

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

Extra Space Storage Inc.  
Form 10-Q  
November 06, 2018

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 September 30, 2018

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 20-1076777  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

2795 East Cottonwood Parkway, Suite 300  
Salt Lake City, Utah 84121  
(Address of principal executive offices)

Registrant's telephone number, including area code: (801) 365-4600

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 has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company   
Emerging growth company

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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 October 31, 2018, was 126,515,354.

---

Table of Contents

EXTRA SPACE STORAGE INC.

TABLE OF CONTENTS

<u>STATEMENT ON FORWARD-LOOKING INFORMATION</u>	4
<u>PART I. FINANCIAL INFORMATION</u>	5
<u>ITEM 1. FINANCIAL STATEMENTS</u>	5
<u>NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)</u>	11
<u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	29
<u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	39
<u>ITEM 4. CONTROLS AND PROCEDURES</u>	39
<u>PART II. OTHER INFORMATION</u>	41
<u>ITEM 1. LEGAL PROCEEDINGS</u>	41
<u>ITEM 1A. RISK FACTORS</u>	41
<u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	41
<u>ITEM 3. DEFAULTS UPON SENIOR SECURITIES</u>	41
<u>ITEM 4. MINE SAFETY DISCLOSURES</u>	41
<u>ITEM 5. OTHER INFORMATION</u>	41
<u>ITEM 6. EXHIBITS</u>	42
<u>SIGNATURES</u>	43

## STATEMENT ON FORWARD-LOOKING INFORMATION

Certain information presented 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 “intends,” or the use 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 estimates 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:

- adverse changes in general economic conditions, the real estate industry and the markets in which we operate;
- failure to close pending acquisitions and developments on expected terms, or at all;
- the effect of competition from new and existing stores or other storage alternatives, which could cause rents and occupancy rates to decline;
- potential liability for uninsured losses and environmental contamination;
- 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 (“REITs”), tenant reinsurance and other aspects of our business, which could adversely affect our results;
- disruptions in credit and financial markets and resulting difficulties in raising capital or obtaining credit at reasonable rates or at all, which could impede our ability to grow;
- increased interest rates;
- reductions in asset valuations and related impairment charges;
- our lack of sole decision-making authority with respect to our joint venture investments;
- the effect of recent or future changes to U.S. tax laws;
- the failure to maintain our REIT status for U.S. federal income tax purposes; and
- economic uncertainty due to the impact of natural disasters, war or terrorism, which could adversely affect our business plan.

The forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. You should carefully consider these risks before you make an investment decision with respect to our securities.

We disclaim any duty or obligation to update or revise any forward-looking statements set forth in this report to reflect new information, future events or otherwise.

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

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

	September 30, 2018	December 31, 2017
	(Unaudited)	
Assets:		
Real estate assets, net	\$7,425,806	\$7,132,431
Investments in unconsolidated real estate ventures	114,451	75,907
Cash and cash equivalents	45,378	55,683
Restricted cash	21,205	30,361
Other assets, net	191,850	166,571
Total assets	\$7,798,690	\$7,460,953
Liabilities, Noncontrolling Interests and Equity:		
Notes payable, net	\$4,104,955	\$3,738,497
Exchangeable senior notes, net	560,613	604,276
Notes payable to trusts, net	95,887	117,444
Revolving lines of credit	—	94,000
Cash distributions in unconsolidated real estate ventures	44,218	5,816
Accounts payable and accrued expenses	126,539	96,087
Other liabilities	96,384	81,026
Total liabilities	5,028,596	4,737,146
Commitments and contingencies		
Noncontrolling Interests and Equity:		
Extra Space Storage Inc. stockholders' equity:		
Preferred stock, \$0.01 par value, 50,000,000 shares authorized, no shares issued or outstanding	—	—
Common stock, \$0.01 par value, 500,000,000 shares authorized, 126,504,802 and 126,007,091 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	1,264	1,260
Additional paid-in capital	2,581,158	2,569,485
Accumulated other comprehensive income	68,362	33,290
Accumulated deficit	(255,065)	(253,284)
Total Extra Space Storage Inc. stockholders' equity	2,395,719	2,350,751
Noncontrolling interest represented by Preferred Operating Partnership units, net of \$119,735 and \$120,230 notes receivable as of September 30, 2018 and December 31, 2017, respectively	160,250	159,636
Noncontrolling interests in Operating Partnership	213,885	213,301
Other noncontrolling interests	240	119
Total noncontrolling interests and equity	2,770,094	2,723,807
Total liabilities, noncontrolling interests and equity	\$7,798,690	\$7,460,953

See accompanying notes to unaudited condensed consolidated financial statements.





Edgar Filing: Extra Space Storage Inc. - Form 10-Q

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Revenues:				
Property rental	\$266,728	\$248,589	\$772,742	\$720,878
Tenant reinsurance	30,105	25,882	85,660	73,050
Management fees and other income	10,120	9,685	30,849	29,239
Total revenues	306,953	284,156	889,251	823,167
Expenses:				
Property operations	73,652	70,430	219,488	204,370
Tenant reinsurance	7,720	6,272	18,798	13,996
General and administrative	19,707	19,498	62,822	60,171
Depreciation and amortization	52,283	48,075	155,924	144,139
Total expenses	153,362	144,275	457,032	422,676
Income from operations	153,591	139,881	432,219	400,491
Gain (loss) on real estate transactions and impairment of real estate	30,807	—	30,807	(6,019 )
Interest expense	(45,926 )	(39,766 )	(130,239 )	(113,192 )
Non-cash interest expense related to amortization of discount on equity component of exchangeable senior notes	(1,140 )	(1,268 )	(3,525 )	(3,827 )
Interest income	1,371	1,401	3,997	5,201
Income before equity in earnings of unconsolidated real estate ventures and income tax expense	138,703	100,248	333,259	282,654
Equity in earnings of unconsolidated real estate ventures	3,622	3,990	10,648	11,407
Income tax expense	(2,638 )	(3,163 )	(6,077 )	(9,154 )
Net income	139,687	101,075	337,830	284,907
Net income allocated to Preferred Operating Partnership noncontrolling interests	(3,723 )	(3,394 )	(10,605 )	(10,775 )
Net income allocated to Operating Partnership and other noncontrolling interests	(5,546 )	(3,917 )	(13,398 )	(11,080 )
Net income attributable to common stockholders	\$130,418	\$93,764	\$313,827	\$263,052
Earnings per common share				
Basic	\$1.03	\$0.74	\$2.49	\$2.09
Diluted	\$1.02	\$0.74	\$2.48	\$2.07
Weighted average number of shares				
Basic	126,466,837	125,717,517	125,959,926	125,665,787
Diluted	134,240,290	133,044,473	133,015,690	133,008,622
Cash dividends paid per common share	\$0.86	\$0.78	\$2.50	\$2.34

See accompanying notes to unaudited condensed consolidated financial statements.

Extra Space Storage Inc.  
 Condensed Consolidated Statements of Comprehensive Income  
 (amounts in thousands)  
 (unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	\$ 139,687	\$ 101,075	\$ 337,830	\$ 284,907
Other comprehensive income:				
Change in fair value of interest rate swaps	5,716	759	36,812	992
Total comprehensive income	145,403	101,834	374,642	285,899
Less: comprehensive income attributable to noncontrolling interests	9,553	7,342	25,743	21,886
Comprehensive income attributable to common stockholders	\$ 135,850	\$ 94,492	\$ 348,899	\$ 264,013

See accompanying notes to unaudited condensed consolidated financial statements.

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

Extra Space Storage Inc.  
 Condensed Consolidated Statement of Noncontrolling Interests and Equity  
 (amounts in thousands, except share data)  
 (unaudited)

	Noncontrolling Interests Preferred Operating Partnership						Extra Space Storage Inc. Stockholders' Equity				
	Series A	Series B	Series C	Series D	Operating Partnership	Other	Shares	Par Value	Additional Paid-in Capital	Accumulated Other Comprehensive Income	Accumulated Deficit
Balances at December 31, 2017	\$14,940	\$41,902	\$10,730	\$92,064	\$213,301	\$119	126,007,091	\$1,260	\$2,569,485	\$33,290	\$(25,000)
Issuance of common stock upon the exercise of options	—	—	—	—	—	—	54,575	—	1,169	—	—
Restricted stock grants issued	—	—	—	—	—	—	84,264	1	—	—	—
Restricted stock grants cancelled	—	—	—	—	—	—	(9,379)	) —	—	—	—
Issuance of common stock, net of offering costs	—	—	—	—	—	—	343,251	3	33,777	—	—
Compensation expense related to stock-based awards	—	—	—	—	—	—	—	—	8,455	—	—
Repayment of receivable for preferred operating units pledged as collateral on loan	—	—	495	—	—	—	—	—	—	—	—
Issuance of Operating Partnership units in conjunction with acquisitions	—	—	—	—	1,877	—	—	—	—	—	—
Redemption of Operating Partnership	—	—	—	—	(955)	) —	25,000	—	955	—	—

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

units for stock												
Redemption of												
Operating Partnership	—	—	—	—	(1,126 )	—	—	—	(1,432 )	—	—	—
units for cash												
Noncontrolling interest in consolidated joint venture	—	—	—	—	—	122	—	—	—	—	—	—
Repurchase of equity portion of 2013 exchangeable senior notes	—	—	—	—	—	—	—	—	(31,251 )	—	—	—
Net income	3,793	1,886	2,140	2,786	13,399	(1 )	—	—	—	—	—	313
Other comprehensive income	233	—	—	—	1,507	—	—	—	—	—	35,072	—
Distributions to Operating Partnership units held by noncontrolling interests	(3,906 )	(1,886 )	(2,140 )	(2,787 )	(14,118 )	—	—	—	—	—	—	—
Dividends paid on common stock at \$2.50 per share	—	—	—	—	—	—	—	—	—	—	—	(315 )
Balances at												
September 30, 2018	\$15,060	\$41,902	\$11,225	\$92,063	\$213,885	\$240	126,504,802	\$1,264	\$2,581,158	\$68,362	\$(25,000)	—

See accompanying notes to unaudited condensed consolidated financial statements.

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

	For the Nine Months Ended September 30,	
	2018	2017
Cash flows from operating activities:		
Net income	\$337,830	\$284,907
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	155,924	144,139
Amortization of deferred financing costs	9,230	9,246
Non-cash interest expense related to amortization of discount on equity component of exchangeable senior notes	3,525	3,827
Compensation expense related to stock-based awards	8,455	7,244
(Gain) loss on real estate transactions and impairment of real estate	(30,807 )	6,019
Distributions from unconsolidated real estate ventures in excess of earnings	5,235	3,498
Changes in operating assets and liabilities:		
Other assets	(639 )	(15,303 )
Accounts payable and accrued expenses	27,677	6,425
Other liabilities	12,597	(373 )
Net cash provided by operating activities	529,027	449,629
Cash flows from investing activities:		
Acquisition of real estate assets	(327,011 )	(119,040 )
Development and redevelopment of real estate assets	(45,376 )	(20,670 )
Proceeds from sale of real estate assets, investments in real estate ventures and other assets	51,889	18,565
Investment in unconsolidated real estate ventures	(52,806 )	(3,021 )
Return of investment in unconsolidated real estate ventures	47,964	581
Issuance of notes receivable	(13,889 )	—
Principal payments received from notes receivable	25,226	44,869
Purchase of equipment and fixtures	(3,026 )	(5,635 )
Net cash used in investing activities	(317,029 )	(84,351 )
Cash flows from financing activities:		
Proceeds from the sale of common stock, net of offering costs	33,780	—
Proceeds from notes payable and revolving lines of credit	973,386	1,023,170
Principal payments on notes payable and revolving lines of credit	(787,939 )	(1,020,144 )
Principal payments on notes payable to trusts	(21,650 )	—
Deferred financing costs	(7,055 )	(5,172 )
Repurchase of exchangeable senior notes	(80,270 )	(19,726 )
Net proceeds from exercise of stock options	1,170	1,266
Redemption of Operating Partnership units held by noncontrolling interests	(2,558 )	(2,510 )
Contributions from noncontrolling interests	122	—
Dividends paid on common stock	(315,608 )	(294,754 )
Distributions to noncontrolling interests	(24,837 )	(24,141 )
Net cash used in financing activities	(231,459 )	(342,011 )
Net increase (decrease) in cash, cash equivalents, and restricted cash	(19,461 )	23,267
Cash, cash equivalents, and restricted cash, beginning of the period	86,044	57,742

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

Cash, cash equivalents, and restricted cash end of the period	\$66,583	\$81,009
---	----------	----------

9

---

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

	For the Nine Months Ended September 30,	
	2018	2017
Supplemental schedule of cash flow information		
Interest paid	\$117,627	\$107,144
Income taxes paid	803	8,086
Supplemental schedule of noncash investing and financing activities:		
Redemption of Operating Partnership units held by noncontrolling interests for common stock		
Noncontrolling interests in Operating Partnership	\$(955 )	\$—
Common stock and paid-in capital	955	—
Acquisitions of real estate assets		
Real estate assets, net	\$88,842	\$20,100
Value of Operating Partnership units issued	(1,877 )	(8,810 )
Notes payable assumed	(87,500 )	(9,463 )
Investment in unconsolidated real estate ventures	535	—
Other noncontrolling interests	—	(1,827 )
Accrued construction costs and capital expenditures		
Acquisition of real estate assets	\$275	\$4,874
Development and redevelopment of real estate assets	—	1,558
Accounts payable and accrued expenses	(275 )	(6,432 )

See accompanying notes to unaudited condensed consolidated financial statements.

EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Amounts in thousands, except store and share data, unless otherwise stated

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, develop and redevelop professionally managed self-storage properties ("stores") located throughout the United States. The Company was formed to continue 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 stores 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 invests in stores by acquiring wholly-owned stores or by acquiring an equity interest in real estate entities. At September 30, 2018, the Company had direct and indirect equity interests in 1,099 stores. In addition, the Company managed 507 stores for third parties, bringing the total number of stores which it owns and/or manages to 1,606. These stores are located in 39 states, Washington, D.C. and Puerto Rico. The Company also offers tenant reinsurance at its owned and managed stores that insures the value of goods in the storage units.

2. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of the Company are presented on the accrual basis of accounting 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 may not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (including normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2018 are not necessarily indicative of results that may be expected for the year ending December 31, 2018. The condensed consolidated balance sheet as of December 31, 2017 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, 2017, as filed with the Securities and Exchange Commission.

Beginning January 1, 2018, the Company has elected to include amounts previously reported on the condensed consolidated balance sheets as "Receivables from related parties and affiliated joint ventures" in "Other assets, net," as these amounts are no longer material. Additionally, the Company has elected to include amounts previously reported on the condensed consolidated statements of operations as "Interest income on note receivable from Preferred Operating Partnership unit holder" in "Interest income" as these amounts are no longer material. Prior year amounts have been reclassified to conform to the current year's presentation.

Immaterial Correction to Consolidated Balance Sheets

In connection with the preparation of the financial statements for the quarter ended March 31, 2018, the Company determined that the negative balances in the "Investments in unconsolidated real estate ventures" line should be presented separately as liabilities. As a result, \$5,816 should have been reported as "Cash distributions in unconsolidated real estate ventures" as of December 31, 2017. The Company concluded that the amount was not material to the consolidated balance sheet as of December 31, 2017 but has elected to present these amounts as liabilities in the accompanying financial statements for consistent presentation. The classification error had no effect



on the previously reported consolidated statements of operations, comprehensive income, stockholders' equity or cash flows for the year ended December 31, 2017.

#### Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, “Revenue from Contracts with Customers,” (“Topic 606”) which amends the guidance for revenue recognition to replace numerous, industry-specific requirements and converges areas under this topic with those of the International Financial Reporting Standards. Topic 606 outlines a five-step process for customer contract revenue recognition that focuses on transfer of control, as opposed to transfer of risk and rewards. The amendment also requires enhanced disclosures regarding the nature, amount, timing and uncertainty of revenues and cash flows from contracts with customers. Topic 606 became effective for

EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

annual and interim periods beginning after December 15, 2017. The Company determined that its property rental revenue and tenant reinsurance revenue are not subject to the guidance in Topic 606, as they qualify as lease contracts and insurance contracts, which are excluded from its scope. The Company's management fee revenue was included in the scope of Topic 606 and revenue recognized under the standard does not differ materially from revenue recognized under previous guidance. The Company adopted the new guidance using the modified retrospective transition method for all contracts as of January 1, 2018. The Company's adoption of this guidance did not result in a cumulative catch-up adjustment or any significant changes to financial statement line items.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)," which modifies the accounting for leases, intending to increase transparency and comparability of organizations by requiring balance sheet presentation of leased assets and increased financial statement disclosure of leasing arrangements. ASU 2016-02 will require entities to recognize a liability for their lease obligations and a corresponding asset representing the right to use the underlying asset over the lease term. Lease obligations are to be measured at their present value and accounted for using the effective interest method. The accounting for the leased asset will differ slightly depending on whether the agreement is deemed to be a financing or operating lease. For financing leases, the leased asset is depreciated on a straight-line basis and depreciation expense is recorded separately from the interest expense in the statements of operations, resulting in higher expense in the earlier part of the lease term. For operating leases, the depreciation and interest expense components are combined, recognized evenly over the term of the lease, and presented as a reduction to operating income. ASU 2016-02 requires that assets and liabilities be presented or disclosed separately, and requires additional disclosure of certain qualitative and quantitative information related to these lease agreements. ASU 2016-02 is effective for annual and interim periods beginning after December 15, 2018. The Company plans to adopt the standard using the modified retrospective approach beginning January 1, 2019. The Company expects to elect the package of practical expedients upon adoption, which allows for the application of the standard solely to the transition period in 2019 but does not require application to prior fiscal comparative periods presented. The primary impact is expected to be related to the Company's 24 ground leases under which it serves as lessee.

In October 2016, the FASB issued ASU 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash," which requires that a statement of cash flows explains the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. This guidance is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company adopted this guidance as of January 1, 2018, and now presents restricted cash with cash and cash equivalents in the statements of cash flows. Prior period amounts have been reclassified to conform to the current year's presentation.

In August 2017, the FASB issued ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements for Accounting for Hedging Activities," which amends and simplifies existing guidance for the financial reporting of hedging relationships to allow companies to better portray the economic effects of risk management activities in their financial statements. ASU 2017-12 is effective for annual periods beginning after December 15, 2018, with early adoption permitted. The Company has chosen to early adopt this standard as of January 1, 2018. The adoption of this standard did not have a material impact on the financial statements.

In August 2018, the FASB issued ASU 2018-15, "Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That is a Service Contract." ASU 2018-15 amends the accounting for implementation costs incurred in a hosting arrangement

that is a service contract, and aligns them with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. ASU 2018-15 also requires that entities amortize the capitalized implementation costs over the term of the hosting arrangement. ASU 2018-15 is effective for annual periods beginning after December 15, 2020, with early adoption permitted, including early adoption in any interim period. The Company has chosen to early adopt this guidance on a prospective basis as of October 1, 2018. The adoption of this standard will not have a material impact on the Company's financial statements.

EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

3. FAIR VALUE DISCLOSURES

Derivative Financial Instruments

Currently, the Company uses interest rate swaps to manage its interest rate risk. The valuation of these instruments is determined using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves. The fair values of interest rate swaps are determined using the market standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on an expectation of future interest rates (forward curves) derived from observable market interest rate forward curves.

The Company incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Company has considered the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts and guarantees. In conjunction with the FASB's fair value measurement guidance, the Company made an accounting policy election to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio.

Although the Company has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by the Company and its counterparties. However, as of September 30, 2018, the Company had assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and determined that the credit valuation adjustments were not significant to the overall valuation of its derivatives. As a result, the Company determined that its derivative valuations in their entirety were classified in Level 2 of the fair value hierarchy.

The table below presents the Company's assets and liabilities measured at fair value on a recurring basis as of September 30, 2018, aggregated by the level in the fair value hierarchy within which those measurements fall.

Description	September 30, 2018	Fair Value Measurements at Reporting Date Using	
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Unobservable Inputs (Level 3)
Other assets - Cash Flow Hedge Swap Agreements	\$ 75,293	\$ -	\$ 75,293

The Company did not have any significant assets or liabilities that are re-measured on a recurring basis using significant unobservable inputs as of September 30, 2018 or December 31, 2017.

Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

Long-lived assets held for use are evaluated for impairment when events or circumstances indicate there may be impairment. The Company reviews each store at least annually to determine if any such events or circumstances have occurred or exist. The Company focuses on stores where occupancy and/or rental income have decreased by a significant amount. For these stores, the Company determines whether the decrease is temporary or permanent, and whether the store will likely recover the lost occupancy and/or revenue in the short term. In addition, the Company carefully reviews stores in the lease-up stage and compares actual operating results to original projections.

When the Company determines that an event that may indicate impairment has occurred, the Company compares the carrying value of the related long-lived assets to the undiscounted future net operating cash flows attributable to the assets. An impairment loss is recorded if the net carrying value of the assets exceeds the undiscounted future net operating cash flows attributable to the assets. The impairment loss recognized equals the excess of net carrying value over the related fair value of the assets.

EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

When real estate assets are identified by management as held for sale, the Company discontinues depreciating the assets and estimates the fair value of the assets, net of selling costs. If the estimated fair value, net of selling costs, of the assets that have been identified as held for sale is less than the net carrying value of the assets, the Company would recognize an impairment loss on the assets held for sale. The operations of assets held for sale or sold during the period are presented as part of normal operations for all periods presented. As of September 30, 2018, the Company had one operating store classified as held for sale and one parcel of land classified as held for sale which are included in real estate assets, net. The estimated fair value less selling costs for each of these is greater than the carrying value of the assets, and therefore no loss has been recorded. During the nine months ended September 30, 2017, the Company recorded an impairment loss of \$6,100 relating to one parcel of land that was held for sale at the time, and an additional two parcels of undeveloped land where the carrying value was greater than the fair value.

The Company assesses whether there are any indicators that the value of the Company's investments in unconsolidated real estate ventures may be impaired annually and when events or circumstances indicate that there may be impairment. An investment is impaired if management's estimate of the fair value of the investment is less than its carrying value. To the extent impairment has occurred, and is considered to be other than temporary, the loss is measured as the excess of the carrying amount of the investment over the fair value of the investment.

In connection with the Company's acquisition of stores, the purchase price is allocated to the tangible and intangible assets and liabilities acquired based on their relative fair values, which are estimated using significant unobservable inputs. The value of the tangible assets, consisting of land and buildings, is determined as if vacant. Intangible assets, which represent the value of existing tenant relationships, are recorded at their fair values based on the avoided cost to replace the current leases. The Company measures the value of tenant relationships based on the rent lost due to the amount of time required to replace existing customers, which is based on the Company's historical experience with turnover in its stores. Debt assumed as part of an acquisition is recorded at fair value based on current interest rates compared to contractual rates. Acquisition-related transaction costs are capitalized as part of the purchase price.

#### Fair Value of Financial Instruments

The carrying values of cash and cash equivalents, restricted cash, receivables, other financial instruments included in other assets, accounts payable and accrued expenses, variable-rate notes payable, lines of credit and other liabilities reflected in the condensed consolidated balance sheets at September 30, 2018 and December 31, 2017 approximate fair value. Restricted cash is comprised of letters of credit and escrowed funds deposited with financial institutions located throughout the United States relating to earnest money deposits on potential acquisitions, real estate taxes, insurance and capital expenditures.

The fair values of the Company's notes receivable from Preferred Operating Partnership unit holders and other fixed rate notes receivable, which are recorded in other assets, net were based on the discounted estimated future cash flows of the notes (categorized within Level 3 of the fair value hierarchy); the discount rate used approximated the current market rate for loans with similar maturities and credit quality. The fair values of the Company's fixed-rate notes payable and notes payable to trusts were estimated using the discounted estimated future cash payments to be made on such debt (categorized within Level 3 of the fair value hierarchy); the discount rates used approximated current market rates for loans, or groups of loans, with similar maturities and credit quality. The fair value of the Company's exchangeable senior notes was estimated using an average market price for similar securities obtained from a third party.

