

HGP

Horizon Group Properties
2008 Annual Report



AÉROPOSTALE

BANANA REPUBLIC
FACTORY STORE

COACH

EST. 1941

 **American Girl**

GYMBOREE
OUTLET

KENNETH COLE

GAP
OUTLET

TOMMY


HILFIGER

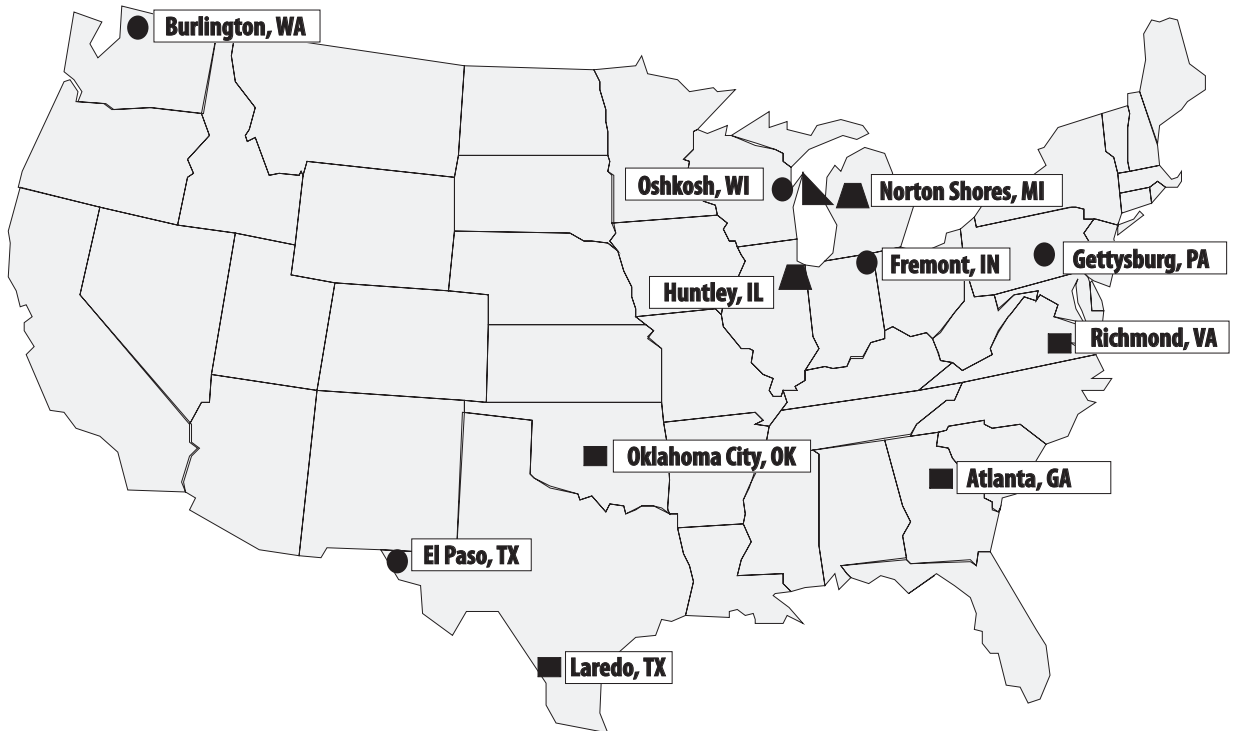


NIKE FACTORY STORE

OSHKOSH
B'gosh.


POLO RALPH LAUREN
FACTORY STORE

Portfolio



- Outlet Center
- Outlet Center under development
- ▲ Office Building
- ▲ Land Development

Company Profile

Based in Norton Shores, Michigan, Horizon Group Properties, Inc. is an owner and developer of factory outlet shopping centers and the developer of a master planned community in suburban Chicago.

Our shopping centers feature favorite name brand stores such as Polo Ralph Lauren, Coach, Kenneth Cole, Banana Republic, Gap Outlet, Nike, Carter's and PacSun, just to name a few.

Dear Stockholder,

In past years, my letters to you have focused primarily on our accomplishments. While I do want to highlight some significant accomplishments, the current economic situation requires that I address a number of challenges facing the Company. Last year, I noted the emergence of a liquidity crisis in the capital markets which, since then, has only worsened. While there are signs that actions by the US Treasury and the Federal Reserve are improving credit market liquidity, many of us believe that the credit crisis still has a way to go before reversing its course.

The lack of debt capital and the declining economy have stalled new development and negatively affected commercial real estate values. Bankruptcies, falling consumer spending, and corporate downsizing have led to declining rents and occupancy levels in almost all classes of real estate assets.

While the scarcity of credit has affected Horizon, the outlet sector is performing far better than other types of retail real estate in terms of sales, traffic, and occupancy. Consumers are focused on value while still insisting on quality brand names. Outlet retailers continue to open new stores, although there have been tenant bankruptcies, requests for rent relief and a general slowdown in leasing in the outlet sector. However, the opportunity for new development remains and there are many areas in the country that do not have convenient access to a factory outlet center.

New Partnership

As I reported last year, the Company planned to commence construction of a 338,000 square foot outlet center in Oklahoma City last fall. In fact, while construction bids were taken and leasing thresholds were nearly met, we were unable to proceed because of our inability to obtain a construction loan. Since then, Horizon has formed a relationship with Cousins Properties, Inc., an Atlanta-based REIT that develops and owns retail, office, and multi-family properties. Cousins is interested in entering the outlet retail sector and believes that teaming up with an existing outlet developer is the best way to enter the sector. In October 2008, we agreed to form a joint venture with Cousins to develop The Outlet Shoppes at Oklahoma City. The Company will act as developer for the joint venture and will lease and manage the project.

We currently anticipate breaking ground on this center in the fall of 2009 with a November 2010 opening. We are hopeful that we will obtain a construction loan based on the level of leasing, the quality of the tenants, the vibrancy of the Oklahoma City economy and the financial strength of our partner.

In addition to Oklahoma City, we have also agreed to enter into a joint venture with Cousins for the development of an outlet center in Woodstock, Georgia on a site on which Cousins had planned to develop a lifestyle center. The site is northwest of Atlanta and is closer to metropolitan Atlanta than any other outlet center. The site has great visibility from and access to busy Interstate 575. We are very excited about the opportunity to build this center with Cousins, which the Company will lease and manage. We are delighted by the very positive reception of this project by outlet tenants.

New Developments

The Company continues to lease The Outlet Shoppes at Richmond (Virginia) located north of the city on Interstate 95. This project, a joint venture with Holladay Properties, is currently scheduled for an initial phase of 275,000 square feet and there is sufficient land to allow for future expansions totaling 145,000 square feet. The Company will act as developer for the joint venture and will lease and manage the project. The project currently has leases signed or out for signature representing 38% of the square footage of the initial phase. We plan to begin construction on this project in the spring of 2010 with an early summer 2011 opening. Across the street from the outlet site, Bass Pro Shops recently opened a 150,000 square foot store, the performance of which is in the upper tier of their stores nationally.

Last year, we had planned to begin the construction of a 30,000 square foot expansion to The Outlet Shoppes at Gettysburg with Polo, Nike, and Tommy Hilfiger as the primary tenants. Unfortunately, we were unable to obtain a construction loan in the current credit environment. It is very frustrating to be stymied by the lack of construction financing when a project has such a strong tenant roster and is part of a successful existing center. We are currently reviewing our options at this center.

Our most challenging outlet project is in Laredo, Texas. I have discussed the issues that have complicated the project in my past letters to you. In spite of these issues, we still remain convinced that our site is ideally suited for an outlet center and that Laredo is a strong border site for an outlet center. We are currently negotiating for the City of Laredo to provide decked parking for the project, without which the development of the center is not feasible. Once this agreement is finalized, we will be in a position to move forward with the development.

In connection with Laredo, we exercised the first part of a two-part option we have with our partner, Morgan Stern. The Company purchased a 12.5% interest in the project for \$375,000 giving it control over most decisions. Horizon has until September 2010 to exercise the second part of the option to buy the balance of the Morgan Stern interest for \$2.125 million.

Leasing and Property Operations

We leased space to Nike, Gymboree, and Le Gourmet Chef at The Outlet Shoppes at Oshkosh (Wisconsin) last fall. The traffic at the center has improved since those stores opened. At The Outlet Shoppes at Burlington (Washington) we completed a significant renovation which turned an outdated, dull-looking center into a vibrant, contemporary center. The new look is quite visible from the adjacent Interstate 5. At about the time the renovation was completed, we leased a space to *lululemon athletica*, a Canadian manufacturer of yoga-inspired athletic apparel, for its first outlet store in the U.S. Sales at the store are very strong and we hope its success will attract other tenants to the center. However, overall sales at this center were negatively affected in 2008 by the decline in the value of the Canadian dollar relative to the U.S. dollar because a large number of our shoppers come from Canada. We have started to see sales trending back up over the last several months.

