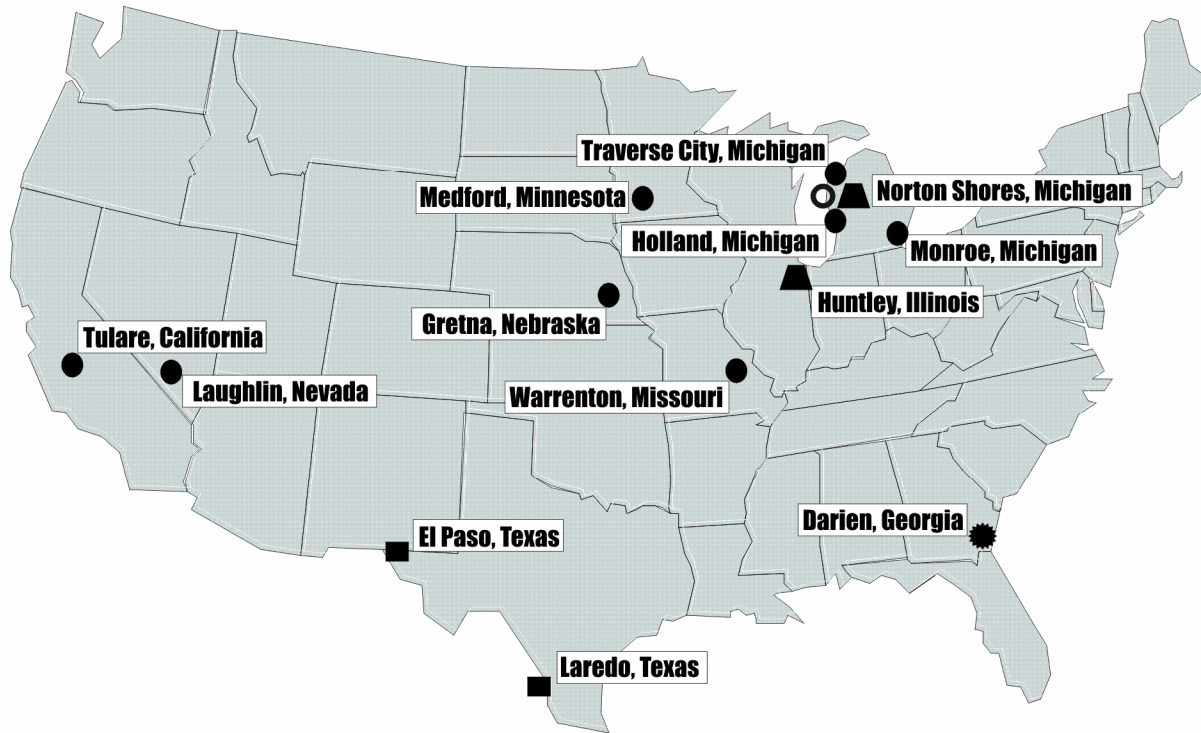




2005 Annual Report

**H·G·P** Horizon Group Properties, Inc.

## Portfolio



- Outlet Center
- Outlet Center under development
- Office Building
- ▲ Land Development
- ☀ Sold 2005

## Company Profile

Based in Rosemont, Illinois, Horizon Group Properties, Inc. has interests in 8 factory outlet centers in seven states totaling approximately 1.9 million square feet and is the developer of a master planned community in suburban Chicago. The tenants in its outlet portfolio include premier brand names including Polo Ralph Lauren, Nike, Calvin Klein, Reebok, Banana Republic, Gap, Old Navy, Liz Claiborne, Columbia Sports, Tommy Hilfiger, PacSun, Quiksilver and Aeropostale.

Dear Stockholder:

I am pleased to report to you that 2005 was a successful although challenging year for Horizon Group Properties, Inc. We completed one development project and launched several new ones. We moved sales and leasing in the right direction at those outlet centers in which the Company has its greatest equity investment while we continued to work to improve the performance of the more challenging and less valuable centers in our portfolio.

### **Portfolio Sale**

In April of 2005, we entered into a contract for the sale of nine factory outlet centers. We anticipated and were assured by the buyer that this sale would close in the summer or early fall of 2005. Several of the properties were security for loans that were not subject to prepayment before mid-2006 and the contract required the buyer to structure its ownership to allow it to assume those loans. In addition, the contract allowed us to terminate the contract if the lenders declined to consent to the buyer's assumption of those loans.

By late January 2006 it became apparent that the lenders had declined the buyer's proposals. Accordingly, in February 2006 we terminated the contract and sought a court ruling confirming our right to terminate the contract. The buyer counterclaimed, asking that the court force us to sell them the properties. At the time of this writing, the parties are trying to reach a mediated settlement.

We believe we were well within our rights to terminate the contract. In fact, we would not have entered into the contract had we known that the only way the buyer would be able to close on the properties was by prepaying the existing loans. There is no certainty about the outcome of the litigation. We are hopeful that it will be resolved quickly. While we hope for a favorable ruling, any conceivable outcome should improve the liquidity of the Company and help position it to take advantage of opportunities that it is pursuing.

We did reach agreement with the buyer with respect to the sale of one of the nine properties in the portfolio -- Georgia Islands Factory Shoppes in Darien, Georgia -- and that sale closed in December 2005. Given the uncertainty surrounding the sale of the remainder of the portfolio, we gave the buyer the right to force us to repurchase the center at any time prior to June 15, 2006. We provided financing to the buyer which is to be repaid at the earlier of June 15, 2006 or the sale of the remainder of the properties in the portfolio.

### **Development**

In 2005, we identified a 100-acre site in El Paso County, Texas for the development and construction of a new outlet center. Of the 30 largest metropolitan areas in the U.S., El Paso is alone in not having an outlet shopping center located within 100 miles. The site is located north of El Paso on I-10 and is positioned to draw traffic from El Paso, Las Cruces, New Mexico, and travelers on I-10. Perhaps most important, the center will draw shoppers from Mexico who desire the name brands that will be sold by tenants at the center. Mexican shoppers have been a significant factor in the success of several outlet centers in Texas and California that are located near Mexico.

In April 2006, we entered into a joint venture to acquire the land and develop the center, which will be named Sun Valley Factory Shoppes. Our partner is also involved in our Laredo shopping center. This new partnership obtained a loan for 55% of the land cost and acquired the development site. The first phase of the center is scheduled to contain 385,000 square feet of retail space. The design of the

center is nearing completion, construction is planned to start this summer and the center is scheduled to open in the summer of 2007. The tenant community has been very receptive to the center and we are confident that Sun Valley Factory Shoppes will boast some of the best brand names in the industry.

Last year, I wrote about the planned 56,000 square foot Phase III expansion of our outlet center in Tulare, California. We have successfully completed the expansion within budget and it is 92% leased. Several tenants opened their stores in time for Christmas and we expect the remainder of the tenants to open shortly. Tenants in Phase III include Tommy Hilfiger, Calvin Klein, Aeropostale, and Banana Republic.

The success of Phase III has improved the performance of all phases of our center in Tulare, increasing tenant sales and permitting us to raise rents. In addition, the land we acquired to develop Phase III is sufficient to enable us to develop another 42,000 square feet of retail space. We have begun marketing Phase IV to the outlet community and expect an enthusiastic response based on the upward trajectory of the center. The center already contains one of the best collections of junior apparel brands in the business and we are very excited by the future prospects for every phase of this center.

Last year I wrote to you regarding the enclosed mall in Laredo, Texas in which we had purchased an interest. After acquiring the center, we began to plan and design the conversion of the mall into a factory outlet center. The initial reaction from the outlet community was positive. Unfortunately, soon after announcing our plans, a wave of drug-related violence erupted in Nuevo Laredo, Mexico which is directly across the Rio Grande River from the center. The national media ran numerous stories regarding this violence. Suddenly a key asset of the center – its proximity to Mexico – became a liability.

We are reassessing our plans for the center. The good news is that the retail vitality of Laredo has not diminished. In fact, it appears as though the problems in Nuevo Laredo might have further encouraged Mexican shoppers to come to Laredo to shop. We believe that the center's proximity to Mexico is attractive to many non-outlet retailers and if we decide to redevelop the mall for these tenants the value of the property may be maximized.

The completion of a new customs, reception and security center this summer should also help attract new tenants. This \$21 million facility, immediately adjacent to our mall, is being built by the City of Laredo. It will funnel the nine million pedestrians crossing over from Mexico directly to our center. In addition, a planned flyway will give vehicle traffic easy access from Interstate 35 to the parking in front of the mall.

We will continue to focus on identifying opportunities to develop or acquire outlet centers across the country. We have targeted three markets that we believe are ripe for new outlet development. We plan to continue our analysis of these markets and identify sites within those markets for the development of new outlet centers.

### **Transactions**

We are aggressively working to sell or develop the 100 acres of land we own in Norton Shores, Michigan. This land has appreciated in value as adjacent development, including the 600,000 square foot The Lakes Mall, has progressed. We are developing a seven-acre parcel adjacent to the mall to provide for six outlots. One of these outlots is currently under contract for sale. We are also considering an offer to sell a 25 acre parcel of prime retail development land and are exploring options for the remaining 28.5 acre and 40 acre sites.

