		1,870	
Total operating expenses	39,423	34,222	115,113	102,222
Operating income	8,111	8,656	27,045	25,168
Acquisition related costs		(2,439)		(2,513)
Change in fair value of derivatives	17	(217)	(2)	(1,374)
Gain on sale of property	1,057		1,057	
Gain on casualty settlement	219		219	198
Net Income	9,404	6,000	28,319	21,479
Noncontrolling interest				
Income attributable to noncontrolling interests	(1,456)	(496)	(4,428)	(2,268)
Net income attributable to Saul Centers, Inc.	7,948	5,504	23,891	19,211
Preferred dividends	(3,785)	(3,785)	(11,355)	(11,355)
Net income available to common stockholders	\$ 4,163	\$ 1,719	\$ 12,536	\$ 7,856
Per share net income available to common stockholders				
Basic and diluted:	\$ 0.21	\$ 0.09	\$ 0.64	\$ 0.42
Dividends declared per common share outstanding	\$ 0.36	\$ 0.36	\$ 1.08	\$ 1.08

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

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Saul Centers, Inc.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME*(Unaudited)*

<i>(Dollars in thousands)</i>	For The Three Months Ended September 30,		For The Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$ 9,404	\$ 6,000	\$ 28,319	\$ 21,479
Other comprehensive income				
Change in unrealized gain (loss) on cash flow hedge	(321)	(3,449)	(1,231)	(2,906)
Total comprehensive income	9,083	2,551	27,088	18,573
Comprehensive income (loss) attributable to noncontrolling interests	1,363	(276)	4,107	1,617
Total comprehensive income attributable to Saul Centers, Inc.	7,720	2,827	22,981	16,956
Preferred dividends	(3,785)	(3,785)	(11,355)	(11,355)
Total comprehensive income (loss) available to common stockholders	\$ 3,935	\$ (958)	\$ 11,626	\$ 5,601

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

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Saul Centers, Inc.

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

	Preferred Stock	Common Stock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive (Loss)	Total Saul Centers, Inc.	Noncontrolling Interest	Total
Balance, December 31, 2011	\$ 179,328	\$ 193	\$ 217,829	\$ (144,659)	\$ (2,863)	\$ 249,828	\$ 43,378	\$ 293,206
Issuance of 478,030 shares of common stock:								
453,428 shares pursuant to dividend reinvestment plan		4	17,130			17,134		17,134
24,602 shares due to exercise of employee stock options and issuance of directors deferred stock		1	1,500			1,501		1,501
Net income				23,891		23,891	4,428	28,319
Unrealized loss on cash flow hedge					(910)	(910)	(321)	(1,231)
Preferred stock distributions:								
Series A				(6,000)		(6,000)		(6,000)
Series B				(5,355)		(5,355)		(5,355)
Common stock distributions				(21,189)		(21,189)	(7,467)	(28,656)
Balance, September 30, 2012	\$ 179,328	\$ 198	\$ 236,459	\$ (153,312)	\$ (3,773)	\$ 258,900	\$ 40,018	\$ 298,918

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

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Saul Centers, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS*(Unaudited)*