Occupancy at our outlet centers is down 2.7% from a year ago, from 87.0% to 84.3%. Tenants entering bankruptcy or exiting the outlet business vacated space representing 3% of our portfolio; thus we actually gained occupancy excluding those tenants. At the same time, sales at

our centers have held steady over the past year, which is encouraging given the declines that have occurred elsewhere in the retail world and traffic at our centers in Gettysburg, El Paso, and Oshkosh has been particularly strong over the past year.

We have initiated significant efforts to reduce operating expenses at all of our centers, which efforts have reduced annual operating expenses by 7% or \$400,000. These savings were achieved without negatively affecting the operation of the properties. At several centers, the majority of tenants have fixed gross rents so the operational savings directly inure to the benefit of the Company. At centers with net leases, the tenants benefit from the savings in the short run while the Company benefits over the longer run by being able to achieve higher net rents.

Huntley Master Planned Community

After years of litigation, the Village of Huntley, Illinois and Horizon reached a mutually beneficial settlement this spring. As part of the settlement, the Village refinanced the existing Series A and B Tax Increment Financing Bonds with the proceeds from new bonds which have a longer maturity and a lower interest rate. In connection with the refinancing, Horizon received \$2.9 million that had been held in escrow and a mortgage was released on 25 acres of land owned by Horizon, both of which had been collateral for the old Series B Bonds. A crucial part of the settlement of the litigation was our agreement to share with the Village a portion of the cash that flows to the Series C Tax Increment Financing Bonds that are owned by Horizon. Specifically, Horizon will receive 100% of the first \$1.43 million of increment allocable to the Series C Bonds; the Village will receive 25% of the next \$3.04 million, and 75% thereafter. An additional benefit of the settlement is the alignment of the interests of the Company and the Village in the sale and development of our land as opposed to other land in the community.

The Company owns 408 acres of land in Huntley subject to a mortgage securing a loan from US Bank as described below. Of all the classes of real estate, vacant land has suffered the most in the current economic downturn. In spite of this, recent appraisals prepared for the lender confirm our belief that the property holds value in excess of the debt. Because it is improved and entitled land at the intersection of a busy interstate and state highway and in the path of growth, we believe that its value will be recognized when markets return to normal.

Debt

Most real estate companies are facing the issue of impending debt maturities in the absence of a functioning debt market. While the majority of the debt at the property level has maturities that are six to nine years out, we have a \$2.8 million loan on our strip shopping center in Huntley, Illinois that matures in November of this year. We are currently seeking to extend or replace that loan.

The Company has a loan from US Bank secured by a mortgage on the Huntley land with an outstanding balance of \$21.6 million. In June 2009, Horizon and US Bank signed an agreement to extend the maturity of the loan for one year to October 1, 2010. The agreement included an increase in the interest rate to one-month LIBOR plus 4.5% with a floor of 5.5% compared to the current interest rate of one-month LIBOR plus 3% with no floor. The Company also provided a mortgage to US Bank on 25 acres of land in Huntley that was released when the TIF bonds were refinanced. Proceeds from the sale of the Holland Town Center (see below)

paid down the loan by \$690,000. In addition, Horizon funded an interest reserve using \$600,000 of the proceeds from the sale and \$900,000 of cash on hand. The Company will continue to stay focused on selling Huntley land to retire this debt. We are encouraged that several land buyers have recently entered the market, but we currently have no sales contracts pending.

Dispositions

Pursuant to the Company business plan, we create value through the development and operation of outlet centers. Our development and leasing activities generate fees which pay for a significant portion of the cost of running the Company. The lack of new development activity and the related fees have created a liquidity issue for the Company. To deal with the current liquidity squeeze, we have increased our efforts to sell assets. I am pleased to report that in spite of the moribund real estate markets we have recently made several sales. In July of this year, we sold the Holland Town Center in Holland, MI. While the \$2.8 million sales price is less than we might have hoped, it is solid in the current environment and it relieves us of an asset that we have had difficulty repositioning. Horizon owns a 51% interest in the property. As noted above, these proceeds were used to pay down the US Bank loan and fund an interest reserve for the loan.

The Company also sold an outlot at The Outlet Shoppes at El Paso for a gross sale price of \$725,000. This is the second outlot sale at the center with eleven remaining, all of which we are aggressively marketing.

Cost Containment

We have worked diligently to reduce the overhead costs of the Company during these challenging times. These reductions include, but are not limited to, suspending all bonuses and raises during 2009, reducing the salaries of the most highly compensated executives, reducing staffing levels through lay-offs, suspending the Company match for the 401(k) plan and limiting travel. In total these actions reduce annual corporate overhead costs by more than 20%.

We will continue to assess other areas in which we can economize. Unfortunately, we believe that we have reduced overhead as much as possible without seriously affecting our ability to complete the projects in our development pipeline and the demands of operating our properties.

Conclusion

Our goals for the upcoming year are straightforward: improving the occupancies and sales at our shopping centers, preserving capital, beginning construction of The Outlet Shoppes at Oklahoma City, continuing to lease the centers in Richmond, Atlanta, and Laredo, and selling land in Huntley and El Paso. While straightforward, these tasks are not without significant challenge. I assure you that the employees, the Board, and I are working tirelessly to achieve these goals.

Sincerely,



Gary J. Skoien

INDEPENDENT AUDITORS' REPORT

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, 2008 and 2007, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated 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 consolidated financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Horizon Group Properties, Inc. at December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States.

Cohen & Company

Cleveland, Ohio
March 26, 2009

HORIZON GROUP PROPERTIES, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands)

	December 31, 2008	December 31, 2007
ASSETS		
Real estate – at cost:		
Land	\$ 35,588	\$ 26,619
Buildings and improvements	107,446	103,849
Less accumulated depreciation	<u>(11,884)</u>	<u>(5,817)</u>
	131,150	124,651
Construction in progress	3,051	1,093
Land held for investment	<u>20,429</u>	<u>21,284</u>
Total net real estate	154,630	147,028
Investment in joint ventures	1,968	3,490
Cash and cash equivalents	755	6,743
Restricted cash	7,693	8,104
Marketable securities	10,174	10,253
Tenant and other accounts receivable, net	2,173	3,971
Deferred costs (net of accumulated amortization of \$1,510 and \$659, respectively)	3,933	4,160
Other assets	<u>3,097</u>	<u>2,936</u>
Total assets	<u><u>\$184,423</u></u>	<u><u>\$186,685</u></u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Mortgages and other debt	\$145,267	\$143,009
Accounts payable and other accrued expenses	5,481	6,302
Prepaid rents and other tenant liabilities	819	1,152
Participation interests and other liabilities	<u>2,300</u>	<u>2,655</u>
Total liabilities	<u>153,867</u>	<u>153,118</u>
Minority interests	<u>12,966</u>	<u>12,625</u>
Commitments and contingencies		
Stockholders' equity:		
Common shares (\$.01 par value, 50,000 shares authorized, 2,895 and 2,913 issued and outstanding, respectively)	29	29
Additional paid-in capital	37,514	37,522
Accumulated deficit	<u>(19,953)</u>	<u>(16,609)</u>
Total stockholders' equity	<u>17,590</u>	<u>20,942</u>
Total liabilities and stockholders' equity	<u><u>\$184,423</u></u>	<u><u>\$186,685</u></u>

See accompanying notes to consolidated financial statements.

HORIZON GROUP PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands)

	Year ended December 31, 2008	Year ended December 31, 2007
REVENUE		
Base rent	\$12,990	\$ 7,249
Percentage rent	250	104
Expense recoveries	3,603	2,208
Other	1,661	1,301
Interest	<u>677</u>	<u>1,229</u>
Total revenue	<u>19,181</u>	<u>12,091</u>
EXPENSES		
Property operating	5,303	3,121
Real estate taxes	1,571	910
Other operating	796	527
Depreciation and amortization	8,327	3,850
General and administrative	4,374	5,366
Interest	8,447	7,710
(Gain)/loss on marketable securities	<u>(75)</u>	<u>112</u>
Total expenses	<u>28,743</u>	<u>21,596</u>
Income from investment in joint ventures	<u>1,700</u>	<u>5,504</u>
Loss from continuing operations before minority interests, gain on sale of real estate and income from discontinued operations	(7,862)	(4,001)
Minority interests	<u>2,544</u>	<u>1,615</u>
Loss from continuing operations	(5,318)	(2,386)
Gain on sale of real estate, net of minority interests	1,974	-
Income from discontinued operations, net of minority interests	<u>-</u>	<u>472</u>
Net loss	<u>\$(3,344)</u>	<u>\$(1,914)</u>

See accompanying notes to consolidated financial statements.