The fair values of the Company's fixed-rate assets and liabilities were as follows for the periods indicated:

September 30, 2018	December 31, 2017
--------------------	-------------------

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

	Fair Value	Carrying Value	Fair Value	Carrying Value
Notes receivable from Preferred Operating Partnership unit holders	\$112,826	\$119,735	\$113,683	\$120,230
Fixed rate notes receivable	\$—	\$—	\$20,942	\$20,608
Fixed rate notes payable and notes payable to trusts	\$3,469,014	\$3,573,996	\$2,774,242	\$2,815,085
Exchangeable senior notes	\$617,125	\$575,000	\$719,056	\$624,259

14

---

## EXTRA SPACE STORAGE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

## 4. EARNINGS PER COMMON SHARE

Basic earnings per common share is computed using the two-class method by dividing net income attributable to common stockholders by the weighted average number of common shares outstanding during the period. All outstanding unvested restricted stock awards contain rights to non-forfeitable dividends and participate in undistributed earnings with common stockholders; accordingly, they are considered participating securities that are included in the two-class method. 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 weighted average number of basic shares and 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 two-class, treasury stock or as if-converted method, whichever is most dilutive. Potential common shares are securities (such as options, convertible debt, Series A Participating Redeemable Preferred Units (“Series A Units”), Series B Redeemable Preferred Units (“Series B Units”), Series C Convertible Redeemable Preferred Units (“Series C Units”), Series D Redeemable Preferred Units (“Series D Units”) and common Operating Partnership units (“OP Units”)) that do not have a current right to participate in earnings of the Company but could do so in the future by virtue of their option, redemption or conversion right.

In computing the dilutive effect of convertible securities, net income 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 common share, only potential common shares that are dilutive (i.e. those that reduce earnings per common share) are included. For the three months ended September 30, 2018 there were no anti-dilutive options. For the three months ended September 30, 2017, options to purchase an aggregate of approximately 45,438 shares of common stock, and for the nine months ended September 30, 2018 and 2017, options to purchase an aggregate of approximately 36,404 and 97,697 shares of common stock, respectively, were excluded from the computation of earnings per share as their effect would have been anti-dilutive.

For the purposes of computing the diluted impact of the potential exchange of the Preferred Operating Partnership units for common shares upon redemption, where the Company has the option to redeem in cash or shares and where the Company has stated the intent and ability to settle the redemption in shares, the Company divided the total value of the Preferred Operating Partnership units by the average share price for the period presented. The average share price for the three months ended September 30, 2018 and 2017 was \$92.83 and \$77.84, respectively, and for the nine months ended September 30, 2018 and 2017, the average share price was \$90.09 and \$76.67, respectively.

The following table presents the number of Preferred Operating Partnership units, and the potential common shares, that were excluded from the computation of earnings per share as their effect would have been anti-dilutive.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Equivalent Shares (if converted)	Equivalent Shares (if converted)	Equivalent Shares (if converted)	Equivalent Shares (if converted)	Equivalent Shares (if converted)
Series B Units	451,386	538,312	465,115	546,526
Series C Units	319,283	380,769	328,994	386,580



Edgar Filing: Extra Space Storage Inc. - Form 10-Q

Series D Units —	1,126,831	1,021,901	1,091,319
	770,669	2,045,912	1,816,010
			2,024,425

The Operating Partnership had no Exchangeable Senior Notes due 2033 (the “2013 Notes”) issued and outstanding as of September 30, 2018, as the remaining principal balance had been redeemed in July 2018. Prior to their redemption, the 2013 Notes could potentially have had a dilutive impact on the Company’s earnings per share calculations. The 2013 Notes were exchangeable by holders into shares of the Company’s common stock under certain circumstances per the terms of the indenture governing the 2013 Notes. The exchange price of the 2013 Notes could change over time as described in the indenture. The Company had irrevocably agreed to pay only cash for the accreted principal amount of the 2013 Notes relative to its exchange obligations, but retained the right to satisfy the exchange obligation in excess of the accreted principal amount in cash and/or common stock.

EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

The Operating Partnership had \$575,000 of its 3.125% Exchangeable Senior Notes due 2035 (the “2015 Notes”) issued and outstanding as of September 30, 2018. The 2015 Notes could potentially have a dilutive impact on the Company’s earnings per share calculations. The 2015 Notes are exchangeable by holders into shares of the Company’s common stock under certain circumstances per the terms of the indenture governing the 2015 Notes. The exchange price of the 2015 Notes was \$93.06 per share as of September 30, 2018, and could change over time as described in the indenture. The Company has irrevocably agreed to pay only cash for the accreted principal amount of the 2015 Notes relative to its exchange obligations, but retained the right to satisfy the exchange obligation in excess of the accreted principal amount in cash and/or common stock.

Although the Company has retained the right to satisfy the exchange obligation in excess of the accreted principal amount of the 2013 Notes and 2015 Notes in cash and/or common stock, Accounting Standards Codification (“ASC”) 260, “Earnings per Share,” requires an assumption that shares would be used to pay the exchange obligation 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 the diluted earnings per share computation. For the three and nine months ended September 30, 2018 and 2017, zero and 413,498 shares, respectively, related to the 2013 Notes were included in the computation for diluted earnings per share. For the three and nine months ended September 30, 2018 and 2017, no shares related to the 2015 Notes were included in the computation for diluted earnings per share as the exchange price exceeded the average per share price of the Company’s common stock during these periods.

For the purposes of computing the diluted impact on earnings per share of the potential exchange of Series A Units for common shares upon redemption, where the Company has the option to redeem in cash or shares and where the Company has stated the positive intent and ability to settle at least \$101,700 of the instrument in cash (or net settle a portion of the Series A Units against the related outstanding note receivable), only the amount of the instrument in excess of \$101,700 is considered in the calculation of shares contingently issuable for the purposes of computing diluted earnings per share as allowed by ASC 260-10-45-46. Accordingly, the number of shares included in the computation for diluted earnings per share related to the Series A Units is equal to the number of Series A Units outstanding, with no additional shares included related to the fixed \$101,700 amount.

## EXTRA SPACE STORAGE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

The computation of earnings per common share was as follows for the periods presented:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income attributable to common stockholders	\$ 130,418	\$ 93,764	\$ 313,827	\$ 263,052
Earnings and dividends allocated to participating securities	(219 )	(191 )	(550 )	(595 )
Earnings for basic computations	130,199	93,573	313,277	262,457
Earnings and dividends allocated to participating securities	—	191	550	595
Income allocated to noncontrolling interest - Preferred Operating Partnership Units and Operating Partnership Units	7,336	5,163	17,191	15,448
Fixed component of income allocated to noncontrolling interest - Preferred Operating Partnership (Series A Units)	(572 )	(572 )	(1,716 )	(2,547 )
Net income for diluted computations	\$ 136,963	\$ 98,355	\$ 329,302	\$ 275,953
Weighted average common shares outstanding:				
Average number of common shares outstanding - basic	126,466,837	125,717,517	125,959,926	125,665,787
OP Units	5,636,845	5,590,231	5,650,599	5,586,908
Series A Units	875,480	875,480	875,480	875,480
Series D Units	991,738	—	—	—
Unvested restricted stock awards included for treasury stock method	—	280,484	250,630	288,831
Shares related to exchangeable senior notes and dilutive stock options	269,390	580,761	279,055	591,616
Average number of common shares outstanding - diluted	134,240,290	133,044,473	133,015,690	133,008,622
Earnings per common share				
Basic	\$ 1.03	\$ 0.74	\$ 2.49	\$ 2.09
Diluted	\$ 1.02	\$ 0.74	\$ 2.48	\$ 2.07

## EXTRA SPACE STORAGE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

## 5. STORE ACQUISITIONS AND DISPOSITIONS

The following table shows the Company's acquisitions of stores for the three and nine months ended September 30, 2018 and 2017. The table excludes purchases of raw land or improvements made to existing assets. All acquisitions are considered asset acquisitions under ASU 2017-01, "Business Combinations (Topic 805): Clarifying the Definition of a Business."

Quarter	Number of Stores	Consideration Paid					Investment in Real Estate Ventures	Net Liabilities (Assets) Assumed	Value of OP Units Issued	Number of OP Units Issued	Total Real estate assets
		Total	Cash Paid	Loan Assumed	Non-controlling interests						
Q3 2018	6	\$74,694	\$71,989	\$—	\$—	\$—	\$2,705	\$—	—	\$74,694	
Q2 2018 <sup>(1)</sup>	17	237,284	148,650	87,500	—	(1,024)	281	1,877	21,768	237,284	
Q1 2018 <sup>(1)</sup>	5	70,787	70,171	—	—	489	127	—	—	70,787	
	28	\$382,765	\$290,810	\$87,500	\$—	\$(535)	\$3,113	\$1,877	21,768	\$382,765	
Q3 2017	4	\$31,966	\$29,919	\$—	\$—	\$—	\$47	\$2,000	25,520	\$31,966	
Q2 2017	3	34,641	16,608	9,463	1,827	—	(67)	6,810	272,400	34,641	
Q1 2017	2	25,556	25,541	—	—	—	15	—	—	25,556	
	9	\$92,163	\$72,068	\$9,463	\$1,827	\$—	\$(5)	\$8,810	297,920	\$92,163	

<sup>(1)</sup> Store acquisitions during the nine months ended September 30, 2018 include the purchase of 15 stores previously held in joint ventures where the Company held a noncontrolling interest. The Company purchased its partners' remaining equity interests in the joint ventures, and the properties owned by the joint ventures became wholly owned by the Company.

## Store Dispositions

On August 16, 2018, the Company closed on the sale of a store located in California that had been classified as held for sale for \$40,235 in cash. The Company recorded a gain on the sale of \$30,671.

On September 13, 2017, the Company closed on the sale of a parcel of land located in New York that had been classified as held for sale for \$19,000 in cash. This parcel of land had been written down to its fair value less selling costs during the six months ended June 30, 2017, and a loss of \$3,500 was recorded. Therefore no additional gain or loss was recorded related to this sale at the time of closing.

## EXTRA SPACE STORAGE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

## 6. INVESTMENTS IN UNCONSOLIDATED REAL ESTATE VENTURES

Net investments in unconsolidated real estate ventures and cash distributions in unconsolidated real estate ventures consist of the following:

	Number of Stores	Equity Ownership %	Excess Profit %	September 30, 2018	December 31, 2017
WICNN JV LLC	7	10%	25%	\$ 27,036	\$—
VRS Self Storage, LLC	16	45%	54%	18,356	19,467
PRISA Self Storage LLC	85	4%	4%	9,345	9,638
Alan Jathoo JV LLC	7	10%	10%	6,205	—
Extra Space West Two LLC	5	5%	40%	3,823	3,939
ESS Bristol Investments LLC	7	10%	28%	2,356	1,258
WCOT Self Storage LLC	—	5%	20%	—	(357 )
Extra Space West One LLC	7	5%	40%	(1,033 )	(900 )
Extra Space Northern Properties Six LLC	10	10%	35%	(1,604 )	(1,279 )
Storage Portfolio II JV LLC	36	10%	30%	(3,806 )	(3,140 )
Storage Portfolio I LLC	24	34%	49%	(37,657 )	11,495
Other minority owned stores	19	10-50%	19-50%	47,212	29,970
Net Investments in and Cash distributions in unconsolidated real estate ventures	223			\$ 70,233	\$ 70,091

Investments in unconsolidated real estate ventures represent the Company's noncontrolling interests in properties. The Company accounts for these investments using the equity method of accounting. The Company initially records these investments at cost and subsequently adjusts for net equity in income or loss, which it allocates in accordance with the provisions of the applicable partnership or joint venture agreement, cash contributions and distributions.

In these joint ventures, the Company and the joint venture partner generally receive a preferred return on their invested capital. To the extent that cash/profits in excess of these preferred returns are generated through operations or capital transactions, the Company would receive a higher percentage of the excess cash/profits than its equity interest.