Last month we retained a national brokerage firm to market our 32,000 square foot office building in Norton Shores. Over the last few years we have reduced the size of our office in the building to 5,000 square feet and have leased the rest of the building to quality tenants. A sale will allow us to monetize the value we have created with the asset.

Finally, we sold an outlot at our center in Gretna, Nebraska and an outlot in Huntley for combined proceeds of \$880,000.

### **Huntley Master Planned Community**

We are focused on three areas in our Master Planned Community in Huntley. The first is developing the balance of the 65 acres of land zoned for retail. There is significant interest from big box retail users desiring to locate on this land. Our goal is to have contracts for the sale of parcels with one or two of these retail users by the end of this year. If we are successful, in addition to the proceeds we will receive from the sale(s), we will also benefit from the property tax and sales tax revenues that we will receive as holders of the Tax Increment Financing ("TIF") bonds.

Our second objective is to convince the Village of Huntley to agree to and the Illinois Legislature to approve an extension of the term of the TIF district currently set to expire in 2016. Development activity to date has not produced sufficient revenue to repay the partnership for the cost of the public infrastructure that it provided to the community. An extension of the term of the TIF district would significantly enhance the probability of full repayment. There is no certainty that we will be successful. Our biggest hurdle is convincing newer Village leaders to honor the Village's original contractual and moral commitments to the partnership. Some do not recognize the partnership's significant contributions of highway, water and sewer infrastructure and its role in bringing a Del Webb Sun City to the community. Huntley would be a much different place if the partnership had not taken substantial risk and invested so significantly in the community.

Our final goal is to work with the Village, State of Illinois and other developers in the area to improve access to and from the west by adding additional ramps to and from the Northwest Tollway to the main arterial road through our development. Adding two additional ramps to this intersection, which currently has only two, will be a tremendous benefit to the Village, County and our development. Each will benefit from the additional tax revenue and community growth that this improved access will create.

I wish to thank you for your continued confidence in Horizon, the Board for its dedication, insight and help as we develop and implement our strategy and our hardworking and dedicated staff. I believe we will all share in a good 2006.

Very truly yours,

A handwritten signature in black ink, appearing to read 'G. Skoien', with a stylized flourish at the end.

Gary J. Skoien

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## REPORT OF INDEPENDENT AUDITORS

To the Board of Directors  
Horizon Group Properties, Inc.

We have audited the accompanying consolidated balance sheets of Horizon Group Properties, Inc. (the “Company”) as of December 31, 2005 and 2004, and the related consolidated statements of operations, shareholders’ equity and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the 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. We were not engaged to perform an audit of the Company’s internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and 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 Horizon Group Properties, Inc. at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

Chicago, Illinois  
March 24, 2006

HORIZON GROUP PROPERTIES, INC.

CONSOLIDATED BALANCE SHEETS  
(In thousands)

	<u>December 31, 2005</u>	<u>December 31, 2004</u>
<b>ASSETS</b>		
Real estate – at cost:		
Land	\$ 10,631	\$ 8,641
Buildings and improvements	92,231	88,574
Less accumulated depreciation	<u>(21,757)</u>	<u>(19,142)</u>
	81,105	78,073
Land held for investment	<u>20,070</u>	<u>20,070</u>
Total net real estate	101,175	98,143
Investment in joint venture	2,651	2,860
Cash and cash equivalents	813	466
Restricted cash	7,751	6,462
Marketable securities	8,626	-
Tenant accounts receivable, net	1,458	1,069
Real estate – held for sale	2,079	1,443
Deferred costs (net of accumulated amortization of \$1,695 and \$1,992, respectively)	2,017	1,873
Other assets	<u>4,146</u>	<u>3,167</u>
Total assets	<u>\$130,716</u>	<u>\$115,483</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities:</b>		
Mortgages and other debt	\$ 91,080	\$ 60,070
Accounts payable and other accrued expenses	5,288	4,054
Prepaid rents and other tenant liabilities	891	1,111
Participation interests and other liabilities	<u>1,565</u>	<u>10,563</u>
Total liabilities	<u>98,824</u>	<u>75,798</u>
<b>Minority interests</b>	<u>18,346</u>	<u>22,155</u>
<b>Shareholders' equity:</b>		
Common shares (\$.01 par value, 50,000 shares authorized, 2,862 and 2,859 issued and outstanding, respectively)	29	29
Additional paid-in capital	37,200	37,174
Accumulated deficit	<u>(23,683)</u>	<u>(19,673)</u>
Total shareholders' equity	<u>13,546</u>	<u>17,530</u>
Total liabilities and shareholders' equity	<u>\$130,716</u>	<u>\$115,483</u>

*See accompanying notes to consolidated financial statements.*

HORIZON GROUP PROPERTIES, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS  
(In thousands)

	<u>Year ended December 31, 2005</u>	<u>Year ended December 31, 2004</u>
<b>REVENUE</b>		
Base rent	\$15,091	\$14,333
Percentage rent	401	204
Expense recoveries	2,698	2,869
Other	<u>2,219</u>	<u>1,765</u>
Total revenue	<u>20,409</u>	<u>19,171</u>
<b>EXPENSES</b>		
Property operating	5,853	5,328
Real estate taxes	1,431	1,361
Other operating	1,118	1,084
Depreciation and amortization	4,360	4,396
General and administrative	4,744	4,175
Provision for impairment	5,000	-
Interest	6,001	4,954
Loss on marketable securities	3	-
Gain on debt extinguishment	<u>(929)</u>	<u>-</u>
Total expenses	27,581	21,298
Loss from investment in joint venture	<u>(217)</u>	<u>(133)</u>
Loss from continuing operations before minority interests and loss on sale of real estate	(7,389)	(2,260)
Minority interests	<u>3,499</u>	<u>341</u>
Loss from continuing operations	(3,890)	(1,919)
Loss on sale of real estate, net of minority interests	-	(22)
Income/(loss) from discontinued operations, net of minority interests	<u>(120)</u>	<u>27</u>
<b>Net loss</b>	<u><b>\$(4,010)</b></u>	<u><b>\$(1,914)</b></u>

See accompanying notes to consolidated financial statements.

HORIZON GROUP PROPERTIES, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
(In thousands)

	<u>Common Shares</u>		<u>Additional</u>	<u>Accumulated</u>	<u>Shareholders'</u>
	<u>Number</u>	<u>Amount</u>	<u>Paid -In</u>	<u>Earnings/(Deficit)</u>	<u>Equity</u>
			<u>Capital</u>		
Balance, January 1, 2004	2,855	\$ 29	\$37,063	\$ (17,759)	\$ 19,333
Contribution	-	-	87	-	87
Units converted to shares	4	-	24	-	24
Net loss	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,914)</u>	<u>(1,914)</u>
Balance, December 31, 2004	2,859	29	37,174	(19,673)	17,530
Contribution	-	-	8	-	8
Units converted to shares	3	-	18	-	18
Net loss	<u>-</u>	<u>-</u>	<u>-</u>	<u>(4,010)</u>	<u>(4,010)</u>
Balance, December 31, 2005	<u>2,862</u>	<u>\$ 29</u>	<u>\$ 37,200</u>	<u>\$ (23,683)</u>	<u>\$ 13,546</u>

See accompanying notes to consolidated financial statements.

HORIZON GROUP PROPERTIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS  
For the Year ended December 31, *(In thousands)*

	<u>2005</u>	<u>2004</u>
<b>Cash flows from operating activities:</b>		
Net loss	\$ (4,010)	\$(1,914)
Net gain on sale of real estate, including amounts in discontinued operations	(97)	(307)
Gain on debt extinguishment	(929)	-
Adjustments to reconcile net loss to net cash (used in)/provided by Operating activities:		
Minority interests, including amounts in net gain on sale of real estate and discontinued operations	(3,586)	(365)
Loss from investment in joint venture	217	133
Depreciation	3,926	3,973
Amortization, including deferred financing costs	766	697
Provision for impairment	5,000	-
HGP partnership unit grants	114	265
Changes in assets and liabilities:		
Restricted cash	(1,289)	105
Tenant accounts receivable	(389)	(132)
Deferred costs and other assets	(1,549)	(184)
Accounts payable and other accrued expenses	1,237	(1,515)
Participation interests and other liabilities	431	28
Prepaid rents and other tenant liabilities	<u>(28)</u>	<u>114</u>
<b>Net cash (used in)/provided by operating activities</b>	<u>(186)</u>	<u>898</u>
<b>Cash flows from investing activities:</b>		
Acquisition of property	(2,634)	(4,367)
Purchase of marketable securities	(8,626)	-
Investment in joint venture	-	(2,992)
Expenditures for buildings and improvements	(9,967)	(3,786)
Net proceeds from sale of real estate	<u>106</u>	<u>14,030</u>
<b>Net cash (used in)/provided by investing activities</b>	<u>(21,121)</u>	<u>2,885</u>
<b>Cash flows from financing activities:</b>		
Net contributions primarily by minority interests	(319)	730
Principal payments on mortgages and other debt	(6,168)	(14,138)
Proceeds from borrowings	37,178	7,688
Debt issue costs	(537)	(162)
Payment of participation interests	<u>(8,500)</u>	<u>-</u>
<b>Net cash provided by/(used in) financing activities</b>	<u>21,654</u>	<u>(5,882)</u>
<b>Net increase/(decrease) in cash and cash equivalents</b>	347	(2,099)
<b>Cash and cash equivalents:</b>		
<b>Beginning of year</b>	<u>466</u>	<u>2,565</u>
<b>End of year</b>	<u>\$ 813</u>	<u>\$ 466</u>