HORIZON GROUP PROPERTIES, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)

	<i>Common Shares</i>		<i>Additional</i>	<i>Accumulated</i>	<i>Stockholders'</i>
	<i>Number</i>	<i>Amount</i>	<i>Paid-In</i>	<i>Deficit</i>	<i>Equity</i>
	<u>Number</u>	<u>Amount</u>	<u>Capital</u>	<u>Deficit</u>	<u>Equity</u>
Balance, January 1, 2007	2,879	\$29	\$37,295	\$(14,695)	\$ 22,629
Stock grant to officers	34	-	227	-	227
Net loss	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,914)</u>	<u>(1,914)</u>
Balance, December 31, 2007	2,913	29	37,522	(16,609)	20,942
Stock grant to officers	48	1	291	-	292
Share repurchase	(66)	(1)	(299)	-	(300)
Net loss	<u>-</u>	<u>-</u>	<u>-</u>	<u>(3,344)</u>	<u>(3,344)</u>
Balance, December 31, 2008	<u>2,895</u>	<u>\$29</u>	<u>\$37,514</u>	<u>\$(19,953)</u>	<u>\$ 17,590</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>2008</u>	<u>2007</u>
Cash flows from operating activities:		
Net loss	\$(3,344)	\$ (1,914)
Net gain on sale of real estate, including amounts in discontinued operations	(2,864)	(877)
Adjustments to reconcile net loss to net cash used in operating activities:		
Minority interests, including amounts in gain on sale of real estate and income from discontinued operations	(1,654)	(1,266)
Income from investment in joint ventures	(1,700)	(5,504)
Depreciation	8,124	3,824
Amortization, including deferred financing costs	975	903
(Gain)/loss on marketable securities	(75)	112
HGPI stock grants	292	227
Changes in assets and liabilities:		
Restricted cash	833	1,703
Tenant and other accounts receivable	1,807	(3,687)
Deferred costs and other assets	(1,558)	561
Accounts payable and other accrued expenses	(1,005)	1,030
Participation interests and other liabilities	(355)	-
Prepaid rents and other tenant liabilities	(339)	939
Net cash used in operating activities	<u>(863)</u>	<u>(3,949)</u>
Cash flows from investing activities:		
Acquisition of property	-	(17,691)
Net marketable securities activity	154	7,160
Distribution from joint ventures	384	6,106
Expenditures for buildings and improvements	(5,030)	(44,410)
Cash transferred in connection with sale of subsidiaries	-	(928)
Cash transferred in connection with consolidation/ (de-consolidation) of entities	50	(1,669)
Net proceeds from sale of real estate	<u>3,707</u>	<u>4,029</u>
Net cash used in investing activities	<u>(735)</u>	<u>(47,403)</u>
Cash flows from financing activities:		
Net contributions from/(distributions to) minority interests	352	(3,989)
Principal payments on mortgages and other debt	(8,544)	(58,130)
Proceeds from borrowings	4,102	115,357
Debt issue costs	-	(1,677)
HGPI stock buyback and retirement	(300)	-
Net cash provided by/(used in) financing activities	<u>(4,390)</u>	<u>51,561</u>
Net increase/(decrease) in cash and cash equivalents	(5,988)	209
Cash and cash equivalents:		
Beginning of year	<u>6,743</u>	<u>6,534</u>
End of year	<u>\$ 755</u>	<u>\$ 6,743</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)*

2008 2007

Supplemental Information -

During the years ended December 31, 2008 and 2007, the Company sold assets that affected the following accounts:

Buildings and improvements	\$ -	\$ 3
Accumulated depreciation	-	(57)
Real estate-held for sale	-	3,380
Land held for investment	854	-
Deferred costs	-	(4)
Other assets	-	30
Accounts payable and accrued expenses	292	286
Prepaid rents and other tenant liabilities	-	(53)
Minority interests	-	(106)
Net assets sold	<u>1,146</u>	<u>3,479</u>
Gross proceeds from sale of real estate	<u>4,010</u>	<u>4,356</u>
Gain on sale of real estate	<u>\$2,864</u>	<u>\$ 877</u>

The following represents supplemental disclosure of significant cash activity from the gross proceeds from the sale of real estate (above) to arrive at the net proceeds from the sale of real estate as shown on the consolidated statements of cash flows for the years ended December 31, 2008 and 2007:

Gross proceeds from sale of real estate	\$4,010	\$4,356
Accounts payable and other accrued expenses – closing costs	(303)	(321)
Prepaid rents and other tenant liabilities	-	(6)
Net proceeds from sale of real estate	<u>\$3,707</u>	<u>\$4,029</u>

The following represents supplemental disclosure of the sale of ownership interests in a subsidiary during the year ended December 31, 2007:

Cash and cash equivalents		\$ 928
Restricted cash		22
Marketable securities		4,005
Tenant and other accounts receivable, net		(30)
Other assets		473
Mortgages and other debt		(3,998)
Accounts payable and other accrued expenses		(11)
Minority interests		(758)
Accounts receivable – net proceeds		<u>\$ 631</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>2008</u>	<u>2007</u>
Supplemental Information (Continued) -		
The following represents supplemental disclosure of noncash activity for the de-consolidation of the assets and liabilities of the El Paso Center on December 1, 2007 and the consolidation of the assets and liabilities of El Portal Center on October 1, 2008 (See Note 1):		
Land	\$ 8,878	\$ (4,604)
Buildings and improvements	2,855	(2)
Construction in progress	111	(49,162)
Accumulated depreciation	(293)	-
Investment in joint venture	(2,842)	260
Cash and cash equivalents	50	(1,669)
Restricted cash	422	(27,956)
Tenant and other accounts receivable, net	9	(1,072)
Deferred costs	73	(966)
Other assets	(722)	1,096
Mortgages and other debt	(6,700)	79,500
Accounts payable and other accrued expenses	(195)	4,191
Prepaid rents and other tenant liabilities	(7)	(6)
Minority interests	<u>(1,639)</u>	<u>390</u>
	<u>\$ -</u>	<u>\$ -</u>

The following represents supplemental disclosure of noncash activity for the disposal of fully depreciated/amortized assets during the years ended December 31, 2008 and 2007:

Buildings and improvements	\$1,040	\$ 189
Deferred costs	<u>50</u>	<u>379</u>
	<u>\$1,090</u>	<u>\$ 568</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 conducted primarily through a subsidiary limited partnership, Horizon Group Properties, L.P. (“HGP LP”) of which HGPI is the sole general partner. As of December 31, 2008 and 2007, HGPI owned approximately 68.8% and 68.9%, respectively, 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).

The Company’s primary assets are its investments in subsidiary entities that own real estate. HGPI consolidates the results of operations and the balance sheets of those entities of which the Company owns the majority interest and of those variable interest entities of which the Company is the primary beneficiary. The Company accounts for its investments in entities which do not meet these criteria using the equity method. The entities referred to herein are consolidated subsidiaries of the Company, unless they are discussed in Note 3; those entities are accounted for using the equity method of accounting.

The Company acquired the entity that owns an outlet shopping center located in Gettysburg, Pennsylvania on July 18, 2007. The center contains a total of approximately 252,000 square feet of gross leasable area (“GLA”), a 35,000 square foot movie theater and ground leases to the Carlson Country Inn and TGI Friday’s. The contract price was \$61.0 million, subject to customary prorations. The Company assumed existing debt secured by the property which had a principal balance of \$43.5 million as of the date of closing. The Company has also obtained a \$6.0 million mezzanine loan in connection with the acquisition.

On August 9, 2007, the Company acquired three outlet shopping centers located in Burlington, Washington; Fremont, Indiana; and Oshkosh, Wisconsin (the “BFO Centers”). The centers contain approximately 174,000, 229,000 and 271,000 square feet of GLA, respectively. The aggregate acquisition price was \$59.1 million, subject to customary prorations. The centers collectively secure debt which the Company assumed at closing. The principal balance of the debt was \$53.0 million as of the date of acquisition.

The Company owns 88.2% of the preferred interests and 80.7% of the common interests in Horizon El Paso, LLC (“Horizon El Paso”), which owns 50% of El Paso Outlet Center Holding, LLC, (together with its subsidiaries, “El Paso Center”), a joint venture that developed an outlet shopping center in El Paso, Texas, which opened on October 11, 2007 and contains approximately 380,000 square feet of GLA and owns several outparcels adjacent to the shopping center. Horizon El Paso also owns a 50% interest in TOSEP Land Company, LLC (“TOSEP”), an entity that owns approximately 45 acres of undeveloped land adjacent to the outlet center. An affiliate of Howard Amster (“Amster”), a director and significant stockholder of the Company, owns 5.9% of the preferred and common interests and Gary Skoien (“Skoien”), Chairman, President and CEO of the Company, owns 5.9% of the preferred interests and 7.2% of the common interests of Horizon El Paso. Horizon El Paso reported the results of operations and the assets and liabilities of El Paso Center using the equity method of accounting through August 31, 2006. As a result of certain loans made to the joint venture partner by the Company, El Paso Center was judged to be a variable interest entity and Horizon El Paso was the primary beneficiary. Therefore, the Company began to consolidate the results of operations and the assets and liabilities of El Paso Center effective September 1, 2006. The loans to the joint venture partner have been repaid and, effective December 1, 2007, the Company was no longer judged to be the primary beneficiary of El Paso Center.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Accordingly, starting December 1, 2007, Horizon El Paso began to use the equity method of accounting with respect to El Paso Center (See Note 3).