	For The Nine Months Ended September 30,	
	2012	2011
<i>(Dollars in thousands)</i>		
Cash flows from operating activities:		
Net income	\$ 28,319	\$ 21,479
Adjustments to reconcile net income to net cash provided by operating activities:		
Change in fair value of derivatives	2	1,374
Gain on sale of property	(1,057)	
Gain on casualty settlement	(219)	(198)
Depreciation and amortization of deferred leasing costs	29,816	25,308
Amortization of deferred debt costs	1,181	1,146
Non cash compensation costs of stock grants and options	802	806
Provision for credit losses	761	1,628
Increase in accounts receivable and accrued income	(3,110)	(3,396)
Additions to deferred leasing costs	(3,826)	(3,747)
Decrease in prepaid expenses	(2,499)	(2,819)
(Increase) decrease in other assets	7,764	(5,500)
Increase in accounts payable, accrued expenses and other liabilities	1,975	3,946
Increase (decrease) in deferred income	(953)	111
Net cash provided by operating activities	58,956	40,138
Cash flows from investing activities:		
Acquisitions of real estate investments		(170,100)
Additions to real estate investments	(8,410)	(8,127)
Additions to development and redevelopment projects	(4,853)	(19,640)
Proceeds from sale of property	1,888	
Proceeds from casualty settlement	1,702	1,004
Net cash used in investing activities	(9,673)	(196,863)
Cash flows from financing activities:		
Proceeds from mortgage notes payable	83,500	236,410
Repayments on mortgage notes payable	(79,408)	(121,781)
Proceeds from revolving credit facility		16,000
Repayments on revolving credit facility	(8,000)	(8,000)
Additions to deferred debt costs	(2,197)	(923)
Proceeds from the issuance of:		
Common stock	17,833	21,309
Partnership units		49,589
Distributions to:		
Series A preferred stockholders	(6,000)	(6,000)
Series B preferred stockholders	(5,355)	(5,355)
Common stockholders	(21,014)	(20,195)
Noncontrolling interest	(7,467)	(5,850)
Net cash provided by (used in) financing activities	(28,108)	155,204

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Net increase (decrease) in cash and cash equivalents	21,175	(1,521)
Cash and cash equivalents, beginning of period	12,323	12,968
Cash and cash equivalents, end of period	\$ 33,498	\$ 11,447

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

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Notes to Consolidated Financial Statements (Unaudited)

1. Organization, Formation and Structure

Saul Centers, Inc. ("Saul Centers") was incorporated under the Maryland General Corporation Law on June 10, 1993. Saul Centers operates as a real estate investment trust (a "REIT") under the Internal Revenue Code of 1986, as amended (the "Code"). A REIT is required to annually distribute at least 90% of its REIT taxable income (excluding net capital gains) to its stockholders and meet certain organizational and other requirements. Saul Centers has made and intends to continue to make regular quarterly distributions to its stockholders. Saul Centers, together with its wholly owned subsidiaries and the limited partnerships of which Saul Centers or one of its subsidiaries is the sole general partner, are referred to collectively as the "Company". B. Francis Saul II serves as Chairman of the Board of Directors and Chief Executive Officer of Saul Centers.

Saul Centers was formed to continue and expand the shopping center business previously owned and conducted by the B. F. Saul Real Estate Investment Trust, the B. F. Saul Company and certain other affiliated entities, each of which is currently controlled by B. Francis Saul II and his family members (collectively, "The Saul Organization"). On August 26, 1993, members of The Saul Organization transferred to Saul Holdings Limited Partnership, a newly formed Maryland limited partnership (the "Operating Partnership"), and two newly formed subsidiary limited partnerships (the "Subsidiary Partnerships", and collectively with the Operating Partnership, the "Partnerships"), shopping center and mixed-use properties, and the management functions related to the transferred properties. Since its formation, the Company has developed and purchased additional properties.

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

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

As of September 30, 2012, the Company's properties (the "Current Portfolio Properties") consisted of 50 operating shopping center properties (the "Shopping Centers"), seven mixed-use properties which are comprised of office, retail and multi-family residential uses (the "Mixed-Use Properties") and two (non-operating) development properties.

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Notes to Consolidated Financial Statements (Unaudited)

2. Summary of Significant Accounting Policies

Nature of Operations

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

Because the properties are located primarily in the Washington, DC/Baltimore metropolitan area, the Company is subject to a concentration of credit risk related to these properties. A majority of the Shopping Centers are anchored by one or more major tenants. As of September 30, 2012, 34 of the Shopping Centers were anchored by a grocery store and offer primarily day-to-day necessities and services. Two retail tenants, Giant Food (5.0%), a tenant at ten Shopping Centers, and Safeway (2.7%), a tenant at eight Shopping Centers, individually accounted for 2.5% or more of the Company's total revenue for the nine months ended September 30, 2012.