*See accompanying notes to consolidated financial statements.*

HORIZON GROUP PROPERTIES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS, continued  
For the Year ended December 31, *(In thousands)*

	<u>2005</u>	<u>2004</u>
<b>Supplemental Information:</b>		
Real estate disposition and transfer of debt:		
Real estate – held for sale		\$ 3,242
Other assets		(344)
Mortgages and other debt transferred		(3,122)
Accounts payable and accrued expenses		(65)
Gain on sale of real estate		<u>329</u>
Cash received, net		<u>\$ 40</u>
Fully depreciated/amortized assets disposed of:		
Buildings and improvements	\$1,218	\$32
Deferred costs	<u>1,003</u>	<u>64</u>
	<u>\$2,221</u>	<u>\$96</u>

*See accompanying notes to consolidated financial statements.*

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1 – Organization and Principles of Consolidation**

Horizon Group Properties, Inc. (“HGPI” or, together with its subsidiaries “HGP” or the “Company”) is a Maryland corporation that was established on June 15, 1998. The operations of the Company are primarily conducted through a subsidiary limited partnership, Horizon Group Properties, L.P. (“HGP LP”) of which HGPI is the sole general partner. As of December 31, 2005, HGPI owned approximately 68.8% of the partnership interests (the “Common Units”) of HGP LP. In general, Common Units are exchangeable for shares of Common Stock on a one-for-one basis (or for an equivalent cash amount at HGPI’s election).

HGP LP’s primary assets are its investments in subsidiary partnerships that own real estate. HGPI consolidates the results of operations and the balance sheets of those partnerships in which HGPI or HGP LP (or their wholly owned subsidiaries) collectively own the majority interest, and of variable interest entities of which they are the primary beneficiaries. For a partnership in which HGPI and HGP LP do not meet these criteria, the Company reflects its net investment in such partnership and reports such partnership’s results of operations using the equity method of accounting.

As of December 31, 2005, HGP owned nine factory outlet centers located in seven states comprising an aggregate of approximately 1.8 million square feet of gross leasable area (“GLA”). The Company also owns a 22,200 square foot shopping center located in Huntley, Illinois. In addition, the Company owns its corporate office building located in Norton Shores, Michigan, a substantial portion of which is leased to third party tenants. In November and December 2003, the Company sold an aggregate of 48.9% ownership interest in the entities that own the outlet centers and its corporate office building to an affiliate of Howard Amster (“Amster”), a director and significant shareholder of HGPI. In April 2004, HGPI and HGP LP collectively acquired a 51% controlling interest in the entity that controls the outlet center in Darien, Georgia. Amster and Gary J. Skoien, President, Chairman, and Chief Executive Officer of the Company, acquired the remaining 49% limited partner interest in this entity. HGPI consolidates the results of operations and the assets and liabilities of these entities in its financial statements. All references to GLA, square feet and acreage contained in the notes to the consolidated financial statements are unaudited.

The Company also owns 51% of Horizon El Portal, LLC (“Horizon El Portal”), which owns 50% of a joint venture (“El Portal Center”) that owns a shopping center in Laredo, Texas containing approximately 345,000 square feet of GLA. Horizon El Portal reports the results of operations and the assets and liabilities of El Portal Center using the equity method of accounting. HGPI consolidates the results of operations and the assets and liabilities of Horizon El Portal.

The Company also owns approximately 411 acres of land in Huntley, Illinois that is held for investment purposes (“Huntley”).

The portion of the net income or loss of HGPI’s subsidiaries owned by parties other than HGPI is reported as Minority Interests on the Company’s statements of operations and such parties’ portion of the net equity in such subsidiaries is reported on the Company’s balance sheets as Minority Interests.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 2 - Summary of Significant Accounting Policies**

*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and all subsidiaries that the Company controls, including HGP LP. The Company considers itself to control an entity if it is the majority owner of and has voting control over such entity. All significant intercompany balances and transactions have been eliminated in consolidation. In accordance with Financial Accounting Standards Board Interpretation No. 46, "Consolidation of Variable Interest Entities," the Company consolidates variable interest entities if it is that entity's primary beneficiary.

*Reclassifications*

Certain prior year amounts have been reclassified to conform to the current year presentation.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

*Investment in Real Estate*

The Company allocates the purchase price of properties to net tangible and identifiable assets acquired based on their fair values in accordance with the provisions of Statement of Financial Accounting Standards No. 141, *Business Combinations*. In making estimates of fair values for purposes of allocating purchase price, the Company utilizes a number of sources, including independent appraisals that may be obtained in connection with the acquisition or financing of the respective property and other market data. The Company also considers information obtained about each property as a result of its pre-acquisition due diligence, marketing, and leasing activities, in estimating the fair value of the tangible and intangible assets acquired.

The Company allocates a portion of the purchase price to above-market and below-market lease values for acquired properties based on the present value (using an interest rate which reflects the risks associated with the leases acquired) of the difference between: (i) the contractual amounts to be paid pursuant to the in-place leases and (ii) management's estimate of fair market lease rates for the corresponding in-place leases, measured over the remaining non-cancelable term of the lease. 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 capitalized above/below-market lease values (included in deferred costs or other tenant liabilities on the balance sheet) are amortized as either a reduction of, or addition to, rental income over the remaining noncancelable terms of the respective leases. Should a tenant terminate its lease prior to its scheduled expiration, the unamortized portion of the lease intangibles would be charged to expense.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company allocates a portion of the purchase price to the value of leases acquired based on the difference between: (i) the property valued with existing in-place leases adjusted to market rental rates and (ii) the property valued as if vacant. The Company utilizes independent appraisals or its internally developed estimates to determine the respective in-place lease values. The Company's estimates of value are made using methods similar to those used by independent appraisers. Factors management considers in its analysis include an estimate of carrying costs during the expected lease-up periods considering current market conditions and costs to execute similar leases including leasing commissions, legal and other related expenses.

The value of in-place leases (included in buildings and improvements on the balance sheet) is amortized to expense over the remaining initial term of the respective leases. Should a tenant terminate its lease prior to its scheduled expiration, the unamortized portion of the tenant origination costs would be charged to expense.

*Real Estate and Depreciation*

Costs incurred for the acquisition, development, construction and improvement of properties, as well as significant renovations and betterments to the properties, are capitalized. Maintenance and repairs are charged to expense as incurred. Interest costs incurred with respect to qualified expenditures relating to the construction of assets are capitalized during the construction period. During the year ended December 31, 2005, \$180,000 of interest was capitalized related to the construction of Phase III of the outlet center in Tulare, California. During the years ended December 31, 2005 and 2004, \$68,000 and \$23,000, respectively, of interest was capitalized related to the construction of the shopping center in Huntley, Illinois.

Amounts included under buildings and improvements on the consolidated balance sheets include the following types of assets and are depreciated on the straight-line method over estimated useful lives, which are:

Buildings and improvements	31.5 years
Tenant improvements	10 years or lease term, if less
Furniture, fixtures or equipment	3 - 7 years

In accordance with Statement of Financial Accounting Standards, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), the Company records impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated over their expected holding periods are less than the carrying amounts of those assets. For assets to be held in the portfolio, impairment losses are measured as the difference between carrying value and fair value. For assets to be sold, impairment is measured as the difference between carrying value and fair value, less costs to dispose. Fair value may be based upon estimated cash flows discounted at a risk-adjusted rate of interest, comparable or anticipated sales in the marketplace, or estimated replacement cost, as adjusted to consider the costs of retenanting and repositioning those properties which have significant vacancy issues, depending on the facts and circumstances of each property.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Depreciation and amortization expense includes charges for unamortized capitalized costs related to unscheduled tenant move-outs totaling \$91,000 and \$55,000 for the years ended December 31, 2005 and 2004, respectively, excluding properties classified as discontinued operations.

*Cash Equivalents*

The Company considers all liquid investments with a maturity of three months or less when purchased to be cash equivalents.

*Restricted Cash*

Restricted cash consists of amounts deposited (1) in accounts with the Company's primary lenders in connection with certain loans (see Note 10), (2) in escrow accounts for infrastructure requirements related to land sales in Huntley and future infrastructure expenses and interest payments related to Huntley and (3) with the trustee for the TIF Bonds (as hereinafter defined) until certificates of occupancy are received for previously sold Huntley land parcels which secure the US Bank Mortgage (see Note 10). At December 31, 2005, the escrow accounts related to the Company's primary lenders included approximately \$1.4 million in capital improvement and tenant allowance reserves, \$800,000 in real estate tax and insurance escrows, and approximately \$1.6 million for debt service and operating expenses. At December 31, 2005, the Huntley infrastructure escrow accounts totaled \$330,000 and the US Bank Mortgage account had a balance of approximately \$3.6 million.

*Marketable Securities*

The Company classifies its marketable securities as available-for-sale in accordance with the provisions of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities". These securities are carried at fair market value, with unrealized gains and losses, if any, reported as a component of shareholders' equity.

