

Extra Space Storage Inc.
Form 10-Q
August 08, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **June 30, 2007**

or

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

For the transition period from _____ to _____.

Commission File Number: **001-32269**

EXTRA SPACE STORAGE INC.

(Exact name of registrant as specified in its charter)

Maryland

(State or other jurisdiction of incorporation or organization)

20-1076777

(I.R.S. Employer Identification No.)

**2795 East Cottonwood Parkway, Suite 400
Salt Lake City, Utah 84121**

(Address of principal executive offices)

Registrant's telephone number, including area code: **(801) 562-5556**

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The number of shares outstanding of the registrant's common stock, par value \$0.01 per share, as of July 31, 2007 was 64,837,892.

EXTRA SPACE STORAGE INC.
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STATEMENT ON FORWARD-LOOKING INFORMATION

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Certain information set forth in this report contains forward-looking statements within the meaning of the federal securities laws. Forward-looking statements include statements concerning our plans, objectives, goals, strategies, future events, future revenues or performance, capital expenditures, financing needs, plans or intentions relating to acquisitions and other information that is not historical information. In some cases, forward-looking statements can be identified by terminology such as believes, expects, estimates, may, will, should, anticipates, or the negative of such terms or other comparable terminology, or by discussions of strategy. We may also make additional forward-looking statements from time to time. All such subsequent forward-looking statements, whether written or oral, by us or on our behalf, are also expressly qualified by these cautionary statements.

All forward-looking statements, including without limitation, management's examination of historical operating trends and estimate of future earnings, are based upon our current expectations and various assumptions. Our expectations, beliefs and projections are expressed in good faith and we believe there is a reasonable basis for them, but there can be no assurance that management's expectations, beliefs and projections will result or be achieved. All forward-looking statements apply only as of the date made. We undertake no obligation to publicly update or revise forward-looking statements which may be made to reflect events or circumstances after the date made or to reflect the occurrence of unanticipated events.

There are a number of risks and uncertainties that could cause our actual results to differ materially from the forward-looking statements contained in or contemplated by this report. Any forward-looking statements should be considered in light of the risks referenced in Part II. Item 1A. Risk Factors below and in Part I. Item 1A. Risk Factors included in our most recent Annual Report on Form 10-K. Such factors include, but are not limited to:

- changes in general economic conditions and in the markets in which we operate;
- the effect of competition from new self-storage facilities or other storage alternatives, which could cause rents and occupancy rates to decline;
- potential liability for uninsured losses and environmental contamination;
- difficulties in our ability to evaluate, finance and integrate acquired and developed properties into our existing operations and to lease up those properties, which could adversely affect our profitability;
- the impact of the regulatory environment as well as national, state, and local laws and regulations including, without limitation, those governing real estate investment trusts, which could increase our expenses and reduce our cash available for distribution;
- difficulties in raising capital at reasonable rates, which could impede our ability to grow;
- delays in the development and construction process, which could adversely affect our profitability; and
- economic uncertainty due to the impact of war or terrorism, which could adversely affect our business plan.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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Extra Space Storage Inc.
Condensed Consolidated Balance Sheets
(in thousands, except share data)