The Company owns the majority interest in Horizon El Portal LLC (“Horizon El Portal”), which is a joint venture partner in El Portal Center LLC (“El Portal Center”) that owns a shopping center in Laredo, Texas containing approximately 345,000 square feet of GLA. Through the third quarter of 2008, Horizon El Portal reported the results of operations and the assets and liabilities of El Portal Center using the equity method of accounting. On September 26, 2008, Horizon El Portal purchased a 12.5% interest in El Portal Center from its joint venture partner. HGP LP made a capital contribution to Horizon El Portal to acquire the interest and increased its ownership in that entity to 60.8%. The Company began consolidating the results of operations and the assets and liabilities of El Portal Center in the fourth quarter of 2008 (See Note 3). The Company consolidates the results of operations and the assets and liabilities of Horizon El Portal.

The Company also owns 51% of 5000 Hakes Drive LLC, an entity that owns an office building located in Norton Shores, Michigan (a portion of which it occupies) and a 194,000 square foot shopping center located in Holland, Michigan. The remaining 49% of the entity is owned by an affiliate of Amster. The Company also owns Village Green Associates LLC which owns a 22,000 square foot shopping center located in Huntley, Illinois and holds for investment purposes approximately 408 acres of land in a master planned community in Huntley, Illinois in Huntley Development Limited Partnership (the “Huntley Project”) and approximately 46 acres of vacant land in Fruitport Township, Michigan in HGP LP.

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 consolidated statements of operations and such parties’ portion of the net equity in such subsidiaries is reported on the Company’s consolidated balance sheets as Minority Interests.

Distributions in excess of the Company’s net investments in entities accounted for using the equity method are recognized as income if the Company is not obligated to make future contributions to those entities. Such distributions are included in Income from Investment in Joint Ventures on the consolidated statements of operations. For the years ended December 31, 2008 and 2007, the Company recognized income from distributions in excess of equity investments of \$2.1 million and \$5.9 million respectively related to El Paso Center.

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. 46R, “Consolidation of Variable Interest Entities,” the Company also 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.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (“GAAP”) 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 intangible 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 Prepaid Rents and Other Tenant Liabilities on the consolidated balance sheets) 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. The net book value of capitalized above/below-market lease values was \$1,685,000 and \$2,137,000 at December 31, 2008 and 2007, respectively.

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 consolidated balance sheets) 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 would be charged to expense. The net book value of in-place leases was \$6,416,000 and \$11,387,000 at December 31, 2008 and 2007, respectively.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2008, \$182,000 of interest was capitalized related to the acquisition of land in Oklahoma City, Oklahoma. For the period in which the property was consolidated, during the year ended December 31, 2007, \$1,258,000 of interest was capitalized related to the construction of the outlet center in El Paso, Texas.

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/origination costs	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 retreating and repositioning those properties which have significant vacancy issues, depending on the facts and circumstances of each property.

Depreciation and amortization expense includes charges for unamortized capitalized costs related to unscheduled tenant move-outs totaling \$951,000 and \$12,000 for the years ended December 31, 2008 and 2007, respectively.

The pre-development stage of a project involves certain costs to ascertain the viability of a potential project and to secure the necessary land. Direct costs to acquire the assets are capitalized once the acquisition becomes probable. These costs are carried in Other Assets until conditions are met that indicate that development is forthcoming, at which point the costs are reclassified to Construction in Progress. In the event a development is no longer deemed probable, the costs previously capitalized are expensed when the project is abandoned. At December 31, 2008, pre-development costs classified as Other Assets and Construction in Progress were \$687,000 and \$2,820,000, respectively. At December 31, 2007, pre-development costs classified as Other Assets and Construction in Progress were \$159,000 and \$861,000, respectively.

Cash Equivalents

The Company considers all liquid investments with a maturity of three months or less when purchased to be cash equivalents. The Company's cash is held in accounts with balances, which at times,

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

exceed federally insured limits. The Company has not experienced any losses on such accounts and believes it is not exposed to any significant credit risk on Cash and Cash Equivalents.

Restricted Cash

Restricted Cash consists of amounts deposited (i) in accounts with the Company's primary lenders in connection with certain loans (see Note 9), (ii) in escrow accounts for infrastructure requirements related to land sales in Huntley and future infrastructure expenses and interest payments related to Huntley and (iii) 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 TIF Bond Mortgage (see Note 9). At December 31, 2008 and 2007, the escrow accounts related to the Company's primary lenders included approximately \$993,000 and \$962,000 in capital improvement and tenant allowance reserves, respectively, \$735,000 and \$804,000 in real estate tax and insurance escrows, respectively, and approximately \$1,914,000 and \$2,182,000 for cash collateral accounts, respectively. At December 31, 2008 and 2007, the Huntley infrastructure and expense escrow accounts totaled \$64,000 and \$87,000, respectively, and the TIF Bond Collateral Account had a balance of approximately \$3,987,000 and \$4,069,000, respectively.

Marketable Securities

The Company classifies its marketable securities as trading securities in accordance with the provisions of Statement of Financial Accounting Standard 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 in the consolidated statements of operations.

Tenant Accounts Receivable

Management regularly reviews accounts receivable and estimates the necessary amounts to be recorded as an allowance for uncollectability. 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.

At December 31, 2008 and 2007, total tenant accounts receivable include balances greater than 90 days totaling \$678,000 and \$225,000, respectively, and are reflected net of reserves of \$626,000 and \$352,000, respectively. The provision for doubtful accounts was \$354,000 and \$280,000 for the years ended December 31, 2008 and 2007, respectively. This charge is included in the line item entitled "Other Operating" in the consolidated statements of operations.

Discontinued Operations

In accordance with Statement of Financial Accounting Standards, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), assets held for sale are valued at the lower of carrying value or fair value less costs to dispose. SFAS 144 requires that the results of operations and gain/(loss) on real estate properties sold or held for sale be reflected in the consolidated statements of operations as "Income/Loss from Discontinued Operations" for all periods presented. As of December 31, 2008, no assets were classified as held for sale. Results of operations from vacant land parcels in Michigan sold in January 2007 and the outlet center located in Gretna, Nebraska sold in June 2007 are included in the 2007 discontinued operations line items on the statements of operations.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Deferred Costs

Deferred leasing costs consist of fees and direct internal costs incurred to initiate and renew operating leases, as well as allocated purchase price related to above market lease values, 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's financial instruments consist of cash and cash equivalents, restricted cash, tenant and other receivables, notes payable, accounts payable and accrued expenses. Management believes that the carrying value of the Company's financial instruments approximate their respective fair market values at December 31, 2008 and 2007.

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 \$313,000 and \$176,000 as of December 31, 2008 and 2007, 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 income from management 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.

As of December 31, 2008 and 2007 and for the years then ended, the Company did not have a net liability for any unrecognized tax benefits. The Company recognizes interest and penalties, if any, related to unrecognized tax benefits as interest or general and administrative expense in the statement of operations. During 2008 and 2007, the Company did not incur any interest or penalties. The Company is not subject to examination by U.S. federal tax authorities for tax years before 2005.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Recent Financial Accounting Standards

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 157, “Fair Value Measurements” (“SFAS 157”). SFAS 157 is definitional and disclosure oriented and addresses how companies should approach measuring fair value when required by GAAP; it does not create or modify any current GAAP requirements to apply fair value accounting. The Standard provides a single definition for fair value that is to be applied consistently for all accounting applications, and also generally describes and prioritizes according to reliability the methods and inputs used in valuations. SFAS 157 prescribes various disclosures about financial statement categories and amounts which are measured at fair value, if such disclosures are not already specified elsewhere in GAAP. The new measurement and disclosure requirements of SFAS 157 are effective January 1, 2008, except as it relates to certain nonfinancial assets and liabilities for which the effective date will be first quarter of 2009. The various inputs that may be used to determine the fair value of the Company’s assets are summarized in three broad levels:

- Level 1 – Quoted prices in active markets for identical securities
- Level 2 – Other significant observable inputs (including quoted prices for similar securities, interest rates, credit risk, etc.)
- Level 3 – Significant unobservable inputs (including the Company’s own assumptions used to determine value)

At December 31, 2008, the Company held marketable securities that total approximately \$10,174,000 and are considered to have Level 1 fair value inputs. The Company did not hold any Level 3 assets during the year.