*Tenant Accounts Receivable*

Management regularly reviews accounts receivable and estimates the necessary amounts to be recorded as an allowance for uncollectibility. These reserves are established on a tenant-specific basis and are based upon, among other factors, the period of time an amount is past due and the financial condition of the obligor.

Total tenant accounts receivable are reflected net of reserves of \$128,000 and \$277,000 as of December 31, 2005 and 2004, respectively. The provision for doubtful accounts was \$4,000 and \$304,000 for the years ended December 31, 2005 and 2004, respectively. This charge is included in the line item entitled "Other operating" in the statements of operations.

*Discontinued Operations*

Periodically, in the course of reviewing its portfolio, management may determine that it is appropriate for the Company to offer certain properties for sale, and accordingly, such properties will be classified as discontinued operations on the Company's balance sheets. In accordance with SFAS 144,

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

assets held for sale are valued at the lower of carrying value or fair value less costs to dispose. For fiscal years beginning after December 15, 2001, SFAS 144 requires that the results of operations and gain/(loss) on real estate properties sold or held for sale subsequent to December 31, 2001 be reflected in the consolidated statements of operations as “Income/Loss from Discontinued Operations” for all periods presented. As of December 31, 2005, the Company was actively marketing for sale several parcels of vacant land. Pursuant to the requirements of SFAS 144, the Company has reclassified the real estate assets to Real Estate-Held for Sale on the balance sheets and reports the revenue and expenses from the properties as Income from Discontinued Operations on the statements of operations. In addition, results of operations from the single tenant building in Roseville, Michigan leased to Petsmart, Inc. which was sold in February 2004 and the 103,000 square foot strip building at the outlet center in Monroe, Michigan which was sold in May 2004 are also included in the discontinued operations line item in the 2004 statement of operations. SFAS 144 also requires that prior period financial statements presented are also reclassified for comparability. This reclassification has no effect on the Company’s previously reported net income or loss.

*Deferred Costs*

Deferred leasing costs consist of fees and direct internal costs incurred to initiate and renew operating leases and are amortized on the straight-line method over the initial lease term or renewal period. Deferred financing costs are amortized as interest expense over the life of the related debt.

*Fair Value of Financial Instruments*

The Company estimates the fair value of its debt to be approximately \$92.1 million as of December 31, 2005. This value is estimated using a discounted cash flow analysis, based on the incremental borrowing rates for similar types of borrowing arrangements. The carrying value for this debt is \$91.1 million. The carrying value of cash and cash equivalents, receivables and payables approximate their fair values due to their short-term nature.

*Derivatives and Hedging Instruments*

The Company accounts for derivatives in accordance with SFAS No. 133, “Accounting for Derivative Instruments and Hedging Activities” (“SFAS 133”), as amended, which requires that all derivatives be recognized as assets and liabilities on the balance sheet and be measured at fair value. SFAS 133 also requires changes in fair value of the derivatives to be recorded each period in current earnings (other income or other expense) or other comprehensive income depending on the intended use and effectiveness of the derivatives.

*Asset Retirement Obligations*

SFAS No. 143 “Accounting for Asset Retirement Obligations”, requires that the fair value of a liability related to an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of the fair value can be made. During 2005, Interpretation No. 47 was issued, clarifying the required accounting and measurement process for an asset retirement obligation for which settlement is subject to uncertainties that may or may not be within the control of an entity (a “conditional” asset retirement obligation). In connection with the issuance of this Interpretation, the

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Company evaluated any potential asset retirement obligations including those related to the disposal of asbestos containing materials. Based on this review, the Company did not identify any conditional asset retirement obligations.

*Revenue Recognition*

Leases with tenants are accounted for as operating leases. Minimum annual rentals are recognized on a straight-line basis over the terms of the respective leases. As a result of recording rental revenue on a straight-line basis, tenant accounts receivable include \$236,000 and \$191,000 as of December 31, 2005 and 2004, respectively, which is expected to be collected over the remaining lives of the leases. Rents which represent basic occupancy costs, including fixed amounts and amounts computed as a function of sales, are classified as base rent. Amounts which may become payable in addition to base rent and which are computed as a function of sales in excess of certain thresholds are classified as percentage rents and are accrued after the reported tenant sales exceed the applicable thresholds. Expense recoveries based on common area maintenance expenses and certain other expenses are accrued in the period in which the related expense is incurred.

*Other Revenue*

Other revenue consists primarily of interest income, fees related to marketing services that are paid by tenants pursuant to lease agreements and income from tenants with lease terms of less than one year.

*Income Taxes*

Deferred income taxes are recorded based on enacted statutory rates to reflect the tax consequences in future years of the differences between the tax bases of assets and liabilities and their financial reporting amounts. Deferred tax assets, such as net operating loss carryforwards which will generate future tax benefits, are recognized to the extent that realization of such benefits through future taxable earnings or alternative tax strategies in the foreseeable future is more likely than not.

*Share Options*

The Company has elected to follow Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" ("APB 25"), in accounting for its options on common shares. Under APB 25, no compensation expense is recognized because the exercise price of the Company's employee share options equals or exceeds the market price of the underlying shares at the date of grant.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" ("SFAS No. 123(R)"), which is a revision to SFAS No. 123, "Accounting for Stock-Based Compensation" ("SFAS No. 123"). SFAS No. 123 (R) supersedes Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB Opinion No. 25"). Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123, except that SFAS No. 123(R) requires all share-based awards to employees, including grants of employee stock options, to be recognized in the income statement based on their fair

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values. Pro forma disclosure is no longer an alternative under SFAS No. 123(R). We adopted SFAS No. 123(R) on January 1, 2006.

*Legal Proceedings*

In 2005, the Company entered into a contract to sell the Company's nine outlet centers for total consideration of approximately \$110.0 million including the assumption by the buyer of approximately \$47.0 million of existing debt. In order to close the transaction, certain lenders were required to consent to the buyer's assumption of certain loans. In February 2006, the Company terminated the contract and filed suit seeking a declaratory judgment that, because the lenders had declined to consent to buyer's assumption of the loans, pursuant to the terms of the contract, the Company was entitled to terminate the contract and collect liquidated damages of \$1.0 million. In response, the buyer alleged that the Company's termination of the contract was wrongful, and asserted a counterclaim for specific performance. Discovery is ongoing. The financial statements do not contain any adjustments that may ultimately arise from the resolution of this uncertainty.

**Note 3- Investment in Joint Venture**

On July 14, 2004, the Company acquired a 51% ownership interest in Horizon El Portal, an entity of which HGP LP is the managing member and of which the remaining 49% is owned by Pleasant Lake Apts. Limited Partnership ("PLA"), an affiliate of Amster, and Gary Skoien. For its ownership in the El Portal Center joint venture, Horizon El Portal contributed \$3.0 million in cash and assumed the responsibility for the payments on an existing \$3.0 million loan secured by the shopping center owned by El Portal Center.

Summary financial information (stated at 100%) of the El Portal Center joint venture at December 31, 2005 and 2004 and for the year ended December 31, 2005 and the period from July 14, 2004 (inception) through December 31, 2004, follows (in thousands):

	As of <u>December 31, 2005</u>	As of <u>December 31, 2004</u>
<b>Assets</b>		
Real estate	\$12,573	\$12,034
Other assets	<u>405</u>	<u>351</u>
Total assets	<u>\$12,978</u>	<u>\$12,385</u>
<b>Liabilities and members' capital</b>		
Mortgages and other debt	\$ 4,500	\$ 3,450
Other liabilities	175	198
Members' capital	<u>8,303</u>	<u>8,737</u>
Total liabilities and members' capital	<u>\$12,978</u>	<u>\$12,385</u>

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<b>Statement of Operations</b>	<u>Year Ended December 31, 2005</u>	<u>Period From July 14, 2004 to December 31, 2004</u>
Revenue	<u>\$1,288</u>	<u>\$ 632</u>
Operating expenses	882	563
General and administrative expenses	232	34
Depreciation and amortization expense	178	176
Interest expense	<u>430</u>	<u>122</u>
Total expenses	<u>1,723</u>	<u>895</u>
Net loss	<u>\$ (434)</u>	<u>\$ (263)</u>

**Note 4 – Income Taxes**

The Company is taxable as a corporation under the provisions of Subchapter C of the Internal Revenue Code. The Company adopted the provisions of Financial Accounts Standards Board Statement No. 109 (“FASB 109”) “Accounting for Income Taxes” first effective for the year ended December 31, 2004. The provision for income taxes for the years ended December 31, 2005 and 2004 consisted of the following:

	<u>2005</u>	<u>2004</u>
	<i>(in thousands)</i>	
Federal	\$ -	\$ -
State	<u>-</u>	<u>-</u>
Net provision (benefit)	<u>\$ -</u>	<u>\$ -</u>

For federal income tax purposes, the Company had net operating loss carryforwards (“NOLs”) of approximately \$47.9 million and \$33.9 million at December 31, 2005 and 2004, respectively, and capital loss carryforwards of approximately \$42.2 million at December 31, 2005 and 2004. The NOLs expire from 2020 to 2025 and the accumulated capital loss carryforward expires in 2008.