Principles of Consolidation

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

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments necessary for the fair presentation of the financial position and results of operations of Saul Centers, Inc. for the interim periods have been included. All such adjustments are of a normal recurring nature. These consolidated financial statements and the accompanying notes should be read in conjunction with the audited consolidated financial statements of Saul Centers, Inc. for the year ended December 31, 2011, which are included in its Annual Report on Form 10-K. The results of operations for interim periods are not necessarily indicative of results to be expected for the year.

Use of Estimates

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

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Notes to Consolidated Financial Statements (Unaudited)

Accounts Receivable, Accrued Income and Allowance for Doubtful Accounts

Accounts receivable primarily represents amounts currently due from tenants in accordance with the terms of the respective leases. Receivables are reviewed monthly and reserves are established with a charge to current period operations when, in the opinion of management, collection of the receivable is doubtful. Accounts receivable in the accompanying financial statements are shown net of an allowance for doubtful accounts of approximately \$880,000 and \$671,000 at September 30, 2012 and December 31, 2011, respectively.

In addition to rents due currently, accounts receivable includes approximately \$34.2 million and \$31.0 million, at September 30, 2012 and December 31, 2011, respectively, net of allowance for doubtful accounts totaling \$79,000 and \$63,000 respectively, representing minimum rental income accrued on a straight-line basis to be paid by tenants over the remaining term of their respective leases.

Assets Held for Sale

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

management commits to a plan to sell a property;

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

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

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

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

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

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

Cash and Cash Equivalents

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

Construction In Progress

Construction in progress includes preconstruction and development costs of active projects. Preconstruction costs include legal, zoning and permitting costs and other project carrying costs incurred prior to the commencement of construction. Development costs include direct construction costs and indirect costs incurred subsequent to the start of construction such as architectural, engineering, construction management and carrying costs consisting of interest, real estate taxes and insurance. Construction in progress totaled \$1.4 million and \$1.1 million as of September 30, 2012 and December 31, 2011, respectively.

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Notes to Consolidated Financial Statements (Unaudited)

Deferred Debt Costs

Deferred debt costs consist of fees and costs incurred to obtain long-term financing, construction financing and the revolving line of credit. These fees and costs are being amortized on a straight-line basis over the terms of the respective loans or agreements, which approximates the effective interest method. Deferred debt costs totaled \$8.1 million and \$7.1 million, net of accumulated amortization of \$3.9 million and \$6.9 million, at September 30, 2012 and December 31, 2011, respectively.

Deferred Income

Deferred income consists of payments received from tenants prior to the time they are earned and recognized by the Company as revenue, including tenant prepayment of rent for future periods, real estate taxes when the taxing jurisdiction has a fiscal year differing from the calendar year, reimbursements specified in the lease agreement and tenant construction work provided by the Company. In addition, deferred income includes the fair value of certain below market leases.

Deferred Leasing Costs

Deferred leasing costs consist of commissions paid to third-party leasing agents, internal direct costs such as employee compensation and payroll-related fringe benefits directly related to time spent performing leasing-related activities for successful commercial leases and amounts attributed to in place leases associated with acquired properties. Leasing related activities include evaluating the prospective tenant's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating lease terms, preparing lease documents and closing the transaction. Unamortized deferred costs are charged to expense if the applicable lease is terminated prior to expiration of the initial lease term. Deferred leasing costs are amortized over the term of the lease or remaining term of acquired leases. Collectively, deferred leasing costs totaled \$25.4 million and \$25.9 million, net of accumulated amortization of \$15.9 million and \$14.7 million, as of September 30, 2012 and December 31, 2011, respectively. Amortization expense, included in depreciation and amortization in the consolidated statements of operations, totaled \$4.3 million and \$3.2 million for the nine months ended September 30, 2012 and 2011, respectively.

Derivative Financial Instruments

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

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Notes to Consolidated Financial Statements (Unaudited)

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

Income Taxes

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

Legal Contingencies

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

Predevelopment Expenses

In connection with the potential repositioning of Van Ness Square, the Company has recently entered into arrangements with various tenants which effectively accelerated the termination of the tenant leases. Costs incurred by the Company related to those arrangements are included in Predevelopment Expenses in the Statement of Operations.