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 141 (revised 2007), “Business Combinations” (“SFAS 141(R)”). SFAS 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008, and will be adopted by the Company in the first quarter of fiscal 2009. The Company will account for acquisitions subsequent to December 31, 2008, if any, in accordance with SFAS 141(R).

In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160 “Noncontrolling Interests in Consolidated Financial Statements” (“SFAS 160”). SFAS 160 will require noncontrolling interests (previously referred to as minority interests) to be treated as a separate component of equity, not as a liability or other item outside of permanent equity. In addition, the statement applies to the accounting for noncontrolling interests and transactions with noncontrolling interest holders in consolidated financial statements. SFAS 160 is effective for periods beginning on or after December 15, 2008. The Company is currently evaluating the effect of SFAS 160 on the consolidated financial statements.

Legal Proceedings

In the ordinary course of business the Company is subject to certain legal actions. While any litigation contains an element of uncertainty, management believes the losses, if any, resulting from such matters will not have a material adverse effect on the consolidated financial statements of the Company.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 3- Investment in Joint Ventures

El Portal Entities

As of December 31, 2008, the Company owned a 60.8% interest in Horizon El Portal, an entity of which HGP LP is the managing member and of which the remaining 39.2% is owned by Gary Skoien and Pleasant Lake Apts. Limited Partnership (“PLA”), an affiliate of Amster. Horizon El Portal owns 62.5% of El Portal Center, a joint venture that owns a shopping center in Laredo, Texas containing approximately 345,000 square feet of GLA (See Note 1). Through the third quarter of 2008, Horizon El Portal reported the results of operations and the assets and liabilities of El Portal Center using the equity method of accounting.

On September 26, 2008, Horizon El Portal purchased a 12.5% interest in El Portal Center from its joint venture partner for \$375,000. HGP LP made a capital contribution to Horizon El Portal to acquire the interest and increased its ownership in that entity to 60.8%. The Company also acquired an option to purchase the remaining 37.5% interest in El Portal Center for \$2,125,000 from the joint venture partner at any time prior to September 26, 2010. Horizon El Portal acts as sole manager of El Portal Center with full authority with respect to the activities of the venture, excluding the authority to amend the operating agreement and enter into agreements with affiliates of Horizon. Horizon El Portal has the obligation to advance, as loans to El Portal Center bearing interest at a rate of 15.0%, all reasonably necessary funds. The Company has agreed to fund 75.5% of such amounts. In the event that Horizon does not exercise the purchase option, the property will be marketed for sale and each joint venture partner will have the obligation to fund its proportionate share of any required funds, also as loans to El Portal Center bearing interest at a rate of 15.0%.

The Company began consolidating the results of operations and the assets and liabilities of El Portal Center in the fourth quarter of 2008. The Company consolidates the results of operations and the assets and liabilities of Horizon El Portal.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Summary financial information (stated at 100%) of the El Portal Center joint venture as of December 31, 2007 and for the nine months ended September 30, 2008 and for the year ended December 31, 2007 are as follows (in thousands):

	As of
	<u>December 31, 2007</u>
Assets	
Real estate	\$11,700
Other assets	<u>287</u>
Total assets	<u>\$11,987</u>
Liabilities and members' capital	
Mortgages and other debt	\$ 6,700
Other liabilities	195
Members' capital	<u>5,092</u>
Total liabilities and members' capital	<u>\$11,987</u>

	Nine Months	Year Ended
	Ended	December 31, 2007
	<u>September 30, 2008</u>	<u>December 31, 2007</u>
Statements of Operations		
Revenue	<u>\$ 375</u>	<u>\$ 563</u>
Operating expenses	567	932
Depreciation and amortization expense	54	73
General and administrative expenses	24	7
Interest expense	<u>466</u>	<u>697</u>
Total expenses	<u>1,111</u>	<u>1,709</u>
Net loss	<u>\$ (736)</u>	<u>\$ (1,146)</u>

The shopping center owned by El Portal Center secures a loan from Cathay Bank which had a principal balance of \$6.7 million at December 31, 2008 and 2007, bears interest at Prime plus 1.0% (with a minimum rate of 7.5%) and matured on March 1, 2009. The Company is currently negotiating with Cathay Bank for two six month extensions of the loan on the same terms, with a principal payment of \$250,000 in connection with each extension. HGPI has guaranteed 50% of the principal and interest due on the loan from Cathay Bank.

The Company received management fees pursuant to a management agreement that totaled \$10,900 and \$19,600 during the nine months ended September 30, 2008 and the year ended December 31, 2007, while El Portal Center was accounted for using the equity method.

El Paso Entities

The Company owns 88.2% of the preferred interests and 80.7% of the common interests in Horizon El Paso, which owns 50% of El Paso Center, a joint venture that developed an outlet shopping center in El Paso, Texas, which opened on October 11, 2007 containing approximately 380,000 square feet of GLA. El Paso Center also owns several outparcels adjacent to the shopping center. From inception through August 31, 2006, Horizon El Paso used the equity method to account for its investment

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

in El Paso Center. From September 1, 2006 through November 30, 2007, Horizon El Paso consolidated the results of operations and the assets and liabilities of El Paso Center. Effective December 1, 2007 Horizon El Paso again began using the equity method to account for its investment in El Paso Center (See Note 1).

Horizon El Paso also owns a 50% interest in TOSEP Land Company, LLC (“TOSEP”), an entity that owns approximately 45 acres of undeveloped land adjacent to the outlet center (See Note 1).

Summary financial information (stated at 100%) of El Paso Center and TOSEP as of December 31, 2008 and for the year ended December 31, 2008 and the one month ended December 31, 2007 is as follows (in thousands):

	<u>As of</u> <u>December 31, 2008</u>	<u>As of</u> <u>December 31, 2007</u>
Assets		
Real estate	\$58,241	\$58,440
Cash and cash equivalents	3,022	495
Restricted cash	3,970	16,027
Other assets	<u>5,513</u>	<u>2,289</u>
Total assets	<u>\$70,746</u>	<u>\$77,251</u>
Liabilities and members' deficit		
Mortgages and other debt	\$78,882	\$79,500
Other liabilities	3,362	5,729
Members' deficit	<u>(11,498)</u>	<u>(7,978)</u>
Total liabilities and members' deficit	<u>\$70,746</u>	<u>\$77,251</u>
	<u>Year Ended</u> <u>December 31, 2008</u>	<u>Month Ended</u> <u>December 31, 2007</u>
Statement of Operations		
Revenue	<u>\$12,764</u>	<u>\$ 1,139</u>
Operating expenses	4,188	273
Depreciation and amortization expense	2,791	-
General and administrative expenses	859	91
Interest expense	<u>6,667</u>	<u>515</u>
Total expenses	<u>14,505</u>	<u>879</u>
Gain on sale of real estate	<u>320</u>	<u>-</u>
Net income/(loss)	<u>\$ (1,421)</u>	<u>\$ 260</u>

The shopping center owned by El Paso Center secures a loan originated by NATIXIS Commercial Mortgage Funding, LLC which had a principal balance of \$69.4 million and \$70.0 million at December 31, 2008 and 2007, respectively, bears interest at 7.06%, requires principal payments over a 30-year amortization schedule and is due December 5, 2017. In November 2007, Dominion Capital Asset Company A, LLC made a preferred equity investment in El Paso Center in the amount of \$9.5 million, bearing interest at 15.0% and due October 27, 2010. The preferred equity investment is classified as debt on the balance sheet of El Paso Center.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company received management and similar fees pursuant to a management agreement that totaled \$932,000 and \$86,000 during the year ended December 31, 2008 and the one month ended December 31, 2007, while El Paso Center was accounted for using the equity method.

In November 2007, El Paso Center distributed approximately 45 acres of undeveloped land with a carrying value of \$1.9 million to its members which then contributed that land to TOSEP. In September 2008, El Paso Center distributed site improvements with a carrying value of approximately \$1.7 million to its members, which then contributed them to TOSEP.

In September 2008, El Paso Center sold an out parcel, comprised of approximately one acre of unimproved land, for \$600,000. A gain of approximately \$320,000 was recognized on the transaction.

Note 4 – Income Taxes

HGPI is taxable as a corporation under the provisions of Subchapter C of the Internal Revenue Code.