The Company separately reports investments with net equity less than zero in cash distributions in unconsolidated real estate ventures in the condensed consolidated balance sheets. The net equity of certain joint ventures is less than zero because distributions have exceeded the Company's investment in and share of income from these joint ventures. This is generally the result of financing distributions or operating distributions that are usually greater than net income, as net income includes non cash charges for depreciation and amortization while distributions do not.

On May 18, 2018, the Company entered into a new joint venture, WICNN JV LLC. On June 19, 2018, WICNN JV LLC purchased seven stores located in Connecticut, New Jersey and Wisconsin, and the Company made an initial contribution of \$4,505 and received a 10.0% equity interest in the joint venture. The Company also made a preferred equity contribution of \$22,734. The Company receives an annual return of 8.0% on its preferred equity, which has a distribution preference over common equity.

On April 26, 2018, the Company purchased its joint venture partner's 95% interest in the WCOT Self Storage LLC joint venture, which owned 14 stores. The partner's interest was purchased for \$115,797 and the existing joint venture loan of \$87,500. Subsequent to this acquisition, the Company owned 100% of the joint venture and the related stores which are consolidated in the Company's financial statements.

On February 2, 2018, the Company and Teachers REA II LLC ("TIAA") entered into the "Third Amendment to Amended and Restated Limited Liability Company Agreement of Storage Portfolio I LLC" (the "Amendment"). The Amendment was deemed effective as of January 1, 2018. Under the Amendment, the Company's capital percentage in Storage Portfolio I LLC ("SP I") increased from 25.0% to 34.0%, and its excess profit participation percentage increased from 40.0% to 49.0%, among other changes. Additionally, SP I refinanced its mortgage loan and the Company received a financing distribution of \$47,944,

## EXTRA SPACE STORAGE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

which was recorded as a reduction in the Company's investment in SP I. The Company continues to account for its investment in SP I under the equity method of accounting.

## 7. VARIABLE INTERESTS

The Operating Partnership has three wholly-owned unconsolidated subsidiaries ("Trust," "Trust II" and "Trust III," together, the "Trusts") that have issued trust preferred securities to third parties and common securities to the Operating Partnership. The proceeds from the sale of the preferred and common securities were loaned in the form of notes to the Operating Partnership. The Trusts are variable interest entities ("VIEs") because the holders of the equity investment at risk (the trust preferred securities) do not have the power to direct the activities of the entities that most significantly affect the entities' economic performance because of their lack of voting or similar rights. Because the Operating Partnership's investment in the Trusts' common securities was financed directly by the Trusts as a result of its loan of the proceeds to the Operating Partnership, that investment is not considered an equity investment at risk. The Operating Partnership's investment in the Trusts is not a variable interest because equity interests are variable interests only to the extent that the investment is considered to be at risk, and therefore the Operating Partnership cannot be the primary beneficiary of the Trusts. Since the Company is not the primary beneficiary of the Trusts, they have not been consolidated. A debt obligation has been recorded in the form of notes for the proceeds as discussed above, which are owed to the Trusts. The Company has also included its investment in the Trusts' common securities in other assets on the condensed consolidated balance sheets.

The Company has not provided financing or other support during the periods presented to the Trusts that it was not previously contractually obligated to provide. The Company's maximum exposure to loss as a result of its involvement with the Trusts is equal to the total amount of the notes discussed above less the amounts of the Company's investments in the Trusts' common securities. The net amount is equal to the notes payable that the Trusts owe to third parties for their investments in the Trusts' preferred securities.

Following is a tabular comparison of the assets and liabilities the Company has recorded as a result of its involvement with the Trusts to the maximum exposure to loss the Company is subject to as a result of such involvement as of September 30, 2018:

	Notes payable to Trusts	Investment Balance	Maximum exposure to loss	Difference
Trust	\$36,083	\$ 1,083	\$ 35,000	\$ —
Trust II	20,619	619	20,000	—
Trust III	41,238	1,238	40,000	—
	97,940	\$ 2,940	\$ 95,000	\$ —
Unamortized debt issuance costs	(2,053 )			
	\$95,887			

On September 28, 2018, the Operating Partnership repaid \$21,650 of principal amount of notes payable to Trust II.

The Company had no consolidated VIEs during the three and nine months ended September 30, 2018.

## 8. DERIVATIVES

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity and credit risk,

primarily by managing the amount, sources and duration of its debt funding and by using derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposure that arises from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to the Company's investments and borrowings.



EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish these objectives, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income ("OCI") and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. A portion of these changes is excluded from accumulated other comprehensive income as it is allocated to noncontrolling interests. During the three and nine months ended September 30, 2018 and 2017, such derivatives were used to hedge the variable cash flows associated with existing variable-rate debt. In the coming 12 months, the Company estimates that \$19,640 will be reclassified as a decrease to interest expense.

The Company held 29 derivative financial instruments which had a total combined notional amount of \$2,156,475 as of September 30, 2018.

Fair Values of Derivative Instruments

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the condensed consolidated balance sheets:

	Asset / Liability	
	Derivatives	
	September	December
	30,	31,
	2018	2017
Derivatives designated as hedging instruments:	Fair Value	
Other assets	\$75,293	\$ 38,365
Other liabilities	\$—	\$ 9

Effect of Derivative Instruments

The table below presents the effect of the Company's derivative financial instruments on the condensed consolidated statements of operations for the periods presented. No tax effect has been presented as the derivative instruments are held by the Company:

Type	Gain (loss) recognized in OCI For the		Location of amounts reclassified from OCI into income	Gain (loss) reclassified from OCI For the	
	Three Months Ended	Three Months Ended		Three Months Ended	Three Months Ended
	September 30,	September 30,		September 30,	September 30,
	2018	2017		2018	2017
Swap Agreements	\$8,325	\$(787)	Interest Expense	\$2,561	\$(1,572)
	Gain (loss) recognized in OCI		Location of amounts reclassified from OCI into	Gain (loss) reclassified from OCI For the	
	For the Nine Months Ended		income	from OCI For the	

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

Type	September 30,			Nine Months Ended	
	2018	2017		September 30,	2018
Swap Agreements	\$ 41,610	\$ (6,474	) Interest expense	\$ 4,684	\$ (7,497 )

Credit-risk-related Contingent Features

The Company has agreements with some of its derivative counterparties that contain provisions pursuant to which the Company could be declared in default of its derivative obligations if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender.

The Company also has an agreement with some of its derivative counterparties that incorporates the loan covenant provisions of the Company's indebtedness with a lender affiliate of the derivative counterparty. Failure to comply with the loan covenant provisions would result in the Company being in default on any derivative instrument obligations covered by the agreement.

EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

As of September 30, 2018, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was immaterial. As of September 30, 2018, the Company had not posted any collateral related to these agreements. If the Company had breached any of these provisions as of September 30, 2018, it could have been required to cash settle its obligations under the agreements at their termination value.

9. EXCHANGEABLE SENIOR NOTES

In September 2015, the Operating Partnership issued \$575,000 of its 3.125% Exchangeable Senior Notes due 2035. Costs incurred to issue the 2015 Notes were approximately \$11,992, consisting primarily of a 2.0% underwriting fee. These costs are being amortized as an adjustment to interest expense over five years, which represents the estimated term based on the first available redemption date, and are included in exchangeable senior notes, net, in the condensed consolidated balance sheets. The 2015 Notes are general unsecured senior obligations of the Operating Partnership and are fully guaranteed by the Company. Interest is payable on April 1 and October 1 of each year beginning April 1, 2016, until the maturity date of October 1, 2035. The 2015 Notes bear interest at 3.125% per annum and contain an exchange settlement feature, which provides that the 2015 Notes may, under certain circumstances, be exchangeable for cash (for the principal amount of the 2015 Notes) and, with respect to any excess exchange value, for cash, shares of the Company's common stock, or a combination of cash and shares of the Company's common stock, at the Company's option. The exchange rate of the 2015 Notes as of September 30, 2018 was approximately 10.75 shares of the Company's common stock per \$1,000 principal amount of the 2015 Notes.

The Operating Partnership may redeem the 2015 Notes at any time to preserve the Company's status as a REIT. In addition, on or after October 5, 2020, the Operating Partnership may redeem the 2015 Notes for cash, in whole or in part, at 100% of the principal amount plus accrued and unpaid interest, upon at least 30 days but not more than 60 days prior written notice to the holders of the 2015 Notes. The holders of the 2015 Notes have the right to require the Operating Partnership to repurchase the 2015 Notes for cash, in whole or in part, on October 1 of the years 2020, 2025 and 2030 (unless the Operating Partnership has called the 2015 Notes for redemption), and upon the occurrence of certain designated events, in each case for a repurchase price equal to 100% of the principal amount of the 2015 Notes plus accrued and unpaid interest. Certain events are considered "Events of Default," as defined in the indenture governing the 2015 Notes, which may result in the accelerated maturity of the 2015 Notes.

Additionally, the 2015 Notes can be exchanged during any calendar quarter, if the last reported sale price of the common stock of the Company is greater than or equal to 130% of the exchange price for at least 20 trading days during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter. The price of the Company's common stock did not exceed 130% of the exchange price for the required time period for the 2015 Notes during the quarter ended September 30, 2018.

On June 21, 2013, the Operating Partnership issued \$250,000 of its 2.375% Exchangeable Senior Notes due 2033 at a 1.5% discount, or \$3,750, and costs incurred to issue the 2013 Notes were approximately \$1,672. These costs were amortized as an adjustment to interest expense over five years, which represented the estimated term based on the first available redemption date. The 2013 Notes bore interest at 2.375% per annum and contained an exchange settlement feature. On or after July 5, 2018, the Operating Partnership could redeem the 2013 Notes for cash, in whole or in part, at 100% of the principal amount plus accrued and unpaid interest, upon at least 30 days but not more than 60 days prior written notice to the holders of the 2013 Notes. The Operating Partnership redeemed all remaining outstanding 2013 Notes on July 5, 2018.

GAAP requires entities with convertible debt instruments that may be settled entirely or partially in cash upon conversion to separately account for the liability and equity components of the instrument in a manner that reflects the issuer's economic interest cost. The Company therefore accounts for the liability and equity components of the 2013 Notes and 2015 Notes separately. The equity components are included in paid-in capital in stockholders' equity in the condensed consolidated balance sheets, and the value of the equity components are treated as original issue discount for purposes of accounting for the debt components. The discounts are amortized as interest expense over the remaining period of the debt through its first redemption date: July 1, 2018 for the 2013 Notes, and October 1, 2020 for the 2015 Notes. The effective interest rate on the liability components of both the 2013 Notes and the 2015 Notes is 4.0%, which approximated the market rate of interest of similar debt without exchange features (i.e. nonconvertible debt) at the time of issuance.

## EXTRA SPACE STORAGE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

Information about the Company's 2013 Notes and 2015 Notes, including the total carrying amounts of the equity components, the principal amounts of the liability components, the unamortized discounts and the net carrying amounts was as follows for the periods indicated:

	September 30, 2018	December 31, 2017
Carrying amount of equity component - 2013 Notes	\$—	\$—
Carrying amount of equity component - 2015 Notes	22,597	22,597
Carrying amount of equity components	\$22,597	\$22,597
Principal amount of liability component - 2013 Notes	\$—	\$49,259
Principal amount of liability component - 2015 Notes	575,000	575,000
Unamortized discount - equity component - 2013 Notes	—	(315 )
Unamortized discount - equity component - 2015 Notes	(9,579 )	(12,974 )
Unamortized cash discount - 2013 Notes	—	(74 )
Unamortized debt issuance costs	(4,808 )	(6,620 )
Net carrying amount of liability components	\$560,613	\$604,276

The amount of interest cost recognized relating to the contractual interest rates and the amortization of the discounts on the liability components of the Notes were as follows for the periods indicated:

	For the Three Months Ended September 30, 2018		For the Nine Months Ended September 30, 2017	
Contractual interest	\$4,492	\$4,785	\$13,614	\$14,519
Amortization of discount	1,140	1,268	3,525	3,827
Total interest expense recognized	\$5,632	\$6,053	\$17,139	\$18,346

## Repurchases of 2013 Notes

During the nine months ended September 30, 2018, the Company repurchased a total principal amount of \$49,259 of the 2013 Notes, which represented all of the remaining principal amount outstanding. The Company paid cash of \$80,270 for the total of the principal amount and the exchange value in excess of the principal amount.