	June 30, 2007 (unaudited)	December 31, 2006
Assets:		
Real estate assets:		
Net operating real estate assets	\$ 1,641,120	\$ 1,382,055
Real estate under development	35,906	35,336
Net real estate assets	1,677,026	1,417,391
Investments in real estate ventures	91,303	88,115
Cash and cash equivalents	45,790	70,801
Short-term investments	90,331	
Restricted cash	35,528	44,282
Receivables from related parties and affiliated real estate joint ventures	8,321	15,880
Other assets, net	35,640	33,356
Total assets	\$ 1,983,939	\$ 1,669,825
Liabilities, Minority Interests, and Stockholders Equity:		
Notes payable	\$ 875,730	\$ 828,584
Notes payable to trusts	119,590	119,590
Exchangeable senior notes	250,000	
Line of credit		
Derivative instrument associated with Preferred Operating Partnership units (Note 14)	15,268	
Accounts payable and accrued expenses	25,363	25,704
Other liabilities	22,960	17,234
Total liabilities	1,308,911	991,112
Commitments and contingencies		
Preferred Operating Partnership units, net of \$100,000 note receivable (Note 14)	6,465	
Minority interest in Operating Partnership	37,020	34,841
Other minority interests	277	317
Stockholders equity:		
Preferred stock, \$0.01 par value, 50,000,000 shares authorized, no shares issued or outstanding		
Common Stock, \$0.01 par value, 200,000,000 shares authorized, 64,833,425 and 64,167,098 shares issued and outstanding at June 30, 2007 and December 31, 2006, respectively	649	642
Paid-in capital	824,088	822,181
Accumulated deficit	(193,471)	(179,268)
Total stockholders equity	631,266	643,555
Total liabilities, Preferred Operating Partnership, minority interests, and stockholders equity	\$ 1,983,939	\$ 1,669,825

See accompanying notes to unaudited condensed consolidated financial statements.

Extra Space Storage Inc.
Condensed Consolidated Statements of Operations
(in thousands, except share data)
(unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Revenues:				
Property rental	\$ 48,392	\$ 42,020	\$ 94,623	\$ 81,195
Management and franchise fees	5,143	5,181	10,351	10,340
Tenant insurance	2,688	971	4,831	1,892
Development fees	182	175	237	225
Other income	145	184	284	249
Total revenues	56,550	48,531	110,326	93,901
Expenses:				
Property operations	17,352	15,248	34,248	29,990
Tenant insurance	1,217	589	2,190	1,222
Unrecovered development and acquisition costs	159	24	409	342
General and administrative	8,968	8,747	18,208	17,992
Depreciation and amortization	9,123	9,057	17,919	18,333
Total expenses	36,819	33,665	72,974	67,879
Income before interest, minority interests and equity in earnings of real estate ventures	19,731	14,866	37,352	26,022
Interest expense	(15,437)	(12,784)	(28,833)	(24,769)
Interest income	3,668	148	5,116	630
Minority interest - Operating Partnership	(515)	(225)	(899)	(279)
Minority interests - other	56		40	
Equity in earnings of real estate ventures	1,192	1,087	2,389	2,226
Net income	\$ 8,695	\$ 3,092	\$ 15,165	\$ 3,830
Net income per common share				
Basic	\$ 0.13	\$ 0.06	\$ 0.24	\$ 0.07
Diluted	\$ 0.13	\$ 0.06	\$ 0.23	\$ 0.07
Weighted average number of shares				
Basic	64,439,138	51,625,135	64,356,827	51,606,618
Diluted	69,248,845	55,991,088	69,214,313	55,983,086
Cash dividends paid per common share	\$ 0.23	\$ 0.23	\$ 0.46	\$ 0.46

See accompanying notes to unaudited condensed consolidated financial statements.

Extra Space Storage Inc.
Condensed Consolidated Statement of Stockholders Equity
(in thousands, except share data)
(unaudited)

	Common Stock Shares	Par Value	Paid-in Capital	Accumulated Deficit	Total Stockholders Equity
Balances at December 31, 2006	64,167,098	\$ 642	\$ 822,181	\$ (179,268)	\$ 643,555
Issuance of common stock upon the exercise of options	76,048	1	1,032		1,033
Restricted stock grants issued	90,529	1			1
Restricted stock grants cancelled	(600)				
Conversion of Contingent Conversion Shares to common stock	500,350	5			5
Compensation expense related to stock-based awards			875		875
Net income				15,165	15,165
Dividends paid on common stock at \$0.455 per share				(29,368)	(29,368)
Balances at June 30, 2007	64,833,425	\$ 649	\$ 824,088	\$ (193,471)	\$ 631,266

See accompanying notes to unaudited condensed consolidated financial statements.