The net provision for income taxes after the change in the valuation reserve for the years ended December 31, 2008 and 2007 consisted of the following (in thousands):

	<u>2008</u>	<u>2007</u>
Federal	\$ -	\$ -
State	<u>-</u>	<u>-</u>
Net provision/(benefit)	<u>\$ -</u>	<u>\$ -</u>

For federal income tax purposes, HGPI had net operating loss carryforwards (“NOLs”) of approximately \$55.9 million and \$60.5 million at December 31, 2008 and 2007, respectively, and accumulated capital loss carryforwards of approximately \$1.5 million and \$43.1 million at December 31, 2008 and 2007, respectively. The NOLs expire from 2019 to 2028 and the accumulated capital loss carryforward expires in 2012. Capital loss carryforwards of \$41.6 million expired in 2008.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Deferred income tax liabilities and assets are determined based on the differences between the financial statement and tax basis of assets and liabilities. The components of the Company's gross deferred tax assets and liabilities are as follows as of December 31, 2008 and 2007 (in thousands):

	<u>2008</u>	<u>2007</u>
Deferred Tax Assets:		
NOL carryforwards - federal and state	\$21,165	\$22,004
Capital loss carryforward	529	15,093
Tax basis of assets in excess of book basis:		
Fixed/intangible assets	1,479	1,048
Impairment	242	241
Other	129	105
Book basis of liabilities in excess of tax basis:		
Prepaid rental revenue	217	135
Profits interests	<u>555</u>	<u>628</u>
Gross deferred tax assets	24,316	39,254
Less: valuation allowance	<u>(23,134)</u>	<u>(36,246)</u>
	<u>1,182</u>	<u>3,008</u>
Deferred Tax Liabilities:		
Book basis of assets in excess of tax basis:		
Fixed/intangible assets	(142)	(39)
Other	<u>(1,040)</u>	<u>(2,969)</u>
Gross deferred tax liabilities	<u>(1,182)</u>	<u>(3,008)</u>
Net deferred tax asset	<u>\$ -</u>	<u>\$ -</u>

The valuation allowance related to the net deferred tax asset decreased by \$13,112,000 and \$480,000 for the years ended December 31, 2008 and 2007, respectively.

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):

2009	\$11,443
2010	9,230
2011	5,029
2012	3,767
2013	3,101
Thereafter	<u>16,206</u>
	<u>\$48,776</u>

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Note 6 - Long Term Stock Incentive Plan and Grants of Common Units

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 170,500 shares were outstanding at December 31, 2008.

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

The HGP Stock Plan provided for the issuance of shares over the ten-year period ended June 15, 2008. Accordingly, as of December 31, 2008, no additional equity awards may be made pursuant to the HGP Stock Plan.

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

	<u>For the Year Ended December 31, 2008</u>		<u>For the Year Ended December 31, 2007</u>	
	<u>Shares</u>	<u>Price</u>	<u>Shares</u>	<u>Price</u>
Outstanding, beginning of the year	323,500	\$3.40 - \$6.49	323,500	\$3.40 - \$6.49
Granted	-	-	-	-
Exercised	-	-	-	-
Expired	<u>(153,000)</u>	\$6.49	<u>-</u>	-
Outstanding, end of the year	<u>170,500</u>	\$3.40 - \$5.04	<u>323,500</u>	\$3.40 - \$6.49

The weighted average exercise price for options outstanding was \$3.89 and \$5.12 at December 31, 2008 and 2007, respectively. The weighted average contractual life of options outstanding at December 31, 2008 and 2007 was 1.74 years and 1.66 years, respectively. At December 31, 2008 and 2007 there were 170,500 and 323,500 options vested and exercisable, respectively.

The Company granted 48,769 shares of stock in HGPI to key employees in 2008 and 33,610 shares of stock in HGPI to board members and key employees in 2007, respectively, and recognized compensation expense based on the fair market value of the stock granted. Total compensation expense recognized related to these awards equaled \$292,000 and \$227,000 in 2008 and 2007, respectively.

HORIZON GROUP PROPERTIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 7 – Marketable Securities

The estimated fair values of securities held by the Company at December 31, 2008 and 2007 based on quoted market prices are as follows (in thousands):

	<u>Face Value</u>	<u>Cost</u>	<u>Fair Market Value</u>
Debt Securities:			
December 31, 2008:			
FNMA Note, 6.0%, maturing November 2036	\$ 9,600	\$ 9,258	\$ 7,568
FNMA Note, 6.0%, maturing November 2036	<u>3,200</u>	<u>2,625</u>	<u>2,606</u>
	<u>\$12,800</u>	<u>\$11,883</u>	<u>\$10,174</u>
December 31, 2007:			
FNMA Note, 6.0%, maturing November 2036	\$ 9,600	\$ 9,258	\$ 8,653
FHLD Note, 4.3%, maturing January 2008	<u>1,600</u>	<u>1,550</u>	<u>1,600</u>
	<u>\$11,200</u>	<u>\$10,808</u>	<u>\$10,253</u>

These securities serve as collateral under repurchase agreements as disclosed in Note 9.

Note 8 – Commitments

The Company has outstanding commitments for capital expenditures on leases signed (which amounts become payable when the spaces are delivered to the tenants) at December 31, 2008 in the amount of \$4.8 million for tenant allowances and \$287,000 for other capital expenditures and construction costs, which are not reflected on the consolidated balance sheet as of December 31, 2008 (See Note 11). These costs are expected to be paid during 2009 and 2010 and are anticipated to be funded from capital improvement escrow accounts (See Note 2), construction financing, equity contributions and additional borrowings.

Note 9 – Mortgages and Other Debt

	Principal Balance as of:	
	<u>December 31,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>
	<i>(in thousands)</i>	
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, secured by the corporate office building in Muskegon, Michigan and indemnified against certain losses by Gary Skoien (See Note 10)	\$2,119	\$2,147

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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	744	950
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 7.875%, due November 17, 2009, secured by the shopping center in Huntley, Illinois and guaranteed by the Company	2,806	2,847
Repurchase agreement between Magnolia Bluff Factory Shops LP, as borrower, and Wachovia Securities, LLC, as lender, dated December 18, 2008, in the original principal amount of \$7.1 million, bearing interest at a rate of 1.82%, due on January 6, 2009 and secured by a pledge of FNMA Notes having a face value of \$9.6 million as of December 31, 2008, a repurchase agreement dated December 18, 2008, in the original principal amount of \$2.4 million, bearing interest at a rate of 1.82%, due on January 6, 2009 and secured by a pledge of FNMA Notes having a face value of \$3.2 million as of December 31, 2008, a repurchase agreement dated December 28, 2007, in the original principal amount of \$8.2 million, bearing interest at a rate of 4.82%, due on January 28, 2008 and secured by a pledge of FNMA Notes having a face value of \$9.6 million as of December 31, 2007, and a repurchase agreement dated December 18, 2007, in the original principal amount of \$1.55 million, bearing interest at a rate of 4.75%, due on January 4, 2008 and secured by a pledge of FNMA Notes having a face value of \$1.6 million as of December 31, 2007. In the normal course of business these notes are repurchased at maturity. This debt is guaranteed by HGP LP, Amster and Gary Skoien.	9,472	9,760
Mortgage loan to HGP LP, as substituted borrower, from First Bank of Beverly Hills, as lender, dated as of July 25, 2006, in the original principal amount of \$5.1 million, bearing interest at 9.5%, due on August 1, 2009 and secured by approximately 46 (100 at December 31, 2007) acres of vacant land in Fruitport Township, Michigan. Initial loan funding of \$3.8 million with \$1.3 million available to be drawn to pay interest on the loan. This loan and the land securing it were transferred from Monroe Outlet Center, LLC to HGP LP on April 30, 2007 (See below)	250	3,707

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Mortgage loan to Gettysburg Outlet Center, LP, as assuming borrower, from Column Financial, Inc., as lender, in the original principal amount of \$43.75 million, bearing interest at 5.87%, due February 11, 2016, secured by The Outlet Shoppes at Gettysburg and subject to certain debt service coverage ratios	42,698	43,236
Mezzanine loan to Gettysburg Outlet Center Holding, LLC, as borrower, from CW Capital LLC, as lender, in the original principal amount of \$6.0 million, bearing interest at an initial rate of LIBOR plus 4.5%, increasing to LIBOR plus 9.5% upon the fourth anniversary of the loan, due February 11, 2016, secured by pledges of the ownership interests in Gettysburg Outlet Center GP, Inc. and Gettysburg Outlet Center, LP, and a first mortgage on approximately 37 acres of vacant land. The loan is recourse to the Company which has also guaranteed the payment of interest on the loan and \$2.8 million of the loan principal and is subject to certain debt coverage ratios. By the fourth anniversary of the loan, a deposit of \$2.8 million is required as collateral for such guaranty.	6,000	6,000
Mortgage loan to BFO Factory Shoppes LLC, as assuming borrower, from Wachovia Bank, National Association, as lender, in the original principal amount of \$54.0 million, bearing interest at 5.58%, due January 11, 2016 and secured by The Outlet Shoppes at Burlington, The Outlet Shoppes at Fremont, and The Outlet Shoppes at Oshkosh	51,925	52,668
Mortgage loan to Huntley Development Limited Partnership, as borrower, from US Bank, as lender, in the maximum principal amount of \$23.4 million, bearing interest at LIBOR plus 3.0%, due September 30, 2009, secured by approximately 379 acres of vacant land in Huntley, Illinois and Holland Town Center in Holland, Michigan and guaranteed by the Company (See below)	22,219	20,906
Loan to HGP LP, as borrower, from Prime Retail, L.P., as lender, dated August 15, 2007, in the original principal amount of \$928,000, bearing interest at 12.0%, due August 15, 2009 and guaranteed by HGPI	334	788
Mortgage loan to El Portal Center LLC, as borrower, from Cathay Bank, as lender, in the original principal amount of \$6.7 million, bearing interest at Prime plus 1.0% with a 7.5% floor, due March 1, 2009, secured by El Portal Center and guaranteed to 50% of principal and interest due by HGPI	6,700	-
	<u>\$145,267</u>	<u>\$143,009</u>

In 2008 and 2007, the Company acquired a portfolio of marketable securities (as defined in Note 2 and listed in Note 7) with the proceeds from repurchase agreements and partner contributions. The margin account repurchase agreements are included in Mortgages and Other Debt on the consolidated balance sheets. These notes are expected to be repurchased at maturity in the normal course of business.