Real Estate Investment Properties

The Company purchases real estate investment properties from time to time and allocates the purchase price to various components, such as land, buildings, and intangibles related to in-place leases and customer relationships, based on the fair value of each component. The fair value of buildings is determined as if the buildings were vacant upon acquisition and subsequently leased at market rental rates. As such, the determination of fair value considers the present value of all cash flows expected to be generated by the property including an initial lease up period. The Company determines the fair value of above and below market intangibles associated with in-place leases by assessing the net effective rent and remaining term of the lease relative to market terms for similar leases at acquisition taking into consideration the remaining contractual lease period, renewal periods, and the likelihood of the tenant exercising its renewal options. The fair value of a below market lease component is recorded as deferred income and accreted as additional revenue over the remaining contractual lease period and any renewal

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Notes to Consolidated Financial Statements (Unaudited)

option periods included in the valuation analysis. The fair value of above market lease intangibles is recorded as a deferred asset and is amortized as a reduction of revenue over the remaining contractual lease term. The Company determines the fair value of at-market in-place leases considering the cost of acquiring similar leases, the foregone rents associated with the lease-up period and carrying costs associated with the lease-up period. Intangible assets associated with at-market in-place leases are amortized as additional expense over the remaining contractual lease term. To the extent customer relationship intangibles are present in an acquisition, the fair values of the intangibles are amortized over the lives of the customer relationships. The Company has never recorded a customer relationship intangible asset. The Company expenses acquisition-related costs as they are incurred.

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

Interest, real estate taxes, development-related salary costs and other carrying costs are capitalized on projects under development and construction. Once construction is substantially completed and the assets are placed in service, their rental income, real estate tax expense, property operating expenses (consisting of payroll, repairs and maintenance, utilities, insurance and other property related expenses) and depreciation are included in current operations. Property operating expenses are charged to operations as incurred. Interest expense capitalized totaled \$18,600 and \$1.8 million for the nine months ended September 30, 2012 and 2011, respectively. Commercial development projects are considered substantially complete and available for occupancy upon completion of tenant improvements, but no later than one year from the cessation of major construction activity. Multi-family residential development projects are considered substantially complete and available for occupancy upon receipt of the certificate of occupancy from the appropriate licensing authority. Substantially completed portions of a project are accounted for as separate projects.

Depreciation is calculated using the straight-line method and estimated useful lives generally between 35 and 50 years for base buildings, or a shorter period if management determines that the building has a shorter useful life, and up to 20 years for certain other improvements that extend the useful lives. Leasehold improvements are capitalized when certain criteria are met, including when the Company supervises construction and will own the improvements. Tenant improvements are amortized, over the shorter of the lives of the related leases or the useful life of the improvements, using the straight-line method. The depreciation

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Notes to Consolidated Financial Statements (Unaudited)

component included in depreciation and amortization expense in the consolidated statements of operations totaled \$25.5 million and \$22.1 million for the nine months ended September 30, 2012 and 2011, respectively. Repairs and maintenance expense, included in property operating expenses, for the nine months ended September 30, 2012 and 2011, was \$7.0 million and \$7.8 million, respectively.

Revenue Recognition

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

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

The Company uses the fair value method to value and account for employee stock options. The fair value of options granted is determined at the time of each award using the Black-Scholes model, a widely used method for valuing stock-based employee compensation, and the following assumptions: (1) Expected Volatility determined using the most recent trading history of the Company's common stock (month-end closing prices) corresponding to the average expected term of the options; (2) Average Expected Term of the options is based on prior exercise history, scheduled vesting and the expiration date; (3) Expected Dividend Yield determined by management after considering the Company's current and historic dividend yield rates, the Company's yield in relation to other retail REITs and the Company's market yield at the grant date; and (4) a Risk-free Interest Rate based upon the market yields of US Treasury obligations with maturities corresponding to the average expected term of the options at the grant date. The Company amortizes the value of options granted ratably over the vesting period and includes the amounts as compensation in general and administrative expenses.