Extra Space Storage Inc.
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Six months ended June 30,	
	2007	2006
Cash flows from operating activities:		
Net income	\$ 15,165	\$ 3,830
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	17,919	18,333
Amortization of deferred financing costs	1,560	1,546
Stock compensation expense	875	1,016
Income allocated to minority interests	859	279
Distributions from operations of real estate ventures in excess of earnings	2,332	2,280
Changes in operating assets and liabilities:		
Receivables from related parties	7,559	11,890
Other assets	3,353	5,349
Accounts payable and accrued expenses	(341)	(8,775)
Other liabilities	2,624	516
Net cash provided by operating activities	51,905	36,264
Cash flows from investing activities:		
Acquisition of real estate assets	(98,148)	(87,964)
Development and construction of real estate assets	(19,381)	(15,118)
Proceeds from sale of real estate assets		728
Investments in real estate ventures	(6,022)	(4,835)
Net purchases of short-term investments	(90,331)	
Change in restricted cash	8,754	(11)
Principal payments received on notes receivable		118
Purchase of equipment and fixtures	(501)	(768)
Net cash used in investing activities	(205,629)	(107,850)
Cash flows from financing activities:		
Proceeds from exchangeable senior notes	250,000	
Proceeds from notes payable, notes payable to trusts and line of credit	46,147	97,602
Principal payments on notes payable and line of credit	(30,137)	(24,598)
Deferred financing costs	(6,408)	(647)
Loan to Preferred Operating Partnership unit holder	(100,000)	
Redemption of Operating Partnership units held by minority interest	(775)	
Net proceeds from exercise of stock options	1,033	127
Dividends paid on common stock	(29,368)	(23,561)
Distributions to Operating Partnership units held by minority interest	(1,779)	(1,740)
Net cash provided by financing activities	128,713	47,183
Net decrease in cash and cash equivalents	(25,011)	(24,403)
Cash and cash equivalents, beginning of the period	70,801	28,653
Cash and cash equivalents, end of the period	\$ 45,790	\$ 4,250

	Six months ended June 30,	
	2007	2006
Supplemental schedule of cash flow information		
Interest paid, net of amounts capitalized	\$ 24,931	\$ 22,900
Supplemental schedule of noncash investing and financing activities:		
Acquisitions:		
Real estate assets	\$ 157,079	\$ 21,009
Notes payable	(31,010)	(7,926)
Notes receivable		(10,298)
Preferred Operating Partnership units	(121,733)	
Investment in real estate ventures	(502)	(2,785)
Minority interest in Operating Partnership	(3,834)	

See accompanying notes to unaudited condensed consolidated financial statements.

Extra Space Storage Inc.

Notes to Condensed Consolidated Financial Statements (unaudited)

Amounts in thousands, except share data

1. ORGANIZATION

Extra Space Storage Inc. (the Company) is a fully-integrated, self-administered and self-managed real estate investment trust (REIT), formed as a Maryland corporation on April 30, 2004 to own, operate, manage, acquire and develop self-storage facilities located throughout the United States. The Company continues the business of Extra Space Storage LLC and its subsidiaries, which had engaged in the self-storage business since 1977. The Company's interest in its properties is held through its operating partnership, Extra Space Storage LP (the Operating Partnership), which was formed on May 5, 2004. The Company's primary assets are general partner and limited partner interests in the Operating Partnership. This structure is commonly referred to as an umbrella partnership REIT, or UPREIT. The Company has elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended. To the extent the Company continues to qualify as a REIT, it will not be subject to tax, with certain limited exceptions, on the taxable income that is distributed to its stockholders.

The Company invests in self-storage facilities by acquiring or developing wholly-owned facilities or facilities held through joint ventures with third parties. At June 30, 2007, the Company had direct and indirect equity interests in 585 storage facilities located in 33 states and Washington, D.C.

The Company operates in two distinct segments: (1) property management, acquisition and development; and (2) rental operations. The Company's property management, acquisition and development activities include managing, acquiring, developing and selling self-storage facilities. The rental operations activities include rental operations of self-storage facilities. No single tenant accounts for more than 5% of rental income.

2. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2007 are not necessarily indicative of results that may be expected for the year ending December 31, 2007. The Condensed Consolidated Balance Sheet as of December 31, 2006 has been derived from the Company's audited financial statements as of that date, but does not include all of the information and footnotes required by GAAP for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006 as filed with the Securities and Exchange Commission (SEC).