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Deferred income tax liabilities or assets are determined based on the differences between the financial statement and tax basis of assets and liabilities. The components of the Company's deferred tax assets and liabilities are as follows as of December 31, 2005 and 2004 (in thousands):

	<u>2005</u>	<u>2004</u>
<b>Deferred Tax Assets:</b>		
NOL carryforwards-federal and state	\$17,972	\$12,525
Capital loss carryforward	14,787	14,787
Tax basis of assets in excess of book basis:		
Fixed/intangible assets	6,937	9,299
Impairment	1,413	825
Other	2,126	1,191
Book basis of liabilities in excess of tax basis:		
Prepaid rental revenue	84	76
Debt restructure	137	173
Profits interests	<u>248</u>	<u>2,563</u>
	43,704	41,439
Less valuation allowance	<u>(39,174)</u>	<u>(36,927)</u>
	4,530	4,512
<b>Deferred Tax Liabilities:</b>		
Book basis of assets in excess of tax basis:		
Fixed/intangible assets	(2,362)	(2,168)
Other	<u>(2,168)</u>	<u>(2,344)</u>
	<u>(4,530)</u>	<u>(4,512)</u>
Net deferred tax asset	<u>\$ -</u>	<u>\$ -</u>

**Note 5 – Leases**

Space in the Company's centers is leased to various tenants under operating leases, which are generally for one to five year periods. Some leases contain renewal options and may also provide for the payment of a tenant's share of certain operating expenses. Leases may also obligate a tenant to pay rent based on a percentage of tenant sales in excess of certain thresholds. Minimum future rentals to be received under non-cancelable leases are summarized as follows (in thousands):

2006	\$11,522
2007	8,470
2008	6,336
2009	4,480
2010	3,018
Thereafter	<u>6,785</u>
	<u>\$40,611</u>

The above scheduled rentals are subject to the usual business risks associated with collection.

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The Company also leases office space under an operating lease. Future minimum rent payments under the lease approximate \$40,000 per year through July 2009. The lease also requires payment of a pro rata share of property taxes and operating expenses.

**Note 6 - Impairment**

Due to declines in occupancy and net operating income, the Company concluded that the carrying value of certain of its shopping centers exceeded the estimated undiscounted cash flows expected over their investment holding period. Based on this, a provision for asset impairment was recorded in the amount of \$5.0 million in 2005 to record such facilities at their estimated fair value. There were no similar charges recorded in 2004.

**Note 7 - Long Term Stock Incentive Plan**

The Company has adopted the HGP 1998 Long Term Stock Incentive Plan (the “HGP Stock Plan”) to advance the interests of the Company by encouraging and enabling the acquisition of a financial interest in the Company by key employees and directors of the Company and its subsidiaries through equity awards. The Company reserved 338,900 common shares for issuance pursuant to the HGP Stock Plan and options covering 323,500 shares were outstanding at December 31, 2005. The Company uses the intrinsic value method of accounting for its stock – based compensation.

The fair value of options granted for the purpose of presenting pro forma information, in accordance with Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” (“SFAS 123”), has been estimated using a Black-Scholes option pricing model with the following weighted-average assumptions:

	<i><u>For the year ended December 31, 2004</u></i>
Expected dividend yield	0.00%
Expected stock price volatility	.175
Risk free interest rate	4.22%
Expected life of options	10 years

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company’s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management’s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

Net income/(loss) for the years ended December 31, 2005 and 2004, computed on a pro forma basis under requirements of SFAS 123 equals \$(4.0) million and \$(1.9) million, respectively.

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Options granted, exercised and canceled under the Long-term Stock Incentive Plan are summarized below:

	<i>For the year ended December 31, 2005</i>		<i>For the year ended December 31, 2004</i>	
	<i>Shares</i>	<i>Price</i>	<i>Shares</i>	<i>Price</i>
Outstanding, beginning of the year	323,500	\$3.40 - \$6.49	308,500	\$3.40 - \$6.49
Granted	-	-	15,000	\$5.04
Exercised	-	-	-	-
Canceled	-	-	-	-
	<u>323,500</u>	<u>\$3.40 - \$6.49</u>	<u>323,500</u>	<u>\$3.40 - \$6.49</u>

The weighted average exercise price for options outstanding at both December 31, 2005 and 2004 was \$5.12. The weighted average contractual life of options outstanding at December 31, 2005 and 2004 was 4.23 years and 5.23 years, respectively.

The Company granted 21,667 units and 55,791 units of HGP LP to key employees in April 2005 and August 2004, respectively and recognized compensation expense based on the fair market value of the units granted.

**Note 8 – Marketable Securities**

The estimated fair values of securities available for sale held by the Company at December 31, 2005 are as follows (in thousands):

	<u>Face Value</u>	<u>Cost</u>	<u>Fair Market Value</u>
Debt Securities:			
U.S. Treasury Note, 3.75%, maturing March 2007	\$ 300	\$ 298	\$ 297
U.S. Treasury Note, 3.75%, maturing March 2007	<u>8,400</u>	<u>8,331</u>	<u>8,329</u>
	<u>\$8,700</u>	<u>\$8,629</u>	<u>\$8,626</u>

The \$8.4 million Treasury Note serves as collateral under a repurchase agreement as disclosed in Note 10.

**Note 9 – Commitments**

The Company has outstanding commitments for capital expenditures on leases signed at December 31, 2005 in the amount of \$1.5 million for tenant allowances and \$85,000 for other capital

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expenditures and construction costs, including the development of an additional phase on the shopping center located in Tulare, California, which are not reflected on the balance sheet as of December 31, 2005. These costs are expected to be paid during 2006 and a portion will be reimbursed from the capital improvement escrows and additional borrowings (see Note 2).

The Company has agreed to assume the payments on an existing \$3.0 million loan secured by a shopping center in Laredo, Texas in exchange for additional ownership in the entity that controls its operations.

**Note 10 - Mortgage Debt and Other Liabilities**

	<b>Principal Balance as of</b>	
	<b>December 31,</b>	
	<b><u>2005</u></b>	<b><u>2004</u></b>
	<i>(in thousands)</i>	
Senior mortgage loan to Laughlin Outlet Center LLC, as borrower, from UBS Warburg Real Estate Investments Inc. ("UBS"), as lender, dated as of July 11, 2002, in the original principal amount of \$11.0 million, bearing interest at 8.15%, due July 11, 2009, secured by the outlet center in Laughlin, Nevada and cross-collateralized with the other UBS senior mortgage loans	\$10,522	\$10,677
Mezzanine loan to Laughlin Holdings LLC, as borrower, from UBS, as lender, dated as of July 11, 2002, in the original principal amount of \$1.75 million, bearing interest at 17.0%, due July 11, 2005, secured by a pledge of the ownership interests in Laughlin Outlet Center LLC and cross-collateralized with the other UBS mezzanine loans	-	423
Senior mortgage loan to Medford Outlet Center LLC, as borrower, from UBS, as lender, dated as of July 11, 2002, in the original principal amount of \$6.5 million, bearing interest at 8.15%, due July 11, 2009, secured by the outlet center in Medford, Minnesota and cross-collateralized with the other UBS senior mortgage loans	6,218	6,309
Mezzanine loan to Medford Holdings LLC, as borrower, from UBS, as lender, dated as of July 11, 2002, in the original principal amount of \$1.0 million, bearing interest at 17.0%, due July 11, 2005, secured by a pledge of the ownership interests in Medford Outlet Center LLC and cross-collateralized with the other UBS mezzanine loans	-	242
Senior mortgage loan to Warrenton Outlet Center LLC, as borrower, from UBS, as lender, dated as of July 11, 2002, in the original principal amount of \$4.5 million, bearing interest at 8.15%, due July 11, 2009, secured by the outlet center in Warrenton, Missouri and cross-collateralized with the other UBS senior mortgage loans	4,304	4,368
Mezzanine loan to Warrenton Holdings LLC, as borrower, from UBS, as lender, dated as of July 11, 2002, in the original principal amount of \$750,000, bearing interest at 17.0%, due July 11, 2005, secured by a pledge of the ownership interests in Warrenton Outlet Center LLC and cross-collateralized with the other UBS mezzanine loans	-	181