During the nine months ended September 30, 2017, the Company repurchased a total principal amount of \$13,786 of the 2013 Notes. The Company paid cash of \$19,853 for the total principal amount and the exchange value in excess of the principal amount.

The Company allocated the value of the consideration paid to repurchase the 2013 Notes (1) to the extinguishment of the liability component and (2) to the reacquisition of the equity component. The amount allocated to the extinguishment of the liability component is equal to the fair value of that component immediately prior to extinguishment. The difference between the consideration attributed to the extinguishment of the liability component and the sum of (a) the net carrying amount of the repurchased liability component, and (b) the related unamortized debt issuance costs, is recognized as a gain on debt extinguishment. The remaining settlement consideration is allocated to the reacquisition of the equity component of the repurchased 2013 Notes and recognized as a reduction of stockholders' equity.



## EXTRA SPACE STORAGE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

Information about the repurchases is as follows:

	For the Nine Months Ended September 30,	
	2018	2017
Principal amount repurchased	\$49,259	\$13,786
Amount allocated to:		
Extinguishment of liability component	\$49,019	\$13,568
Reacquisition of equity component	31,251	6,285
Total consideration paid for repurchase	\$80,270	\$19,853
Exchangeable senior notes repurchased	\$49,259	\$13,786
Extinguishment of liability component	(49,019 )	(13,568 )
Discount on exchangeable senior notes	(230 )	(183 )
Related debt issuance costs	(10 )	(35 )
Gain/(loss) on repurchase	\$—	\$—

## 10. STOCKHOLDERS' EQUITY

On May 6, 2016, the Company filed its current \$400,000 "at the market" equity program with the Securities and Exchange Commission using a shelf registration statement on Form S-3, and entered into separate equity distribution agreements with five sales agents. Under the terms of the current equity distribution agreements, the Company may from time to time offer and sell shares of common stock, up to the aggregate offering price of \$400,000, through its sales agents.

During the three and nine months ended September 30, 2018, the Company sold 343,251 shares of common stock under its "at the market" equity program at an average sales price of \$99.75 per share, resulting in net proceeds of \$33,780. As of September 30, 2018, the Company had \$315,135 available for issuance under the current equity distribution agreements.

## 11. NONCONTROLLING INTEREST REPRESENTED BY PREFERRED OPERATING PARTNERSHIP UNITS

## Classification of Noncontrolling Interests

GAAP requires a company to present ownership interests in subsidiaries held by parties other than the company in the consolidated financial statements within the equity section, but separate from the company's equity. It also requires the amount of consolidated net income attributable to the parent and to the noncontrolling interest to be clearly identified and presented on the face of the consolidated statement of operations and requires changes in ownership interest to be accounted for similarly as equity transactions. If noncontrolling interests are determined to be redeemable, they are to be carried at their redemption value as of the balance sheet date and reported as temporary equity.

The Company has evaluated the terms of the Operating Partnership's preferred units and classifies the noncontrolling interest represented by such preferred units as stockholders' equity in the accompanying condensed consolidated balance sheets. The Company will periodically evaluate individual noncontrolling interests for the ability to continue to recognize the noncontrolling interest as permanent equity in the condensed consolidated balance sheets. Any noncontrolling interests that fail to qualify as permanent equity will be reclassified as temporary equity and adjusted to the greater of (1) the carrying amount and (2) the redemption value as of the end of the period in which the determination is made.





EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

As of September 30, 2018, the noncontrolling interests represented by Operating Partnership preferred units consisted of the following:

Series A Units 875,480

Series B Units 1,676,087

Series C Units 704,016

Series D Units 3,682,521

At September 30, 2018 and December 31, 2017, the noncontrolling interests represented by the Preferred Operating Partnership Units qualified for classification as permanent equity on the Company's condensed consolidated balance sheets. The partnership agreement of the Operating Partnership (as amended, the "Partnership Agreement") provides for the designation and issuance of the OP Units.

Series A Participating Redeemable Preferred Units

The Series A Units were issued in June 2007. Series A Units in the amount of \$101,700 bear a fixed priority return of 2.3% and originally had a fixed liquidation value of \$115,000. The remaining balance participates in distributions with, and has a liquidation value equal to that of the OP Units. The Series A Units are redeemable at the option of the holder, which redemption obligation may be satisfied, at the Company's option, in cash or shares of its common stock. As a result of the redemption of 114,500 Series A Units in October 2014, the remaining fixed liquidation value was reduced to \$101,700. On April 18, 2017, the holder of the Series A Units and the Operating Partnership agreed to reduce the fixed priority return on the Series A Units from 5.0% to 2.3% in exchange for a reduction in the interest rate of the related loan, as more fully described below.

The Partnership Agreement provides for the designation and issuance of the Series A Units. The Series A Units have priority over all other partnership interests of the Operating Partnership with respect to distributions and liquidation.

On June 25, 2007, the Operating Partnership loaned the holder of the Series A Units \$100,000. On April 18, 2017, a loan amendment was signed modifying the maturity date of the loan to the later of the death of the Series A Unit holder or his spouse and also lowering the interest rate of the loan from 4.9% to 2.1%. The loan amendment was determined to be a loan modification under GAAP, and therefore no change in value was recognized. The loan is secured by the borrower's Series A Units. No future redemption of Series A Units can be made unless the loan secured by the Series A Units is also repaid. The Series A Units are shown on the balance sheet net of the \$100,000 loan because the borrower under the loan receivable is also the holder of the Series A Units.

Series B Redeemable Preferred Units

The Partnership Agreement provides for the designation and issuance of the Series B Units. The Series B Units rank junior to the Series A Units, on parity with the Series C Units and Series D Units, and senior to all other partnership interests of the Operating Partnership with respect to distributions and liquidation.

The Series B Units were issued in 2013 and 2014 and have a liquidation value of \$25.00 per unit for a fixed liquidation value of \$41,902. Holders of the Series B Units receive distributions at an annual rate of 6.0%. These distributions are cumulative. The Series B Units became redeemable at the option of the holder on the first anniversary of the date of issuance, which redemption obligation may be satisfied at the Company's option in cash or shares of its common stock.

Series C Convertible Redeemable Preferred Units

The Partnership Agreement provides for the designation and issuance of the Series C Units. The Series C Units rank junior to the Series A Units, on parity with the Series B Units and Series D Units, and senior to all other partnership interests of the Operating Partnership with respect to distributions and liquidation.

The Series C Units were issued in 2013 and 2014 and have a liquidation value of \$42.10 per unit for a fixed liquidation value of \$29,639. From issuance to the fifth anniversary of issuance, each Series C Unit holder will receive quarterly distributions equal to the quarterly distribution per OP Unit plus \$0.18. Beginning on the fifth anniversary of issuance, each Series C Unit holder will receive a fixed quarterly distribution equal to the aggregate quarterly distribution payable in respect of such Series C Unit

EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

during the four quarters immediately preceding the fifth anniversary of issuance, divided by four. These distributions are cumulative. The Series C Units became redeemable at the option of the holder one year from the date of issuance, which redemption obligation may be satisfied at the Company's option in cash or shares of its common stock. The Series C Units are convertible into OP Units at the option of the holder at a rate of 0.9145 OP Units per Series C Unit converted. This conversion option expires upon the fifth anniversary of the date of issuance.

In December 2014, the Operating Partnership loaned certain holders of the Series C Units \$20,230. The notes receivable, which are collateralized by the Series C Units, bear interest at 5.0% per annum and mature on December 15, 2024. The Series C Units are shown on the balance sheet net of the loan balance of \$19,735 as of September 30, 2018 and \$20,230 as of December 31, 2017, because the borrower under the loan receivable is also the holder of the Series C Units.

Series D Redeemable Preferred Units

The Partnership Agreement provides for the designation and issuance of the Series D Units. The Series D Units rank junior to the Series A Units, on parity with the Series B Units and Series C Units, and senior to all other partnership interests of the Operating Partnership with respect to distributions and liquidation.

The Series D Units have been issued at various times from 2014 to 2017. The Series D Units have a liquidation value of \$25.00 per unit, for a fixed liquidation value of \$92,063. Holders of the Series D Units receive distributions at an annual rate between 3.0% and 5.0%. These distributions are cumulative. The Series D Units become redeemable at the option of the holder on the first anniversary of the date of issuance, which redemption obligation may be satisfied at the Company's option in cash or shares of its common stock. In addition, certain of the Series D Units are exchangeable for common OP Units at the option of the holder until the tenth anniversary of the date of issuance, with the number of OP Units to be issued equal to \$25.00 per Series D Unit, divided by the value of a share of common stock as of the exchange date.

12. NONCONTROLLING INTEREST IN OPERATING PARTNERSHIP

The Company's interest in its stores is held through the Operating Partnership. Between its general partner and limited partner interests, the Company held a 91.0% ownership interest in the Operating Partnership as of September 30, 2018. The remaining ownership interests in the Operating Partnership (including Preferred Operating Partnership units) of 9.0% are held by certain former owners of assets acquired by the Operating Partnership.

The noncontrolling interest in the Operating Partnership represents OP Units that are not owned by the Company. OP Units are redeemable at the option of the holder, which redemption may be satisfied at the Company's option in cash, based upon the fair market value of an equivalent number of shares of the Company's common stock (based on the ten-day average trading price) at the time of the redemption, or shares of the Company's common stock on a one-for-one basis, subject to anti-dilution adjustments provided in the Partnership Agreement. As of September 30, 2018, the ten-day average closing price of the Company's common stock was \$87.17 and there were 5,631,138 OP Units outstanding. Assuming that all of the OP Unit holders exercised their right to redeem all of their OP Units on September 30, 2018 and the Company elected to pay the OP Unit holders cash, the Company would have paid \$490,866 in cash consideration to redeem the units.

OP Unit activity is summarized as follows for the periods presented:

For the Nine  
Months Ended  
September 30,

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

	2018	2017
OP Units redeemed for common stock	25,000	—
OP Units redeemed for cash	30,000	33,896
Cash paid for OP Units redeemed	\$2,558	\$2,510
OP Units issued in conjunction with acquisitions	21,768	25,520
Value of OP Units issued in conjunction with acquisitions	\$1,877	\$2,000

GAAP requires a company to present ownership interests in subsidiaries held by parties other than the company in the consolidated financial statements within the equity section, but separate from the company's equity. It also requires the amount of consolidated net income attributable to the parent and to the noncontrolling interest to be clearly identified and presented on the face of the consolidated statement of operations, and requires changes in ownership interest to be accounted for similarly as

EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

equity transactions. If noncontrolling interests are determined to be redeemable, they are to be carried at their redemption value as of the balance sheet date and reported as temporary equity.

The Company has evaluated the terms of the OP Units and classifies the noncontrolling interest represented by the OP Units as stockholders' equity in the accompanying condensed consolidated balance sheets. The Company will periodically evaluate individual noncontrolling interests for the ability to continue to recognize the noncontrolling amount as permanent equity in the condensed consolidated balance sheets. Any noncontrolling interests that fail to qualify as permanent equity will be reclassified as temporary equity and adjusted to the greater of (1) the carrying amount and (2) the redemption value as of the end of the period in which the determination is made.

### 13. OTHER NONCONTROLLING INTERESTS

Other noncontrolling interests represent the ownership interests of third parties in two consolidated joint ventures as of September 30, 2018. One joint venture owns two operating stores in Texas and an operating store in Colorado, and the other joint venture owns one operating property in Pennsylvania and one development property in New Jersey. The voting interests of the third-party owners are between 5.0% and 20.0%.