Certain amounts in the 2006 financial statements and supporting note disclosures have been reclassified to conform to the current year presentation. Such reclassification did not impact previously reported net income or accumulated deficit.

Recently Issued Accounting Standards

Emerging Issues Task Force (EITF) Topic D-109, *Determining the Nature of a Host Contract Related to a Hybrid Financial Instrument Issued in the Form of a Share under FASB Statement No. 133* (Topic D-109), discussed at the March 15, 2007 EITF meeting, is effective at the beginning of the first fiscal quarter beginning after June 15, 2007 (even if that period is other than the first fiscal quarter of the registrant's fiscal year). Topic D-109 provides the SEC staff's view as to how one must evaluate whether a preferred stock host contract is a debt host or an equity host. It states that the determination of the nature of the host contract for a hybrid financial instrument (that is, whether the nature of the host contract is more akin to debt or to equity) issued in the form of a share should be based on a consideration of economic characteristics and risks. The SEC staff believes that the consideration of the economic characteristics and risks of the host contract should be based on all the stated and implied substantive terms and features of the hybrid financial instrument. This may represent a change from the way these instruments were analyzed in the past.

The Company has elected to early adopt Topic D-109 which specifically relates to the AAAAA Rent-A-Space acquisition that was completed during the quarter ended June 30, 2007. See Note 14.

3. NET INCOME PER SHARE

Basic earnings per common share is computed by dividing net income by the weighted average common shares outstanding, less non-vested restricted stock. Diluted earnings per common share measures the performance of the Company over the reporting period while giving effect to all potential common shares that were dilutive and outstanding during the period. The denominator includes the number of additional common shares that would have been outstanding if the potential common shares that were dilutive had been issued and is calculated using either the treasury stock or if converted method. Potential common shares are securities (such as options, warrants, convertible debt, Contingent Conversion Shares (CCS), Contingent Conversion Units (CCU), exchangeable preferred Operating Partnership units and convertible Operating Partnership units) that do not have a current right to participate in earnings but could do so in the future by virtue of their option or conversion right. In computing the dilutive effect of convertible securities, net income or loss is adjusted to add back any changes in earnings in the period associated with the convertible security. The numerator also is adjusted for the effects of any other non-discretionary changes in income or loss that would result from the assumed conversion of those potential common shares. In computing diluted earnings per share, only potential common shares that are dilutive, those that reduce earnings per share, are included.

The Company has \$250.0 million of exchangeable senior notes issued and outstanding that also can potentially have a dilutive effect on its earnings per share calculations. The exchangeable senior notes are exchangeable by holders into shares of the Company's common stock under certain circumstances per the terms of the indenture governing the exchangeable senior notes. The exchangeable senior notes are not exchangeable unless the price of the Company's common stock is greater than or equal to 130% of the applicable exchange price for a specified period during a quarter, or unless certain other events occur. The exchange price was \$23.48 per share at June 30, 2007, and could change over time as described in the indenture. The price of the Company's common stock did not exceed 130% of the exchange price for the specified period of time during the second quarter of 2007, therefore holders of the exchangeable senior notes may not elect to convert them during the third quarter of 2007.

The Company has irrevocably agreed to pay only cash for the accreted principal amount of the exchangeable senior notes relative to its exchange obligations, but has retained the right to satisfy the exchange obligations in excess of the accreted principal amount in cash and/or common stock. Though the Company has retained that right, FAS 128, Earnings Per Share, requires an assumption that shares will be used to pay the exchange obligations in excess of the accreted principal amount, and requires that those shares be included in the Company's calculation of weighted average common shares outstanding for diluted earnings per share computation. No shares were included in the computation at June 30, 2007 because there was no excess over the accreted principal for the period.