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Mortgage loan to Monroe Outlet Center LLC, as borrower, from Beal Bank, S.S.B. (“Beal Bank”), as lender, dated as of July 11, 2002, in the original principal amount of \$3.0 million, bearing interest at the greater of the Wall Street Journal Prime Rate plus 4.5% or 12.0%, due July 10, 2006 (the “Beal Bank Loan I”), secured by vacant land located in Norton Shores, Michigan and Fruitport Township, Michigan, cross-collateralized with Beal Bank Loan II (as defined below), secured by a first priority pledge and security interest in the net proceeds from any future sale of the partnership that owns the outlet center in Laughlin, Nevada and recourse to the Company (See below)	2,000	2,000
Mortgage loan to Monroe Outlet Center LLC, as borrower, from Beal Bank, as lender, dated as of July 11, 2002, in the original principal amount of \$4.0 million, bearing interest at the greater of the Wall Street Journal Prime Rate plus 2.5% or 9.9%, due July 10, 2006 (the “Beal Bank Loan II”), secured by the outlet center in Monroe, Michigan, cross-collateralized with Beal Bank Loan I, secured by a first priority pledge and security interest in the net proceeds from any future sale of the partnership that owns the outlet center in Laughlin, Nevada and recourse to the Company (See below)	1,296	1,296
Mortgage loan to Holland Outlet Center LLC, as borrower, from Republic Bank, as lender, dated as of June 28, 2001, in the original principal amount of \$3.5 million, bearing interest at 8.21%, due July 1, 2006 (“Republic Bank Loan”), secured by the outlet center in Holland, Michigan and guaranteed by HGPI	3,137	3,226
Promissory note to HGP LP, as borrower, from PLA, an affiliate of Amster, as lender, dated as of November 3, 2003, bearing interest at 8.0%, due February 3, 2007 (the “PLA Loan”) and guaranteed by HGPI	2,040	2,040
Mortgage loan to Traverse City Outlet Center LLC, as borrower, from Morgan Guaranty Trust Company of New York (“JP Morgan”), as lender, dated as of July 9, 1999, in the original principal amount of \$5.2 million, with a debt restructuring adjustment for forgiven interest of \$601,000 in December 2003, bearing interest at 8.46%, due August 1, 2009 (the “Traverse City Loan”), secured by the outlet center in Traverse City, Michigan	5,125	5,316
Mortgage loan to Tulare Outlet Center LP, as borrower, from JP Morgan, as lender, dated as of July 9, 1999, in the original principal amount of \$9.3 million, with a debt restructuring adjustment for forgiven interest of \$1,246,000 in June 2003, bearing interest at 8.46%, due August 1, 2009 (the “Tulare Loan”), secured by Phase I of the outlet center in Tulare, California	9,333	9,677

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Mortgage loan to Huntley Development Limited Partnership, as borrower, from Beal Bank, as lender, dated as of June 13, 2003, in the original principal amount of \$10.7 million, bearing interest at the greater of the Wall Street Journal Prime Rate plus 4.0% or 12.0%, due October 31, 2005 (the "Huntley Beal Loan"), secured by the land owned by Huntley Development Limited Partnership ("HDLP"), cross-collateralized with Beal Bank Loan I and Beal Bank Loan II, secured by a first priority pledge and security interest in the net proceeds from any future sale of the partnership that owns the outlet center in Laughlin, Nevada and guaranteed by HGPI (See below)	-	857
Mortgage loan to Horizon Huntley LLC, as borrower, from Amster Trading Company, as lender, in the original principal amount of \$9.09 million, dated as of June 12, 2003, bearing interest at 11.0%, due December 31, 2006 (the "Huntley Amster Loan"), secured by a pledge of the partnership interests in HDLP and guaranteed by HGPI and HGP LP	690	690
Mortgage loan to 5000 Hakes Drive LLC, as borrower, from UBS, as lender, dated as of August 19, 2003, in the original principal amount of \$2.25 million, bearing interest at 6.89%, due September 11, 2013 (the "UBS Office Loan"), secured by the corporate office building in Muskegon, Michigan and indemnified against certain losses by Gary Skoien (See Note 11)	2,201	2,224
Unsecured promissory note to HGP LP, as borrower, from James Slayback, Sr., as lender, dated as of February 25, 2002, in the original principal amount of \$2.0 million, bearing interest at 2.0% above the weighted average cost of funds index for the Eleventh District Savings Institutions, due February 24, 2012	1,332	1,518
Promissory note to Gretna, Sealy, Traverse City Outlet Centers, L.L.C., as borrower, from Amster Trading Company, an affiliate of Amster, as lender, dated as of January 29, 2004, in the original principal amount of \$3.1 million, bearing interest at the greater of the LIBOR rate plus 300 basis points or 5.5%, due August 1, 2009, secured by the shopping center in Gretna, Nebraska and guaranteed by HGPI	3,001	3,054
Capitalized land lease between Magnolia Bluff Factory Shops Limited Partnership, as lessee, and McIntosh County Industrial Development Authority, as lessor, dated as of February 1, 1995, in the original amount of \$2.9 million bearing interest at 8.90%, due February 1, 2008, secured by a pledge of the rights, title and interest in and to the ground lease for the outlet center in Darien, Georgia	1,018	1,384
Mortgage loan to Horizon El Portal LLC, as borrower, from Amster Trading Company, as lender, dated as of July 12, 2004, in the original principal amount of \$2.4 million, bearing interest at a rate equal to the greater of LIBOR plus 4.0% or 6.0%, due July 12, 2006 ("Amster Horizon El Portal Loan"), secured by the outlet center in Darien, Georgia and guaranteed by HGPLP, PLA and Gary Skoien	2,400	2,400

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Line of credit to Horizon El Portal LLC, as borrower, from Amster Trading Company, as lender, dated as of July 14, 2004, with a limit of \$3.0 million, bearing interest at a rate of 10.0%, due July 12, 2006 (“Amster Horizon El Portal Line”), secured by the second phase of the outlet center in Tulare, California and guaranteed by HGP LP, PLA and Gary Skoien	1,500	450
Mortgage loan to Village Green Associates, LLC, as borrower, from Interstate Bank, as lender, dated as of November 17, 2005, in the original principal amount of \$2.9 million, bearing interest at 9.75%, due November 17, 2009 secured by the shopping center in Huntley, Illinois. This was the conversion of the construction loan provided on August 17, 2004	2,898	1,738
Mortgage loan to Huntley Development Limited Partnership, (“HDLP”) as borrower, from First Midwest Bank, as lender, dated as of March 30, 2005, in the original principal amount of \$15.6 million, bearing interest at the Wall Street Journal Prime Rate plus 0.5%, due March 30, 2007, secured by 380 acres of land owned by HDLP and a pledge of the Series C TIF bonds related to the Huntley TIF District. Initial loan funding of \$13.9 million with \$1.7 million available to be drawn to pay interest on the loan (See below)	14,636	-
Construction loan to Tulare III, LLC, as borrower, from IXIS Real Estate Capital, Inc. (“IXIS”), as lender, dated as of September 16, 2005, with a limit of \$11.9 million, bearing interest at a rate of LIBOR plus 3.25%, with a decrease to LIBOR plus 2.5% after certain additional collateral is added to the deed of trust. The Company entered into an agreement capping the LIBOR rate at 5.0% for the term of the loan, maturing October 9, 2006, secured by Phases II and III of the Tulare, CA outlet center and a pledge of excess cash flow from Phase I of the center and guaranteed by HGPI. The fair value of the interest rate cap is judged to be approximately equal to its carrying cost of \$10,000 at December 31, 2005.	9,179	-
Repurchase agreement between Magnolia Bluff Factory Shops LP, as borrower, and Wachovia Securities, LLC, as lender, dated December 30, 2005 in the original principal amount of \$8.25 million bearing interest at the rate of 4.18% due on January 18, 2006 and secured by a pledge of US Treasury Notes having a face value of \$8.4 million	8,250	-
	<u>\$91,080</u>	<u>\$60,070</u>

On January 29, 2004, the Company borrowed \$3.1 million from Amster Trading Company, an affiliate of Amster, a director and significant shareholder of HGPI. The loan is secured by the Company’s shopping center in Gretna, Nebraska and is guaranteed by HGPI. The loan requires monthly principal payments based on a 25-year amortization schedule and bears interest at a rate equal to the greater of LIBOR plus 3.0% or 5.5%. The loan matures on August 1, 2009 and may be prepaid at any time without penalty.

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On March 30, 2005, the Company obtained a \$15.6 million loan from First Midwest Bank which is secured by 380 acres of land in Huntley, Illinois (the "FMB Loan") and used a portion of the proceeds to repay the Huntley Beal Loan and Beal Bank's net profits interest in the Huntley Partnerships. The Company is required to repay at least \$5.6 million on the FMB Loan by September 30, 2006. The loan agreement provides for a 12-month extension of the maturity date provided certain conditions are met.

The Huntley Beal Loan had a balance of \$857,000 as of March 30, 2005, just prior to repayment. Beal Bank's net profits interest was valued by the agreement of the Company and Beal Bank at \$8.5 million in the first quarter of 2005. HDLP recognized a gain of approximately \$929,000 related to the retirement of the net profits interest and the debt refinancing. The land in Huntley was also collateral for Beal Bank Loan I and Beal Bank Loan II. In conjunction with the Huntley refinancing, the maturity dates on those loans were extended from July 10, 2005 to July 10, 2006 and both loans are closed to repayment prior to March 31, 2006.

On July 12, 2004, Horizon El Portal borrowed \$2.4 million from Amster Trading Company, an affiliate of Amster, to fund a portion of the purchase price of a 50% joint venture interest in El Portal Center which owns a shopping center in Laredo, Texas (see Note 3). The Amster Horizon El Portal Loan is secured by the outlet center in Darien, Georgia. The loan matures on July 12, 2006 and requires monthly interest payments at a rate equal to the greater of LIBOR plus 4.0% or 6.0%.