### 14. REVENUE RECOGNITION

Rental revenues are recognized as earned based upon amounts that are currently due from tenants. Leases are generally on month-to-month terms. Prepaid rents are recognized on a straight-line basis over the term of the leases. Promotional discounts are recognized as a reduction to rental income over the promotional period. Late charges, administrative fees, merchandise sales and truck rentals are recognized as income when earned. Tenant reinsurance premiums are recognized as revenue when received.

The Company's management fees are earned subject to the terms of the related management services agreements ("MSAs"). These MSAs provide that the Company will perform management services, which include leasing and operating the property and providing accounting, marketing, banking and maintenance services. These services are provided in exchange for monthly management fees, which are based on a percentage of revenues collected from stores owned by third parties and unconsolidated joint ventures. MSAs generally have original terms from three to five years, after which management services are provided on a month-to-month basis unless terminated. Management fees are due on the last day of each calendar month that management services are provided.

The Company accounts for the management services provided to a customer as a single performance obligation which are rendered over time each month. The total amount of consideration from the contract is variable as it is based on monthly revenues each month. The variable amount of management fees earned is dependent on the revenue and cash collected at the managed stores. Revenue is influenced by multiple factors, including tenant behavior, economic conditions in the markets in which the stores are located, the effect of competition, and other factors outside of the Company's control. Since the management fee is dependent on revenue levels, the MSAs have a large number and broad range of possible consideration amounts that are difficult to estimate.

The total consideration for each contract cannot be estimated as it is dependent on factors outside of the Company's control. The uncertainty about the amount of consideration to be received under each MSA cannot be resolved until the actual revenues and cash collected by the related managed stores is known. The total consideration for each MSA is not known until the end of that MSA's term. One month of uncertainty regarding the consideration amount is resolved as each month passes and the actual revenues for that month can be determined. Therefore, at the end of each month, the Company allocates the actual management fee earned to the distinct services provided during that month and recognizes it as revenue as the uncertainty regarding the amount of revenues for that month has been resolved.

Due to the standardized terms of the MSAs, the Company accounts for all MSAs in a similar, consistent manner. Therefore, no disaggregated information relating to MSAs is presented.

27

---

## EXTRA SPACE STORAGE INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

## 15. SEGMENT INFORMATION

The Company's segment disclosures present the measure used by the chief operating decision makers ("CODMs") for purposes of assessing each segment's performance. The Company's CODMs are comprised of several members of its executive management team who use net operating income ("NOI") to assess the performance of the business for the Company's reportable operating segments. NOI for our self-storage operations represents total property revenue less direct property operating expenses. NOI for our tenant reinsurance segment represents tenant reinsurance revenues less tenant reinsurance expense.

The Company's segments were historically comprised of three reportable segments: (1) rental operations; (2) tenant reinsurance; and (3) property management, acquisition and development. Based on how the CODMs review performance and make decisions, the Company realigned its segments as of December 31, 2017 into two reportable segments: (1) self-storage operations and (2) tenant reinsurance. The self-storage operations activities include rental operations of wholly-owned stores. The Company's consolidated revenues equal total segment revenues plus property management fees and other income. Tenant reinsurance activities include the reinsurance of risks relating to the loss of goods stored by tenants in the stores operated by the Company. Excluded from segment revenues and net operating income is property management fees and other income.

For all periods presented, substantially all of the Company's real estate assets, intangible assets, other assets, and accrued and other liabilities are associated with the self-storage operations segment. The prior periods have been restated to conform to the current presentation. Financial information for the Company's business segments is set forth below:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Revenues:				
Self-Storage Operations	\$266,728	\$248,589	\$772,742	\$720,878
Tenant Reinsurance	30,105	25,882	85,660	73,050
Total segment revenues	\$296,833	\$274,471	\$858,402	\$793,928
Operating expenses:				
Self-Storage Operations	\$73,652	\$70,430	\$219,488	\$204,370
Tenant Reinsurance	7,720	6,272	18,798	13,996
Total segment operating expenses	\$81,372	\$76,702	\$238,286	\$218,366
Net operating income:				
Self-Storage Operations	\$193,076	\$178,159	\$553,254	\$516,508
Tenant Reinsurance	22,385	19,610	66,862	59,054
Total segment net operating income:	\$215,461	\$197,769	\$620,116	\$575,562
Other components of net income (loss):				
Property management fees and other income	10,120	9,685	30,849	29,239
General and administrative expense	(19,707)	(19,498)	(62,822)	(60,171)
Depreciation and amortization expense	(52,283)	(48,075)	(155,924)	(144,139)

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

Gain/(loss) on real estate transactions and impairment of real estate	30,807	—	30,807	(6,019 )
Interest expense	(45,926 )	(39,766 )	(130,239 )	(113,192 )
Non-cash interest expense related to the amortization of discount on equity component of exchangeable senior notes	(1,140 )	(1,268 )	(3,525 )	(3,827 )
Interest income	1,371	1,401	3,997	5,201
Equity in earnings of unconsolidated real estate ventures	3,622	3,990	10,648	11,407
Income tax expense	(2,638 )	(3,163 )	(6,077 )	(9,154 )
Net income	\$139,687	\$101,075	\$337,830	\$284,907



EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited) (continued)

Amounts in thousands, except store and share data, unless otherwise stated

16. COMMITMENTS AND CONTINGENCIES

As of September 30, 2018, the Company was involved in various legal proceedings and was subject to various claims and complaints arising in the ordinary course of business. Because litigation is inherently unpredictable, the outcome of these matters cannot presently be determined with any degree of certainty. In accordance with applicable accounting guidance, management establishes an accrued liability for litigation when those matters present loss contingencies that are both probable and reasonably estimable. In such cases, there may be an exposure to loss in excess of any amounts accrued. The estimated loss, if any, is based upon currently available information and is subject to significant judgment, a variety of assumptions, and known and unknown uncertainties. The Company could in the future incur judgments or enter into settlements of claims that could have a material adverse effect on its results of operations in any particular period, notwithstanding the fact that the Company is currently vigorously defending any legal proceedings against it.

As of September 30, 2018, the Company was under agreement to acquire 13 stores at a total purchase price of \$161,356. Of these stores, seven are scheduled to close in 2018 at a purchase price of \$91,433, five are scheduled to close in 2019 at a purchase price of \$59,395, and one is scheduled to close thereafter at a purchase price of \$10,528. Additionally, the Company is under agreement to acquire 18 stores with joint venture partners, for a total investment of \$62,490. Twelve of these stores are scheduled to close in 2018 and the remaining six stores are expected to close thereafter.

Although there can be no assurance, the Company is not aware of any material environmental liability, for which it believes it will be ultimately responsible, that could have a material adverse effect on its financial condition or results of operations. However, changes in applicable environmental laws and regulations, the uses and conditions of properties in the vicinity of the Company's stores, the activities of its tenants and other environmental conditions of which the Company is unaware with respect to its stores could result in future material environmental liabilities.

17. SUBSEQUENT EVENTS

Subsequent to September 30, 2018, the Company purchased three stores located in California and Georgia for a total purchase price of \$31,900. These acquisitions are included in the amounts shown in the commitments and contingencies footnote.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Amounts in thousands, except store and share data

CAUTIONARY LANGUAGE

The following discussion and analysis should be read in conjunction with our unaudited "Condensed Consolidated Financial Statements" and the "Notes to Condensed Consolidated Financial Statements (unaudited)" appearing elsewhere in this report and the "Consolidated Financial Statements," "Notes to Consolidated Financial Statements" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained in our Form 10-K for the year ended December 31, 2017. We make statements in this section that are forward-looking statements within the meaning of the federal securities laws. For a complete discussion of forward-looking statements, see the section in this Form 10-Q entitled "Statement on Forward-Looking Information."

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based on our unaudited condensed consolidated financial statements contained elsewhere in this report, which have been prepared in accordance with GAAP. Our notes to the unaudited condensed consolidated financial statements contained elsewhere in this report and the audited financial statements contained in our Form 10-K for the year ended December 31, 2017 describe the significant accounting policies essential to our unaudited condensed consolidated financial statements. Preparation of our financial statements requires estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions that we have used are appropriate and correct based on information available at the time they were made. These estimates, judgments and assumptions can affect our reported assets and liabilities as of the date of the financial statements, as well as the reported revenues and expenses during the period presented. If there are material differences between these estimates, judgments and assumptions and actual facts, our financial statements may be affected.

In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require our judgment in its application. There are areas in which our judgment in selecting among available alternatives would not produce a materially different result, but there are some areas in which our judgment in selecting among available alternatives would produce a materially different result. See the notes to the unaudited condensed consolidated financial statements that contain additional information regarding our accounting policies and other disclosures.

OVERVIEW

We are a fully integrated, self-administered and self-managed real estate investment trust ("REIT"), formed to own, operate, manage, acquire, develop and redevelop self-storage properties ("stores"). We derive substantially all of our revenues from our two segments: storage operations and tenant reinsurance. Primary sources of revenue for our storage operations segment include rents received from tenants under leases at each of our wholly-owned stores. Our operating results depend materially on our ability to lease available self-storage units, to actively manage unit rental rates, and on the ability of our tenants to make required rental payments. Consequently, management spends a significant portion of their time maximizing cash flows from our diverse portfolio of stores. Revenue from our tenant reinsurance segment consists of insurance revenues from the reinsurance of risks relating to the loss of goods stored by tenants in the Company's stores. Our segment presentation has changed from the prior year, and all applicable information has been reclassified to conform to the current year's segment presentation.

Our stores are generally situated in locations clustered around large population centers. These areas enjoy above average population growth and income levels. The clustering of our assets around these population centers enables us

to reduce our operating costs through economies of scale. To maximize the performance of our stores, we use an internally developed revenue management system that enables us to analyze, set and adjust rental rates in real time across our portfolio in order to respond to changing market conditions. We believe our systems and processes allow us to more proactively manage revenues.

We operate in competitive markets, often where consumers have multiple stores from which to choose. Competition has impacted, and will continue to impact, our store results. We experience seasonal fluctuations in occupancy levels, with occupancy levels generally higher in the summer months due to increased moving activity. We believe that we are able to respond quickly and effectively to changes in local, regional and national economic conditions by adjusting rental rates through

the combination of our revenue management team and our proprietary pricing systems. We consider a store to be in the lease-up stage after it has been issued a certificate of occupancy, but before it has achieved stabilization. We consider a store to be stabilized once it has achieved either an 80% occupancy rate for a full year measured as of January 1 of the current year, or has been open for three years prior to January 1 of the current year.

## PROPERTIES

As of September 30, 2018, we owned or had ownership interests in 1,099 operating stores. Of these stores, 872 are wholly-owned, four are in consolidated joint ventures, and 223 are in unconsolidated joint ventures. In addition, we managed an additional 507 stores for third parties bringing the total number of stores which we own and/or manage to 1,606. These stores are located in 39 states, Washington, D.C. and Puerto Rico. The majority of our stores are clustered around large population centers. Our acquisitions have given us an increased scale in many core markets as well as a foothold in many markets where we had no previous presence.

As of September 30, 2018, approximately 915,000 tenants were leasing storage units at the operating stores that we own and/or manage, primarily on a month-to-month basis, providing the flexibility to increase rental rates over time as market conditions permit. Existing tenants generally receive rate increases at least annually, for which no direct correlation has been drawn to our vacancy trends. Although leases are short-term in duration, the typical tenant tends to remain at our stores for an extended period of time. For stores that were stabilized as of September 30, 2018, the average length of stay was approximately 15.0 months.

The average annual rent per square foot for our existing customers at stabilized stores, net of discounts and bad debt, was \$16.21 for the three months ended September 30, 2018, compared to \$15.75 for the three months ended September 30, 2017. Average annual rent per square foot for new leases was \$17.77 for the three months ended September 30, 2018, compared to \$16.87 for the three months ended September 30, 2017. The average discount, as a percentage of rental revenues, at all stabilized properties during these periods was 4.5% and 3.8%, respectively.

Our store portfolio is made up of different types of construction and building configurations depending on the site and the municipality where it is located. Most often sites are what we consider “hybrid” stores, a mix of drive-up and multi-floor buildings. We have a number of multi-floor buildings with elevator access only, and a number of stores featuring ground-floor access only.