For the purposes of computing the diluted impact on earnings per share of the potential conversion of Series A Participating Redeemable Preferred Operating Partnership units into common shares, where the Company has the option to redeem in cash or shares as discussed in Note 14 and where the Company has stated the positive intent and ability to settle at least \$115 million of the instrument in cash (or net settle a portion of the preferred Operating Partnership units against the related outstanding note receivable), only the amount of the instrument in excess of \$115 million is considered in the calculation of shares contingently issuable for the purposes of computing diluted earnings per share as allowed by paragraph 29 of FAS 128. As of June 30, 2007 only nine of the ten properties had closed. As such, \$106,465 (the pro rata portion of the \$115 million referenced above) was excluded from the calculation.

For the three months ended June 30, 2007 and 2006, options to purchase approximately 325,934 and 1,143,380 shares of common stock, and for the six months ended June 30, 2007 and 2006, options to purchase approximately 204,315 and 1,148,173 shares of common stock, respectively, were excluded from the computation of earnings per share as their effect would have been anti-dilutive.

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The computation of net income per share is as follows:

	Three months ended		Six months ended	
	June 30, 2007	2006	June 30, 2007	2006
Net income	\$ 8,695	\$ 3,092	\$ 15,165	\$ 3,830
Add:				
Income allocated to minority interest - Operating Partnership	515	225	899	279
Net income for diluted computations	\$ 9,210	\$ 3,317	\$ 16,064	\$ 4,109
Weighted average common shares outstanding:				
Average number of common shares outstanding - basic	64,439,138	51,625,135	64,356,827	51,606,618
Operating Partnership units	4,012,379	3,825,787	4,012,379	3,825,787
Preferred Operating Partnership units	49,949		25,113	
Dilutive stock options, restricted stock and CCS/CCU conversions	747,379	540,166	819,995	550,681
Average number of common shares outstanding - diluted	69,248,845	55,991,088	69,214,313	55,983,086
Net income per common share				
Basic	\$ 0.13	\$ 0.06	\$ 0.24	\$ 0.07
Diluted	\$ 0.13	\$ 0.06	\$ 0.23	\$ 0.07

4. REAL ESTATE ASSETS

The components of real estate assets are summarized as follows:

	June 30, 2007	December 31, 2006
Land	\$ 419,038	\$ 361,569
Buildings and improvements	1,296,813	1,085,269
Intangible assets - tenant relationships	29,937	25,436
Intangible lease rights	5,900	3,400
	1,751,688	1,475,674
Less: accumulated depreciation and amortization	(110,568)	(93,619)
Net operating real estate assets	1,641,120	1,382,055
Real estate under development	35,906	35,336
Net real estate assets	\$ 1,677,026	\$ 1,417,391

5. PROPERTY ACQUISITIONS

The following table shows the Company's acquisition of operating properties for the six months ended June 30, 2007 and does not include purchases of raw land or improvements made to existing assets:

Property Location(s)	Number of Properties	Date of Acquisition	Total Consideration	Cash Paid	Loan Assumed	Net Liabilities / (Assets) Assumed	Value of OPOP Units Issued	Number of Units Issued	Source of Acquisition	Notes
California	1	6/26/2007	\$ 11,216	\$ 196	\$ 2,822	\$ 1	\$ 8,197	61,398	Unrelated third party	(1)
California (6) & Hawaii (2)	8	6/25/2007	126,623	11,154		1,933	113,536	847,677	Unrelated third party	(1)
Georgia	3	6/14/2007	13,693	13,594		99			Unrelated franchisee	
California	1	6/14/2007	18,703	867	14,062	(60)	3,834	218,693	Unrelated third party	(2)
Maryland	1	6/6/2007	14,942	8,128	6,834	(20)			Unrelated third party	
California	1	6/1/2007	4,020	4,036		(16)			Unrelated third party	
Florida	1	5/31/2007	8,975	8,882		93			Unrelated third party	
California	1	5/24/2007	5,585	5,575		10			Unrelated third party	
Maryland	1	4/17/2007	12,670	5,428	7,292	(50)			Unrelated third party	
Florida	1	3/27/2007	6,320	6,257		63			Unrelated franchisee	
Maryland	1	1/11/2007	14,334	14,348		(14)				