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In July 2008, the Company sold approximately 53 acres of unimproved land in Muskegon, Michigan for \$4.0 million. The net proceeds of approximately \$3.7 million were used to pay down the principal balance of the mortgage loan from First Bank of Beverly Hills. A gain of approximately \$2,853,000 before minority interests was recognized on the transaction.

In March 2007, the Company entered into a loan agreement with US Bank (the "US Bank Loan") secured by approximately 379 acres of vacant land owned by the Company in Huntley, Illinois (See Note 1 and below). The agreement provides for advances not to exceed the lesser of \$23.4 million or 65% of the appraised value of the mortgaged land, bears interest at the rate of LIBOR plus 3.0% and matures on September 30, 2009, with an option to extend the loan for one year subject to the satisfaction of certain conditions, including the repayment of at least \$10.0 million of the principal of the loan. The Company entered into a guaranty in connection with the US Bank Loan, which contains a covenant that required the Company to maintain net worth of at least \$35.0 million and liquidity of \$5.0 million (each of which to be reasonably determined by US Bank).

In December 2008, the Company amended the note and other loan documents related to the US Bank Loan to provide for the current payment of interest starting with the payment due February 1, 2009. The interest had previously been paid from an interest reserve established at the closing of the loan. The amendment also reduced the net worth covenant contained in the guaranty executed by the Company to \$25.0 million. The Company also granted US Bank a mortgage on the outlet center in Holland, Michigan, 48.9% of which is owned by an affiliate of Amster, and agreed to apply 51.1% of any sales proceeds from the Holland property as repayment of the US Bank Loan. The amendment also revised the option to extend the maturity of the loan to September 30, 2010 to provide that the required \$10.0 million principal payoff due on or before September 30, 2009 will be reduced by any interest payments made by the Company and any proceeds from the sale of the Holland property. The Company agreed to indemnify Amster's affiliate for losses arising from the sale of the Holland property, but only if the property is sold pursuant to a judicial foreclosure sale. The indemnification obligation is limited to the affiliate's ownership share in Holland multiplied by the difference, if any, between \$3.8 million and the net amount received from such sale.

At December 31, 2008, the outstanding principal balance of the US Bank Loan was \$22.2 million and the undisbursed loan proceeds were designated solely for the payment of interest due through February 1, 2009.

Cash interest payments, including amounts paid on loans associated with properties classified as discontinued operations, for the years ended December 31, 2008 and 2007, totaled \$6,924,000 and \$3,571,000, respectively. Interest advanced on loans and reserve accounts associated with loans totaled \$1,553,000 and \$4,339,000 for the years ended December 31, 2008 and 2007, respectively. The Company capitalized interest totaling \$182,000 and \$1,258,000 for the years ended December 31, 2008 and 2007, respectively.

Huntley Net Profits Interests and TIF Bonds

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 profits generated by the Huntley Project (See Note 1), which obligation the Company assumed in connection with the purchase of the Huntley Project from Prime Group (See Note 1). The Skoien Net Profits Interest consists of a 9.675% participation in the Net

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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 Project plus interest per the terms of the agreement). The Company has recorded a liability for the Skoien Net Profits Interest in the amount of \$2.3 million and \$2.6 million as of December 31, 2008 and 2007, respectively, which represents its estimated fair value as of such dates and which amount is included in Participation Interests and Other Liabilities on the Company's consolidated balance sheets. The change in estimated fair value of the Skoien Net Profits Interest is reflected as a reduction of interest expense in 2008 in the consolidated statement of operations. No such changes occurred in 2007.

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 Project (the "Prime Group Participation Interest") as additional consideration for the purchase of the Huntley Project 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 Project. 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 Project plus a 40% return on such amounts, compounded quarterly. Aggregate 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 Huntley Development Limited Partnership ("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 currently or previously owned by HDLP or Huntley Meadows Residential Venture. 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) reserves established at the time of issuance of the TIF Bonds (the "Initial TIF Reserves"). To the extent the Initial TIF Reserves are not needed to service the bonds, they will be returned to HDLP. The Initial TIF Reserves are held in interest bearing accounts under the control of the TIF Bond trustee and totaled approximately \$1.9 million and \$2.0 million at December 31, 2008 and 2007, respectively. There can be no assurance that the Initial TIF Reserves will be returned to HDLP and, therefore, they are not reflected on the consolidated 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 consolidated 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 on certain land in the TIF District. As of December 31, 2008 and 2007, the mortgage covers approximately 17 acres of land owned by HDLP (the "TIF Bond Mortgage"). Upon the sale of land subject to the TIF Bond Mortgage, such land will be released from the TIF Bond Mortgage provided that HDLP deposits into a collateral account (the "TIF Bond 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 TIF Bond Collateral

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Account are released to HDLP upon the issuance of a certificate of occupancy for the subject land parcel. The balance in the TIF Bond Collateral Account was approximately \$4.0 million and \$4.1 million at December 31, 2008 and 2007, respectively. Based on management's review of the projected 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. Thus, no liability has been recognized related to TIF Bond Mortgage and the funds held in the TIF Bond Collateral Account are included in Restricted Cash on the Company's consolidated balance sheets.

Debt Maturities

Debt maturities and principal payments due subsequent to December 31, 2008 are as follows (in thousands):

<u>Due in:</u>	
2009	\$ 43,408
2010	1,762
2011	5,898
2012	1,733
2013	3,752
Thereafter	<u>88,714</u>
	<u>\$145,267</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 2009 in the normal course of business. In the event that the Company lacks the funds required to make the principal payment required to extend the US Bank Loan, the Company expects to negotiate with US Bank with respect to a modification of the maturity date and other loan terms.

Note 10 - Related Party Transactions

Howard Amster ("Amster") is a director and significant stockholder of HGPI. At December 31, 2008, an affiliate of Amster owns approximately 44% of an entity that owns a portfolio of marketable securities and 49% of the entities that own the office building in Norton Shores, Michigan and a shopping center. His affiliate also owns 39.2% of Horizon El Portal LLC and 5.9% of the preferred and common interests in Horizon El Paso, LLC. In connection with his ownership, Amster's affiliate entered into an agreement to reimburse the Company for a portion of the general and administrative expenses related to the operation of the entities that he owns. Certain expenses related to the general operation of the Company are not subject to the reimbursement agreement. The Company recognized income and a corresponding receivable related to this arrangement of \$2,800 and \$550,000 during the years ended December 31, 2008 and 2007, respectively. Starting July 1, 2007 the fee payable by Amster's affiliate was reduced to \$700 per quarter reflecting the sale of the majority of the jointly owned entities. Included in Other Assets on the consolidated balance sheets at December 31, 2008 and 2007 is an unsecured note receivable from Amster which has a balance of \$1.42 million and bears interest at 5.0%. Included in Tenant and Other Accounts Receivable, Net on the consolidated balance sheets is \$407,000 and \$1.8 million at December 31, 2008 and 2007, respectively, due from Amster for the Company's pro rata share of the net assets of the entities sold to Amster in November 2006 and June 2007.

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Mr. Skoien owns 9.8% of Horizon El Portal LLC, 5.3% of an entity that owns a portfolio of marketable securities and 5.9% of the preferred interests and 7.2% of the common interests in Horizon El Paso, LLC.