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

The following table presents additional information regarding net rentable square feet and the number of stores by state.

Location	September 30, 2018							
	REIT Owned		Joint Venture Owned		Managed		Total	
	Property Count	Net Rentable Square Feet	Property Count	Net Rentable Square Feet	Property Count	Net Rentable Square Feet	Property Count	Net Rentable Square Feet
Alabama	8	557,518	1	75,526	12	795,719	21	1,428,763
Arizona	23	1,622,847	7	466,936	9	670,316	39	2,760,099
California	144	11,343,815	53	3,752,994	60	5,660,581	257	20,757,390
Colorado	15	1,004,050	2	186,253	25	1,746,498	42	2,936,801
Connecticut	7	526,028	7	596,366	2	135,514	16	1,257,908
Delaware	—	—	1	76,765	1	69,269	2	146,034
Florida	86	6,599,179	20	1,557,318	68	4,921,766	174	13,078,263
Georgia	57	4,362,220	3	275,245	15	1,130,576	75	5,768,041
Hawaii	9	603,185	—	—	7	404,404	16	1,007,589
Illinois	31	2,397,176	5	371,836	24	1,665,538	60	4,434,550
Indiana	15	948,611	1	56,926	10	649,526	26	1,655,063
Kansas	1	50,199	2	108,770	1	70,420	4	229,389
Kentucky	11	834,088	1	51,048	4	312,556	16	1,197,692
Louisiana	2	150,555	—	—	1	132,745	3	283,300
Maryland	32	2,561,257	7	530,418	22	1,575,660	61	4,667,335
Massachusetts	44	2,716,881	9	560,218	5	304,991	58	3,582,090
Michigan	7	561,999	4	314,069	1	102,291	12	978,359
Minnesota	3	154,203	—	—	5	303,989	8	458,192
Mississippi	3	215,912	—	—	4	255,730	7	471,642
Missouri	5	332,141	2	119,575	7	451,411	14	903,127
Nebraska	—	—	—	—	2	128,103	2	128,103
Nevada	14	1,042,087	4	472,751	6	772,832	24	2,287,670
New Hampshire	2	135,810	2	84,005	1	46,301	5	266,116
New Jersey	59	4,709,713	17	1,244,535	7	547,312	83	6,501,560
New Mexico	11	720,655	3	163,410	4	335,585	18	1,219,650
New York	23	1,732,868	11	857,293	14	737,484	48	3,327,645
North Carolina	18	1,319,001	3	214,795	17	1,326,600	38	2,860,396
Ohio	17	1,305,110	5	325,327	4	253,354	26	1,883,791
Oklahoma	—	—	—	—	18	1,497,876	18	1,497,876
Oregon	6	399,442	4	281,393	5	302,255	15	983,090
Pennsylvania	17	1,285,395	7	508,266	18	1,296,018	42	3,089,679
Rhode Island	2	130,846	—	—	1	84,665	3	215,511
South Carolina	23	1,752,120	6	415,793	16	1,205,343	45	3,373,256
Tennessee	17	1,421,136	12	802,125	12	910,827	41	3,134,088
Texas	99	8,539,134	10	705,556	61	4,909,889	170	14,154,579
Utah	10	707,771	—	—	10	713,894	20	1,421,665
Virginia	46	3,669,884	7	563,763	13	914,953	66	5,148,600
Washington	8	591,359	1	57,170	3	209,002	12	857,531
Washington, DC	1	99,664	1	104,382	1	73,237	3	277,283
Wisconsin	—	—	5	494,596	3	242,407	8	737,003

Edgar Filing: Extra Space Storage Inc. - Form 10-Q

Puerto Rico	—	—	—	—	8	914,108	8	914,108
Totals	876	67,103,859	223	16,395,423	507	38,781,545	1,606	122,280,827

## RESULTS OF OPERATIONS

Comparison of the three and nine months ended September 30, 2018 and 2017

## Overview

Results for the three and nine months ended September 30, 2018 included the operations of 1,099 stores (872 wholly-owned, four in consolidated joint ventures, and 223 in joint ventures accounted for using the equity method) compared to the results for the three and nine months ended September 30, 2017, which included the operations of 1,028 stores (844 wholly-owned, two in a consolidated joint venture, and 182 in joint ventures accounted for using the equity method).

## Revenues

The following table presents information on revenues earned for the periods indicated:

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
Revenues:								
Property rental	\$266,728	\$248,589	\$18,139	7.3 %	\$772,742	\$720,878	\$51,864	7.2 %
Tenant reinsurance	30,105	25,882	4,223	16.3 %	85,660	73,050	12,610	17.3 %
Management fees and other income	10,120	9,685	435	4.5 %	30,849	29,239	1,610	5.5 %
Total revenues	\$306,953	\$284,156	\$22,797	8.0 %	\$889,251	\$823,167	\$66,084	8.0 %

**Property Rental**—The increase in property rental revenues for the three and nine months ended September 30, 2018 was primarily the result of increases in rental rates at our stabilized stores and revenues from newly-acquired stores. Increases of \$17,063 and \$42,072 for the three and nine months ended September 30, 2018, respectively, were attributable to store acquisitions completed in 2018 and 2017. We acquired 28 stores during the nine months ended September 30, 2018 and 46 stores during the year ended December 31, 2017. Increases of \$7,662 and \$27,940 for the three and nine months ended September 30, 2018, respectively, were due to rental rate increases for new and existing customers at our stabilized stores. These increases were partially offset by decreases of \$7,476 and \$21,088 for the three and nine months ended September 30, 2018, respectively, due to property sales. During 2017, 36 stores were sold to a joint venture in which we hold a ten percent interest.

**Tenant Reinsurance**—The increase in our tenant reinsurance revenues was due primarily to an increase in additional coverages provided to tenants and an increase in the number of stores operated. We operated 1,606 stores at September 30, 2018 compared to 1,513 stores at September 30, 2017.

**Management Fees and Other Income**—Management fees and other income primarily represent the fee collected for our management of stores owned by third parties and unconsolidated joint ventures.

## Expenses

The following table presents information on expenses for the periods indicated:

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,				
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change	
Expenses:									
Property operations	\$73,652	\$70,430	\$3,222	4.6 %	\$219,488	\$204,370	\$15,118	7.4 %	
Tenant reinsurance	7,720	6,272	1,448	23.1 %	18,798	13,996	4,802	34.3 %	
General and administrative	19,707	19,498	209	1.1 %	62,822	60,171	2,651	4.4 %	
Depreciation and amortization	52,283	48,075	4,208	8.8 %	155,924	144,139	11,785	8.2 %	
Total expenses	\$153,362	\$144,275	\$9,087	6.3 %	\$457,032	\$422,676	\$34,356	8.1 %	

**Property Operations**—The increases in property operations expense during the three and nine months ended September 30, 2018 were due primarily to increases of \$5,617 and \$14,341, respectively, related to store acquisitions completed in 2018 and 2017. We acquired 28 stores during the nine months ended September 30, 2018 and 46 stores during the year ended December 31, 2017. An additional increase of \$6,791 was related to increases in expenses at stabilized stores during the nine months ended September 30, 2018. These increases were partially offset by decreases of \$2,310 and \$6,730 for the three and nine months ended September 30, 2018, respectively, due to property sales.

**Tenant Reinsurance**—Tenant reinsurance expense represents the costs that are incurred to provide tenant reinsurance. The change was due primarily to an increase in the number of stores we owned and/or managed and an increase in water and pest claims.

**General and Administrative**—General and administrative expenses primarily include all expenses not directly related to our stores, including corporate payroll, travel and professional fees. We did not observe any material trends in specific payroll, travel or other expenses that contributed to the change in general and administrative expenses.

**Depreciation and Amortization**—Depreciation and amortization expense increased as a result of the acquisition of new stores. We acquired 28 stores during the nine months ended September 30, 2018 and 46 stores during the year ended December 31, 2017.



Other Revenues and Expenses

The following table presents information about other revenues and expenses for the periods indicated:

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2018	2017	\$ Change	% Change	2018	2017	\$ Change	% Change
Other income and expenses:								
Gain (loss) on real estate transactions and impairment of real estate	\$30,807	\$—	\$30,807	100.0 %	\$30,807	\$(6,019)	\$36,826	(611.8)%
Interest expense	(45,926)	(39,766)	(6,160)	15.5 %	(130,239)	(113,192)	(17,047)	15.1 %
Non-cash interest expense related to amortization of discount on equity component of exchangeable senior notes	(1,140)	(1,268)	128	(10.1)%	(3,525)	(3,827)	302	(7.9)%
Interest income	1,371	1,401	(30)	(2.1)%	3,997	5,201	(1,204)	(23.1)%
Equity in earnings of unconsolidated real estate ventures	3,622	3,990	(368)	(9.2)%	10,648	11,407	(759)	(6.7)%
Income tax expense	(2,638)	(3,163)	525	(16.6)%	(6,077)	(9,154)	3,077	(33.6)%
Total other income (expense), net	\$(13,904)	\$(38,806)	\$24,902	(64.2)%	\$(94,389)	\$(115,584)	\$21,195	(18.3)%

Gain (Loss) on Real Estate Transactions and Impairment of Real Estate—During the three and nine months ended September 30, 2018, we recorded \$30,671 related to a gain on the sale of one property in California. During the nine months ended September 30, 2017, we recorded an impairment loss of \$6,019 relating to one parcel of land held for sale and an additional two parcels of undeveloped land where the carrying value was greater than the fair value.

Interest Expense—The increases in interest expense during the three and nine months ended September 30, 2018 were primarily the result of an overall increase in interest rate and total debt during each period when compared to the same periods in the prior year. The average interest rate on our total fixed- and variable-rate debt at September 30, 2018 was 3.5%, compared to 3.3% as of September 30, 2017. Additionally, the total face value of our debt, including our lines of credit, was \$4,803,360 at September 30, 2018 compared to \$4,362,400 at September 30, 2017.

Non-cash Interest Expense Related to Amortization of Discount on Equity Component of Exchangeable Senior Notes—Represents the amortization of the discounts related to the equity components of the exchangeable senior notes issued by our Operating Partnership. The 2013 Notes and 2015 Notes both had an effective interest rate of 4.0% relative to the carrying amount of the liability.

Interest Income—Interest income represents amounts earned on cash and cash equivalents deposited with financial institutions, interest earned on notes receivable and income earned on note receivable from Preferred Operating Partnership unit holders.

Equity in Earnings of Unconsolidated Real Estate Ventures—Equity in earnings of unconsolidated real estate ventures represents the income earned through our ownership interests in unconsolidated joint ventures. In these joint ventures, we and our joint venture partners generally receive a preferred return on our invested capital. To the extent that cash/profits in excess of these preferred returns are generated, we receive a higher percentage of the excess

cash/profits.

Income Tax Expense—For the three and nine months ended September 30, 2018, the decrease in income tax expense relates primarily to a lower tax rate from 35% to 21% due to the Tax Cuts and Jobs Act of 2017.

35

---

## FUNDS FROM OPERATIONS

Funds from Operations (“FFO”) provides relevant and meaningful information about our operating performance that is necessary, along with net income and cash flows, for an understanding of our operating results. We believe FFO is a meaningful disclosure as a supplement to net earnings. Net earnings assume that the values of real estate assets diminish predictably over time as reflected through depreciation and amortization expenses. The values of real estate assets fluctuate due to market conditions and we believe FFO more accurately reflects the value of our real estate assets. FFO is defined by the National Association of Real Estate Investment Trusts, Inc. (“NAREIT”) as net income computed in accordance with GAAP, excluding gains or losses on sales of operating stores and impairment write downs of depreciable real estate assets, plus depreciation and amortization and after adjustments to record unconsolidated partnerships and joint ventures on the same basis. We believe that to further understand our performance, FFO should be considered along with the reported net income and cash flows in accordance with GAAP, as presented in our condensed consolidated financial statements. FFO should not be considered a replacement of net income computed in accordance with GAAP.