On July 14, 2004, Horizon El Portal obtained a \$3.0 million line of credit from Amster Trading Company, an affiliate of Amster. The Amster Horizon El Portal Line is guaranteed by HGP LP, PLA and Gary Skoien. The line matures on July 12, 2006 and requires monthly payments of interest at an annual interest rate of 10.0%. This line of credit was obtained to fund a \$3.0 million line of credit Horizon El Portal has provided to El Portal Center (the "El Portal Center Line") to fund renovation and operating expenses. The El Portal Center Line matures on July 8, 2006, requires monthly payments of interest at an annual rate of 12.0% and is secured by a second mortgage on the center owned by El Portal Center.

On August 18, 2004, the Company obtained a \$2.9 million construction loan which is secured by a shopping center being built in Huntley, Illinois. The construction loan requires monthly payments of interest at an annual rate of the Wall Street Journal prime rate plus 2.75%. On November 17, 2005 the Company converted the construction loan to a mortgage loan. The mortgage loan bears interest at a fixed rate of 9.75%, requires monthly debt service payments based on a 25-year amortization period and matures on November 17, 2009. The outstanding balance at the date of conversion was \$2.9 million. The mortgage loan also provides for the monthly funding of escrow accounts for real estate taxes and insurance at the lender's option.

On September 16, 2005, the Company obtained an \$11.9 million construction loan from IXIS to fund the development of Phase III of the outlet mall in Tulare, California (the "Tulare III Loan"). The loan is secured by phases II and III of the Tulare Outlet Center and a pledge of the excess cash flow from Phase I of the center. The loan requires the payment of an exit fee equal to 1% of the loan amount, which will be charged to expense over the life of the loan. This fee will be waived if the Company refinances the Tulare III Loan with IXIS. HGPI entered into a guaranty of completion with respect to the construction of Phase III and has also guaranteed certain non-recourse "carve-outs".

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In December 2005, the Company entered into an agreement for the sale for its center in Darien, Georgia. The agreement provides for the sale of the center as of December 31, 2005 for a total price of \$8.0 million. The Company received a purchase money note for \$5.6 million and the purchaser assumed the Amster Horizon El Portal Loan with a balance of \$2.4 million. The purchaser holds a put option that allows it to sell the center back to the Company on or before June 15, 2006. Due to the put option, the Company has not recorded this transaction as a sale for accounting purposes and will do so only upon the expiration of the put option. Accordingly, all assets and liabilities of the center are reflected on the balance sheet of the Company as of December 31, 2005 and all results of operations are included on the statement of operations for the year ended December 31, 2005.

In December 2005, the Company acquired a portfolio of US Treasury Securities with a fair market value of \$8.6 million with proceeds of \$8.25 million from a repurchase agreement with Wachovia Securities and partner advances totaling \$495,000 from Messers. Amster and Skoien. The repurchase agreement has a term ending on January 18, 2006 and has an effective interest rate of 4.18% and is guaranteed by Messers. Amster and Skoien. The repurchase agreement is included in Mortgages and other debt on the balance sheet as of December 31, 2005.

*Huntley Net Profits Interests and TIF Bonds*

Pursuant to the terms of the Amended and Restated Agreement and Assignment of Net Profits Interest dated October 27, 1999, as later amended (the "Beal Net Profits Agreement"), Beal Bank was granted a 35% interest in the Net Profits of Huntley Development Limited Partnership ("HDLP") and Huntley Meadows Residential Venture (collectively, the "Huntley Partnerships"). The estimated value of the Beal Bank Net Profits interest is included in Participation Interests and Other Liabilities on the Company's balance sheet at December 31, 2004. The Company repaid the Huntley Beal Loan and Beal Bank's net profits interest on March 30, 2005 (See above).

Gary J. Skoien, Chairman, Chief Executive Officer and President of the Company, was also formerly the Executive Vice President and Chief Operating Officer of The Prime Group, Inc. ("Prime Group"). In connection with his employment with Prime Group, Mr. Skoien was previously granted an interest (the "Skoien Net Profits Interest") in the net proceeds generated by the Huntley Partnerships, which he retained after the Company's purchase of the Huntley Partnerships. The Skoien Net Profits Interest consists of a 9.675% participation in the Net Cash Flow (as defined in Mr. Skoien's Net Profits Agreement) distributed to the Company (excluding distributions of all amounts contributed or advanced by the Company to the Huntley Partnerships plus interest per the terms of the agreement). The Company has recorded a liability for the Skoien Net Profits Interest in the amount of \$1.0 million as of December 31, 2005 and 2004, which represents its estimated fair value and which amount has been included in Participation Interests and Other Liabilities on the Company's balance sheet.

The Company granted to Prime Group and certain of its affiliates, a participation interest of 26% of the net cash flow distributed by the Huntley Partnerships (the "Prime Group Participation Interest") as additional consideration for the purchase of the Huntley Partnerships from Prime Group. The Prime Group Participation Interest does not entitle Prime Group to participate in decision making or otherwise control the activities of the Huntley Partnerships. No amount is payable to Prime Group until the Company has received distributions in excess of its purchase price and advances made by the Company to the Huntley Partnerships plus a 40% return on such amounts, compounded quarterly. Aggregate

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amounts payable pursuant to the Prime Group Participation Interest are limited to \$5.0 million. No liability has been recorded by the Company for the Prime Group Participation Interest as its current fair value is estimated to be zero.

In 1993, the Village of Huntley (the "Village") created a Tax Increment Financing District (the "TIF District") which is authorized to issue up to \$108.0 million of tax-exempt, tax-increment bonds (the "TIF Bonds") to reimburse HDLP for a portion of the land cost and the cost of infrastructure improvements. In 1995, the Village sold \$7.0 million of Series A bonds and \$14.0 million of Series B bonds. HDLP owns the Series C bonds with a principal amount of \$24.4 million plus accrued interest. The Series C bonds are subordinate to the Series A and Series B bonds. Currently no portion of the tax increment is available to the Series C bonds and no value has been ascribed to them by the Company.

The TIF District contains approximately 900 acres of land owned or previously owned by the Huntley Partnerships. The source of repayment for the TIF Bonds is (a) 100% of the increase in real estate taxes on the land in the TIF District above the taxes in place when the TIF District was created, (b) one-half of the Village's one percent (1%) sales tax collected on retail sales occurring within the TIF District and (c) reserve funds established at the time of issuance of the TIF Bonds. Debt service reserve funds were initially established with \$700,000 for the Series A bonds and \$3.09 million for the Series B bonds as security for the payment of principal and interest on the TIF Bonds. To the extent the reserve funds are not needed to service the bonds, they will be returned to HDLP. These funds are held in interest bearing accounts under the control of the TIF Bond trustee and totaled approximately \$2.5 million at December 31, 2005. There can be no assurance that these funds will be returned to HDLP and, therefore, they are not reflected on the balance sheet of the Company. The repayment of the TIF Bonds is not an obligation of the Company and thus they are not reflected on the Company's balance sheet as a liability.

As additional security for the Series B bonds, HDLP granted U.S. Bank Trust National Association, as trustee for the holders of the Series B bonds, a mortgage covering approximately 27 acres of land as of December 31, 2005 (the "US Bank Mortgage"). Upon the sale of any parcel of land subject to the US Bank Mortgage, such parcel will be released from the US Bank Mortgage provided that HDLP deposits into a collateral account (the "US Bank Collateral Account") an amount equal to the greater of (i) 50% of the July 1997 appraised value of such parcel or (ii) an amount per square foot of the parcel sold as set forth in Exhibit B to the Amended and Restated Intercreditor Agreement. Amounts deposited into the US Bank Collateral Account are released to HDLP upon the issuance of a certificate of occupancy for the subject land parcel. The balance in the US Bank Collateral Account was approximately \$3.6 million at December 31, 2005 and is included in Restricted Cash on the Company's balance sheet (see Note 2). Based on management's review of the current incremental real estate and sales tax revenue and the available debt service reserve funds, the Company believes that the tax revenues and debt service reserve funds will be sufficient to make the scheduled debt service payments on the Series A and B bonds. Further, HDLP has no continuing legal obligation related to the proceeds received from the TIF Bonds and thus, no liability has been recognized related to this mortgage.

HORIZON GROUP PROPERTIES, INC.

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*Debt Maturities*

Debt maturities and principal payments, including debt secured by the assets classified as discontinued operations, due subsequent to December 31, 2005 are as follows (in thousands):

<u>Due in:</u>	
2006	\$35,368
2007	12,528
2008	1,132
2009	38,315
2010	265
Thereafter	<u>2,346</u>
	89,954
Tulare Loan restructuring adjustment	738
Traverse City Loan restructuring adjustment	<u>388</u>
	<u>\$91,080</u>

The Company's ability to secure new loans is limited by the fact that most of the Company's real estate assets are currently pledged as collateral for its current loans. The Company anticipates refinancing the obligations due in 2006 in the normal course of business.

**Note 11 – Default on Senior Security**

On October 26, 2005 the Company was notified by the lender that it was in default under the loan agreement on the Republic Bank Loan for failure to maintain the required debt service coverage ratio. Pursuant to the provisions of the agreement, the interest rate is increased by 2% per annum while the note remains in default. The Republic Bank Loan matures on July 1, 2006 and the lender has notified the Company that it has decided that it will not renew the loan at maturity.