Common interests in Horizon El Paso (the "El Paso Net Profits Interests") were granted in May 2007 to certain officers of the Company, Mr. Skoien, Thomas Rumpitz and Andrew Pelmoter, representing 1.3%, 2.6% and 3.5%, respectively, of the total common interests in Horizon El Paso, LLC. Holders of the El Paso Net Profits Interests are not entitled to any distributions until the holders of the preferred interests have received a return of their capital plus interest thereon calculated at an annual rate of 12%, compounded quarterly. The El Paso Net Profits Interests are accounted for as a profit sharing arrangement with compensation expense being recognized for payments related to such interests. The Company recognized compensation expense for the El Paso Net Profits Interests of \$328,000 during the year ended December 31, 2007. There was no similar expense for 2008.

Certain loans of the Company require an officer of the Company to be personally liable for losses suffered by the lender for environmental damages and certain actions prohibited under the loan documents. Mr. Skoien personally indemnified certain lenders for such losses and damages. The Company agreed to indemnify Mr. Skoien for any amounts paid under the indemnifications and to pay Mr. Skoien total annual fees of \$50,000 (\$44,475 for annual periods after August 19, 2008) related to such indemnifications until such loans are repaid (or Mr. Skoien is otherwise released from the indemnification obligations).

The Company utilizes entities affiliated with a Director of the Company as its agent for insurance and risk management programs. The Company paid premiums totaling approximately \$462,000 and \$604,000 during the years ended December 31, 2008 and 2007, respectively, on insurance policies placed by these entities.

Note 11 – Recent Developments

In January 2007, the Company sold a one-acre parcel of land located in Fruitport Township, Michigan for \$506,000. Approximately \$437,000 of the proceeds was used to partially repay the mortgage loan from First Bank of Beverly Hills. A gain of approximately \$446,000, before minority interests of \$139,000, was recognized on the transaction.

The Company sold the 191,500 square foot outlet shopping center located in Gretna, Nebraska in June 2007. The gross sales price was \$3.85 million. The Company owned approximately 51% and an affiliate of Amster owned approximately 49% of the entity that owned the center. A gain of approximately \$325,000, before minority interests of \$213,000, was recognized on the transaction.

In June 2007, the Company sold its ownership interest in the entity that formerly owned the outlet center located in Monroe, Michigan. This interest was sold to an affiliate of Amster for \$631,000, its net book value, pursuant to the terms of an agreement entered into in 2003 in which the Company had agreed to sell the entity to Amster after the entity had sold its real estate assets. A gain of approximately \$106,000, before minority interests of \$33,000, was recognized in connection with this sale transaction.

The Company acquired the entity that owns an outlet shopping center located in Gettysburg, Pennsylvania on July 18, 2007. The center contains a total of approximately 252,000 square feet of retail space, a 35,000 square foot movie theater and ground leases to the Carlson Country Inn and TGI Friday's. The contract price was \$61.0 million, subject to customary prorations. A deposit of \$2.0 million was paid

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during calendar year 2006. The center is subject to existing debt which had a principal balance of \$43.5 million as of the date of closing which was assumed by the Company. The Company has also obtained a \$6.0 million mezzanine loan in connection with the acquisition.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed of the entity that owns the Gettysburg shopping center in addition to the mezzanine financing entered into at the date of acquisition.

	<i>(In thousands)</i>
Land	\$15,900
Buildings and improvements	43,729
Construction in progress	153
Restricted cash	884
Other assets	<u>2,411</u>
	<u>\$63,077</u>
Mortgages and other debt assumed	\$49,447
Accounts payable and other accrued expenses	183
Prepaid rents and other tenant liabilities	26
Cash paid (including 2006 payments)	<u>13,421</u>
	<u>\$63,077</u>

The amount shown above for Buildings and Improvements includes \$4,562,000 for tenant origination costs, representing the value of in-place leases at acquisition, and Other Assets includes \$2,222,000 for lease intangibles, representing the net above/below-market lease values at acquisition.

The Company acquired three outlet shopping centers located in Burlington, Washington; Fremont, Indiana; and Oshkosh, Wisconsin on August 9, 2007. The centers contain a total of approximately 674,000 square feet of retail space. The price was \$59.1 million, subject to customary prorations. The centers are subject to existing debt of \$53.0 million as of the date of closing which was assumed by the Company.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed by the Company in connection with the acquisition of the shopping centers in Washington, Indiana and Wisconsin at the date of acquisition.

	<i>(In thousands)</i>
Land	\$ 9,300
Buildings and improvements	50,125
Restricted cash	1,922
Deferred costs	<u>322</u>
	<u>\$61,669</u>
Mortgages and other debt assumed	\$53,834
Accounts payable and other accrued expenses	1,552
Prepaid rents and other tenant liabilities	13
Cash paid	<u>6,270</u>
	<u>\$61,669</u>

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The amount shown above for Buildings and Improvements includes \$9,159,000 for tenant origination costs, representing the value of in-place leases at acquisition, and Deferred Costs includes \$109,000 for lease intangibles, representing the net above/below-market values at acquisition.

The results of operations of these four properties have been included from the dates of their acquisitions forward. The Company acquired these properties in an effort to enhance the value and size of its portfolio by capitalizing on their occupancy levels, tenant rosters, and the opportunity to expand the centers.

On April 21, 2008, the Company purchased 65,860 shares of Horizon Group Properties, Inc. stock from a stockholder for \$4.55 per share. After acquisition, the shares were retired.

In July 2008, the Company sold approximately 53 acres of unimproved land in Muskegon, Michigan for \$4.0 million. The net proceeds of approximately \$3.7 million were used to pay down the principal balance of the mortgage loan from First Bank of Beverly Hills. A gain of approximately \$2,853,000, before minority interests of \$887,000, was recognized on the transaction.

On July 8, 2008, the Company formed Winding Brook Center, LLC, a joint venture for the development of an outlet center in Richmond, VA. The Company's partner will contribute land and the Company will contribute cash in an amount equal to the land value, when and as needed for the construction of the center. At December 31, 2008, the Company had incurred pre-development costs of \$588,000 for this project which are classified in Other Assets on the balance sheet (See Note 2) and had outstanding commitments for capital expenditures on leases signed (which amounts become payable when the spaces are delivered to the tenants) in the amount of \$615,000 and \$142,000 for other capital expenditures and construction costs (See Note 8).

On September 26, 2008, Horizon El Portal purchased a 12.5% interest in El Portal Center from its joint venture partner for \$375,000. HGP LP made a capital contribution to Horizon El Paso to acquire the interest and increased its ownership in that entity to 60.8%. The Company also acquired an option to purchase the remaining 37.5% interest in El Portal Center for \$2,125,000 from the joint venture partner at any time prior to September 26, 2010. Horizon El Portal acts as sole manager of El Portal Center with full authority with respect to the activities of the venture, excluding the authority to amend the operating agreement and enter into agreements with affiliates of Horizon. Horizon El Portal has the obligation to advance, as loans to El Portal Center bearing interest at a rate of 15.0%, all reasonably necessary funds. The Company has agreed to fund 75.5% of such amounts. In the event that Horizon does not exercise the purchase option, the property will be marketed for sale and each joint venture partner will have the obligation to fund its proportionate share of any required funds as loans to El Portal Center bearing interest at a rate of 15.0%.

On November 18, 2008, the Company announced that it will form a joint venture with Cousins Properties, Inc. ("Cousins") to pursue the development of The Outlet Shoppes at Oklahoma City, a planned 341,400 square foot outlet shopping center in Oklahoma City, Oklahoma. The center is planned for the intersection of Interstate 40 and Council Road. Construction is scheduled to begin in early 2009 with a mid-2010 opening. The Company currently has an option on the land which expires on December 5, 2009. The Company is overseeing the development, management and leasing of the project. At December 31, 2008 and 2007, the Company had incurred pre-development costs of \$2,509,000 and \$861,000, respectively, for this project which are classified as Construction in Progress on the balance sheet (See Note 2) and had outstanding commitments for capital expenditures on leases signed (which

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amounts become payable when the spaces are delivered to the tenants) in the amount of \$4,000,000 and \$16,000 for other capital expenditures and construction costs (See Note 8).

Note 12 – Discontinued Operations

In accordance with SFAS 144, the results of operations and gain on real estate sold are reflected in the consolidated statements of operations as “Income from Discontinued Operations, net of minority interests”.

There were no assets classified as discontinued operations in 2008. The following table is a summary of the results of operations of the properties classified as discontinued operations for the year ended December 31, 2007.

	Year ended December 31, 2007 <i>(in thousands)</i>
Total revenue	<u>\$278</u>
Operating expenses	280
General and administrative expenses	(13)
Depreciation and amortization expense	68
Interest expense	<u>-</u>
Total expenses	<u>335</u>
Loss before minority interests and gain on sale of real estate	(57)
Minority interests	37
Gain on sale of real estate, net of minority interests	<u>492</u>
Income from discontinued operations, net of minority interests	<u>\$472</u>

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Chairman, President and
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STOCK TRADING

The Company's common stock trades in the
over the counter market under the symbol
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Horizon Group Properties

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