The computation of FFO may not be comparable to FFO reported by other REITs or real estate companies that do not define the term in accordance with the current NAREIT definition or that interpret the current NAREIT definition differently. FFO does not represent cash generated from operating activities determined in accordance with GAAP, and should not be considered as an alternative to net income as an indication of our performance, as an alternative to net cash flow from operating activities, as a measure of liquidity, or an indicator of our ability to make cash distributions.

The following table presents the calculation of FFO for the periods indicated:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income attributable to common stockholders	\$130,418	\$93,764	\$313,827	\$263,052
Adjustments:				
Real estate depreciation	48,673	43,303	144,018	127,729
Amortization of intangibles	1,835	2,316	6,427	11,164
(Gain)/loss on real estate transactions and impairment of real estate	(30,807)	—	(30,807)	6,019
Unconsolidated joint venture real estate depreciation and amortization	1,781	1,429	4,931	4,267
Distributions paid on Series A Preferred Operating Partnership units	(572)	(572)	(1,716)	(2,547)
Income allocated to Operating Partnership noncontrolling interests	9,269	7,363	24,003	21,928
Funds from operations attributable to common stockholders and unit holders	\$160,597	\$147,603	\$460,683	\$431,612

## SAME-STORE RESULTS

Our same-store pool for the periods presented consists of 783 stores that are wholly-owned and operated and that were stabilized by the first day of the earliest calendar year presented. We consider a store to be stabilized once it has been open for three years or has sustained average square foot occupancy of 80% or more for one calendar year. We believe that by providing same-store results from a stabilized pool of stores, with accompanying operating metrics including, but not limited to: occupancy, rental revenue growth, operating expense growth, net operating income growth, etc., stockholders and potential investors are able to evaluate operating performance without the effects of non-stabilized occupancy levels, rent levels, expense levels, acquisitions or completed developments. Same-store results should not be used as a basis for future same-store performance or for the performance of our stores as a whole. The following table presents operating data for our same-store portfolio.



Edgar Filing: Extra Space Storage Inc. - Form 10-Q

	For the Three Months Ended September 30,			Percent Change	For the Nine Months Ended September 30,			Percent Change
	2018	2017			2018	2017		
Same-store rental revenues	\$244,051	\$236,408	3.2 %	\$715,970	\$687,418	4.2 %		
Same-store operating expenses	65,799	63,911	3.0 %	198,199	188,888	4.9 %		
Same-store net operating income	\$178,252	\$172,497	3.3 %	\$517,771	\$498,530	3.9 %		
Same-store square foot occupancy as of quarter end	93.9	% 93.7	%	93.9	% 93.7	%		
Properties included in same-store	783	783		783	783			

Same-store revenues for the three and nine months ended September 30, 2018 increased due to higher rental rates for both new and existing customers and were partially offset by increased discounts. Expenses were higher for the three months ended September 30, 2018, primarily due to increases in property taxes, marketing and insurance. Expenses were higher for the nine months ended September 30, 2018, primarily due to increases in property taxes, payroll and benefits and marketing. Four stores were removed from the same-store pool during the three months ended September 30, 2018, due to one disposition and three redevelopment/expansion projects of sufficient scale to require removal from the same-store pool per our same-store pool definition.

The following table presents a reconciliation of same-store net operating income to net income as presented on our condensed consolidated statements of operations for the periods indicated:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	\$139,687	\$101,075	\$337,830	\$284,907
Adjusted to exclude:				
Loss (gain) on real estate transactions and impairment of real estate	(30,807 )	—	(30,807 )	6,019
Equity in earnings of unconsolidated joint ventures	(3,622 )	(3,990 )	(10,648 )	(11,407 )
Interest expense	47,066	41,034	133,764	117,019
Depreciation and amortization	52,283	48,075	155,924	144,139
Income tax expense	2,638	3,163	6,077	9,154
General and administrative (includes stock compensation)	19,707	19,498	62,822	60,171
Management fees, other income and interest income	(11,491 )	(11,086 )	(34,846 )	(34,440 )
Net tenant reinsurance	(22,385 )	(19,610 )	(66,862 )	(59,054 )
Non same store revenue	(22,677 )	(12,181 )	(56,772 )	(33,460 )
Non same store expense	7,853	6,519	21,289	15,482
Total same store NOI	\$178,252	\$172,497	\$517,771	\$498,530
Same-store rental revenues	\$244,051	\$236,408	\$715,970	\$687,418
Same-store operating expenses	65,799	63,911	198,199	188,888
Same-store net operating income	\$178,252	\$172,497	\$517,771	\$498,530

#### LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2018, we had \$45,378 available in cash and cash equivalents. Our cash and cash equivalents are held in accounts managed by third party financial institutions and consist of invested cash and cash in our operating accounts. During 2018 and 2017, we experienced no loss or lack of access to our cash or cash equivalents; however, there can be no assurance that access to our cash and cash equivalents will not be impacted by adverse conditions in the financial markets.



As of September 30, 2018, we had \$4,803,360 face value of debt, resulting in a debt to total enterprise value ratio of 29.1%. As of September 30, 2018, the ratio of total fixed-rate debt and other instruments to total debt was 74.4% (including \$2,168,575 on which we have interest rate swaps that have been included as fixed-rate debt). The weighted average interest rate of the total of fixed- and variable-rate debt at September 30, 2018 was 3.5%. Certain of our real estate assets are pledged as collateral for our debt. We are subject to certain restrictive covenants relating to our outstanding debt. We were in compliance with all financial covenants at September 30, 2018.

We expect to fund our short-term liquidity requirements, including operating expenses, recurring capital expenditures, dividends to stockholders, distributions to holders of Operating Partnership units and interest on our outstanding indebtedness, out of our operating cash flow, cash on hand and borrowings under our revolving lines of credit, including undrawn portions of our unsecured facility. In addition, we are pursuing additional sources of financing based on anticipated funding needs.

Our liquidity needs consist primarily of cash distributions to stockholders, store acquisitions, principal payments under our borrowings and non-recurring capital expenditures. We may from time to time seek to repurchase our outstanding debt, shares of common stock or other securities in open market purchases, privately negotiated transactions or otherwise. Such repurchases, if any, will depend on prevailing market conditions, our liquidity requirements, contractual restrictions and other factors. In addition, we evaluate, on an ongoing basis, the merits of strategic acquisitions and other relationships, which may require us to raise additional funds. We may also use Operating Partnership units as currency to fund acquisitions from self-storage owners.

## CASH FLOWS

Cash flows provided by operating activities were \$529,027 and \$449,629 for the nine months ended September 30, 2018 and 2017, respectively. Cash flows from operating activities were higher primarily due to an increase of \$52,923 in net income during the nine months ended September 30, 2018, which was partially offset by the add back of a non-cash gain on real estate transactions and impairment of real estate of \$36,826. There were also increases of \$21,252 in the change in accounts payable and accrued expenses and \$14,664 in the change in other assets when compared with the nine months ended September 30, 2017.

Cash used in investing activities was \$317,029 and \$84,351, for the nine months ended September 30, 2018 and 2017, respectively. The increase was primarily due to an increase in cash paid for the acquisition of real estate assets of \$207,971 during the nine months ended September 30, 2018 when compared to the prior year. We purchased 28 stores during the nine months ended September 30, 2018, compared to 9 stores purchased during the nine months ended September 30, 2017.

Cash used in financing activities was \$231,459 and \$342,011 for the nine months ended September 30, 2018 and 2017, respectively. The change related primarily to a decrease in principal payments on notes payable and revolving lines of credit of \$232,205 when compared to the same period in the prior year. This decrease was partially offset by an increase in cash paid for the repurchase of our 2013 exchangeable senior notes of \$60,544, a decrease of \$49,784 in proceeds from notes payable and revolving lines of credit, and an increase of \$21,650 for principal payments on notes payable to trusts during the nine months ended September 30, 2018 when compared to the prior year.

## OFF-BALANCE SHEET ARRANGEMENTS

Except as disclosed in the notes to our consolidated financial statements of our most recently filed Annual Report on Form 10-K, we do not currently have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purposes entities, which typically are established for the

purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, except as disclosed in the notes to our condensed consolidated financial statements, we have not guaranteed any obligations of unconsolidated entities, nor do we have any commitments or intent to provide funding to any such entities. Accordingly, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in these relationships.



## SEASONALITY

The self-storage business is subject to seasonal fluctuations. A greater portion of revenues and profits are realized from May through September. Historically, our highest level of occupancy has been at the end of July, while our lowest level of occupancy has been in late February and early March. Results for any quarter may not be indicative of the results that may be achieved for the full fiscal year.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

### Market Risk

Market risk refers to the risk of loss from adverse changes in market prices and interest rates. Our future income, cash flows and fair values of financial instruments are dependent upon prevailing market interest rates.

### Interest Rate Risk

Interest rate risk is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control.

As of September 30, 2018, we had \$4.8 billion in total face value of debt, of which \$1.2 billion was subject to variable interest rates (excluding debt with interest rate swaps). If LIBOR were to increase or decrease by 100 basis points, the increase or decrease in interest expense on the variable-rate debt would increase or decrease future earnings and cash flows by \$12.3 million annually.

Interest rate risk amounts were determined by considering the impact of hypothetical interest rates on our financial instruments. These analyses do not consider the effect of any change in overall economic activity that could occur. Further, in the event of a change of that magnitude, we may take actions to further mitigate our exposure to the change. However, due to the uncertainty of the specific actions that would be taken and their possible effects, these analyses assume no changes in our financial structure.

## ITEM 4. CONTROLS AND PROCEDURES

### (1) Disclosure Controls and Procedures

We maintain disclosure controls and procedures to ensure that information required to be disclosed in the reports we file pursuant to the Securities Exchange Act of 1934, as amended, or the Exchange Act, are recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure based on the definition of “disclosure controls and procedures” in Rule 13a-15(e) of the Exchange Act. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can only provide a reasonable assurance of achieving the desired control objectives, and in reaching a reasonable level of assurance, management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We have a disclosure committee that is responsible for considering the materiality of information and determining our disclosure obligations on a timely basis. The disclosure committee meets quarterly and reports directly to our Chief Executive Officer and Chief Financial Officer.

We carried out an evaluation, under the supervision and with the participation of management, including our Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at

the reasonable assurance level as of the end of the period covered by this report.

(2) Changes in internal control over financial reporting

There were no changes in our internal control over financial reporting (as such term is defined in Exchange Act Rule 13a-15(f)) that occurred during our most recent quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

We are involved in various legal proceedings and are subject to various claims and complaints arising in the ordinary course of business. Because litigation is inherently unpredictable, the outcome of these matters cannot presently be determined with any degree of certainty. In accordance with applicable accounting guidance, management establishes an accrued liability for litigation when those matters present loss contingencies that are both probable and reasonably estimable. In such cases, there may be an exposure to loss in excess of any amounts accrued. The estimated loss, if any, is based upon currently available information and is subject to significant judgment, a variety of assumptions, and known and unknown uncertainties. We could in the future incur judgments or enter into settlements of claims that could have a material adverse effect on our results of operations in any particular period, notwithstanding the fact that we are currently vigorously defending any legal proceedings against us.

### ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in “Part I. Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017, which could materially affect our business, financial condition and results of operations. There have been no material changes to the risk factors described in the “Risk Factors” section in our Annual Report on Form 10-K for the year ended December 31, 2017. The risks described in our Annual Report on Form 10-K are not the only risks facing our company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially adversely affect our business, financial condition and results of operations.

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

### ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable.

### ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 The following materials from Extra Space Storage Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2018, are formatted in XBRL (eXtensible Business Reporting Language): (1) the Condensed Consolidated Balance Sheets, (2) the Condensed Consolidated Statements of Operations, (3) the Condensed Consolidated Statements of Comprehensive Income (4) the Condensed Consolidated Statement of Noncontrolling Interests and Equity, (5) the Condensed Consolidated Statements of Cash Flows and (6) notes to these financial statements.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

EXTRA SPACE STORAGE INC.  
Registrant

Date: November 6, 2018 /s/ Joseph D. Margolis  
Joseph D. Margolis  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 6, 2018 /s/ P. Scott Stubbs  
P. Scott Stubbs  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)