**Note 12 - Related Party Transactions**

The Company utilizes Thilman & Filippini as its agent for insurance and risk management programs. E. Thomas Thilman is a Director of the Company and a partner in Thilman & Filippini. The Company paid premiums totaling approximately \$986,000 and \$931,000 during the years ended December 31, 2005 and 2004, respectively, on insurance policies placed by Thilman & Filippini, including insurance premiums for properties classified as discontinued operations.

Prior to March 2004, the Company sub-leased office space on a month to month basis for its senior executives in Chicago, Illinois from Prime Group. The Company incurred rent expense of \$7,000 during the year ended December 31, 2004.

Pursuant to an expense reimbursement agreement signed in December 2003, an affiliate of Amster reimburses the Company for approximately 49% of the general and administrative expenses related to the operation of the outlet centers and corporate office building in which the affiliate of Amster

HORIZON GROUP PROPERTIES, INC.

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owns a partnership interest. Certain expenses related to the general operation of the Company are not subject to reimbursement under the agreement. The Company recognized income related to this arrangement of \$848,000 and \$726,000 during the years ended December 31, 2005 and 2004, respectively.

The UBS Office Loan requires an officer of the Company to be personally liable for losses suffered by UBS for environmental damages and certain actions prohibited under the UBS Office Loan documents. Gary Skoien personally indemnified UBS for such losses and damages. The Company agreed to indemnify Mr. Skoien for any amounts paid under the UBS indemnification and to pay Mr. Skoien an annual fee of \$30,000 related to such indemnification until the loan is repaid (or Mr. Skoien is otherwise released from the UBS indemnification obligations).

The Company has several loans from affiliates of Amster on which it paid a total of \$549,000 and \$497,000 of interest during the years ended December 31, 2005 and 2004, respectively. See Note 10 for the specific terms of the loans.

For additional disclosure of related party transactions, see Notes 2, 10 and 13.

Gary J. Skoien, Chairman, Chief Executive Officer and President of the Company was also formerly Executive Vice President and Chief Operating Officer of Prime Group. Howard Amster ("Amster") is a director and significant shareholder of the Company.

**Note 13 – Recent Developments**

On January 21, 2004, the Company sold a total of approximately 240 acres of land in Huntley, Illinois for a total of \$12.1 million. A portion of the land was subject to the US Bank Mortgage, and accordingly, \$1.7 million was deposited into a collateral account related to the US Bank Mortgage. The Company used \$636,000 from a previously established infrastructure escrow account to acquire additional water and sewer capacity, a portion of which was sold with the land. A new escrow account was established with \$300,000 of the net proceeds to fund wetland mitigation and sewer line construction, as required by the contract. The net proceeds of \$9.8 million were used to partially repay the Huntley Beal Loan (See Note 10). No gain or loss was recorded as a result of this sale.

On February 10, 2004, the Company sold its interests in the entities which own the triple net leased property in Roseville, Michigan, which is leased to Petsmart, Inc. The sales price was \$475,000, and the assumption of the mortgage loan by the purchaser. The Company received a \$370,000 note from the purchaser as a portion of the purchase price. The note bore interest at 4.0%, through December 30, 2005 when it was extended to a maturity date of November 1, 2006 at an interest rate of 8.0%. The note is secured by the entities that own the property leased to Petsmart. The Company recognized a gain of \$327,000 on the sale.

On April 1, 2004, the Company acquired a 51.0% ownership interest in the entities that operate an outlet shopping center in Darien, Georgia pursuant to a ground lease (which contains a lessee purchase option for a nominal fee). The remaining ownership interests were purchased by PLA, an affiliate of Amster, and Gary Skoien. The total purchase price of \$3.0 million for the entities was paid in cash at closing. The acquisition was accounted for under the purchase method.

HORIZON GROUP PROPERTIES, INC.

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The following table summarizes the estimated fair value of the assets acquired and liabilities of the entities that own the Darien shopping center assumed at the date of acquisition.

	<i>(In thousands)</i>
Land	\$ 942
Buildings and improvements	2,571
Other assets	<u>1,598</u>
	<u>\$5,111</u>
Mortgages and other debt	\$1,598
Accounts payable and other accrued expenses	24
Prepaid rents and other tenant liabilities	636
Contributed capital (minority interests)	1,398
Contributed capital (cash paid)	<u>1,455</u>
	<u>\$5,111</u>

On May 7, 2004, the Company sold the 103,000 square foot strip building at the shopping center in Monroe, Michigan for \$1.75 million. The net proceeds of approximately \$1.7 million were deposited into an escrow account with Beal Bank. On July 12, 2004, the funds were applied to the outstanding principal balance on the Beal Bank Loan II. A net loss of \$51,000 was recognized.

On May 13, 2004, the Company exercised a purchase option and acquired approximately 40 acres of vacant land in Fruitport Township, Michigan. Pursuant to the terms of the option and after-purchase credits, the net cash settlement of \$182,000 was paid from a portion of an escrow account related to the Beal Bank Loan II. The land is classified as held for sale on the Company's balance sheet.

On June 8, 2004, the Company sold 1.74 acres of vacant land adjacent to its shopping center in Gretna, Nebraska for \$152,000. A net gain of \$113,000 was recognized.

On June 21, 2004, the Company sold approximately 19 acres of vacant land in Daleville, Indiana, adjacent to an outlet center formerly owned by the Company, for \$154,000. A net loss of \$49,000 was recognized.

On October 4, 2004, the Company sold approximately 3.3 acres of land held for investment located in Huntley, Illinois for \$438,000 to an unrelated third party. The consideration consisted of \$317,000 in cash from the purchaser and a note for \$121,000 from an affiliate of Prime Group, a party to a transaction related to the land sale. The note matures on October 4, 2005 and bears interest at a rate of 7.0%, payable upon maturity. Approximately \$268,000 of the net proceeds was deposited into a collateral account related to the US Bank Mortgage. A loss of \$33,000 was recognized in the transaction and is included, net of minority interests, in the Company's statement of operations in the line item entitled "Gain/(Loss) on Sale of Partnership Interests and Real Estate".

On September 19, 2005, the Company purchased approximately 10.7 acres of land for \$2.6 million, the majority of which was utilized for the development of Phase III of the Tulare Outlet Center which was substantially completed in November 2005. Three outparcels that are part of the 10.7 acres

HORIZON GROUP PROPERTIES, INC.

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are under contract for sale to third parties and are classified as held for sale on the Company's balance sheet. The funds for this acquisition were provided from the Tulare III Loan (See Note 10). IXIS has a security interest in the outparcels and the loan agreement requires that sales proceeds from the outparcels be used to fund development costs.

On November 23, 2005, the Company sold 1.42 acres of vacant land adjacent to its shopping center in Gretna, Nebraska for \$124,000. A net gain of \$97,000 was recognized.

**Note 14 – Discontinued Operations**

In accordance with SFAS 144, the results of operations and gain/(loss) on real estate properties sold or held for sale are reflected in the consolidated statements of operations as "Income/Loss from Discontinued Operations".

The following table is a summary of the results of operations of the properties classified as discontinued operations:

	<b>Year ended</b> <b><u>December 31, 2005</u></b>	<b>Year ended</b> <b><u>December 31, 2004</u></b>
	<i>(in thousands)</i>	
Total revenue	\$ 20	\$ 96
Total expenses	<u>(325)</u>	<u>(422)</u>
Loss before minority interests	(305)	(326)
Minority interests	117	99
Gain on sale of real estate, net of minority interests	<u>68</u>	<u>254</u>
Income/(loss) from discontinued operations	<u><u>\$(120)</u></u>	<u><u>\$ 27</u></u>

Mortgages and Other Debt on the Company's balance sheet includes \$2.0 million of outstanding debt as of December 31, 2005 and 2004 related to assets classified as held for sale.

## **BOARD OF DIRECTORS**

**Howard M. Amster**  
President  
Pleasant Lake Apts. Corp.

**Gov. Jim Edgar**  
Distinguished Fellow  
University of Illinois Institute of  
Government and Public Affairs

**Margaret A. Gilliam**  
President  
Gilliam & Co.

**Gary J. Skoien**  
Chairman, President and  
Chief Executive Officer  
Horizon Group Properties, Inc.

**E. Thomas Thilman**  
Partner  
Thilman & Filippini

## **CORPORATE OFFICERS**

**Gary J. Skoien**  
Chairman, President and  
Chief Executive Officer

**David R. Tinkham**  
Chief Financial Officer and Secretary

**Andrew F. Pelmoter**  
Senior Vice President, Leasing

**Thomas A. Rumptz**  
Senior Vice President,  
Asset Management

## **CORPORATE EXECUTIVE OFFICES**

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## **TRANSFER AGENT AND REGISTRAR**

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59 Maiden Lane  
New York, NY 10038  
(718) 921-8380

## **INDEPENDENT AUDITORS**

Ernst & Young LLP  
233 South Wacker Drive  
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## **SHAREHOLDER INQUIRIES**

Information is available upon request:

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(231) 798-9191

Information is also available on the  
Company's web site:  
<http://www.horizongroup.com>

## **STOCK TRADING**

The Company's common stock trades in the  
over the counter market under the symbol  
"HGPI.PK".



H·G·P Horizon Group Properties, Inc.

Horizon Group Properties, Inc. · 6250 N. River Road · Suite 10-400 · Rosemont, IL 60018