Extra Space Storage Inc.
Form 10-Q
May 08, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

or

o 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 incorporation or organization)	(I.R.S. Employer Identification No.)

2795 East Cottonwood Parkway, Suite 400

Salt Lake City, Utah 84121

(Address of principal executive offices)

Registrant s telephone number, including area code: **(801) 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 x No o

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

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

Large accelerated filer x	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The number of shares outstanding of the registrant s common stock, par value $0.01 per share, as of April 30, 2013, was 110,980,031.

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EXTRA SPACE STORAGE INC.

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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, intends , or the negative of such terms or other comparable terminology, or by discussions of strategy. We may also make additional forward-looking statements from time to time. All such subsequent forward-looking statements, whether written or oral, by us or on our behalf, are also expressly qualified by these cautionary statements.

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

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

- adverse changes in general economic conditions, the real estate industry and the markets in which we operate;
- the effect of competition from new and existing self-storage facilities or other storage alternatives, which could cause rents and occupancy rates to decline;
- difficulties in our ability to evaluate, finance, complete and integrate acquisitions and developments successfully and to lease up those properties, which could adversely affect our profitability;
- 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), which could increase our expenses and reduce our cash available for distribution;

- 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 and operating costs;
- reductions in asset valuations and related impairment charges;
- the failure of our joint venture partners to fulfill their obligations to us or their pursuit of actions that are inconsistent with our objectives;
- the failure to maintain our REIT status for federal income tax purposes;
- economic uncertainty due to the impact of war or terrorism, which could adversely affect our business plan; and
- difficulties in our ability to attract and retain qualified personnel and management members.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Extra Space Storage Inc.

Condensed Consolidated Balance Sheets

(amounts in thousands, except share data)

	March 31, 2013 (Unaudited)	December 31, 2012
Assets:		
Real estate assets, net	$ 2,995,510	$ 2,991,722
Investments in unconsolidated real estate ventures	102,102	106,313
Cash and cash equivalents	35,575	30,785
Restricted cash	20,157	16,976
Receivables from related parties and affiliated real estate joint ventures	9,096	11,078
Other assets, net	66,656	66,603
Total assets	$ 3,229,096	$ 3,223,477
Liabilities, Noncontrolling Interests and Equity:		
Notes payable	$ 1,361,554	$ 1,369,690
Premium on notes payable	2,754	3,319
Notes payable to trusts	119,590	119,590
Lines of credit	100,000	85,000
Accounts payable and accrued expenses	45,435	52,299
Other liabilities	46,611	48,248
Total liabilities	1,675,944	1,678,146
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, 300,000,000 shares authorized, 110,924,996 and 110,737,205 shares issued and outstanding at March 31, 2013 and December 31, 2012, respectively	1,109	1,107
Paid-in capital	1,742,569	1,740,037
Accumulated other comprehensive deficit	(12,759)	(14,273)
Accumulated deficit	(231,369)	(235,064)
Total Extra Space Storage Inc. stockholders equity	1,499,550	1,491,807
Noncontrolling interest represented by Preferred Operating Partnership units, net of $100,000 note receivable	29,964	29,918
Noncontrolling interests in Operating Partnership	22,603	22,492
Other noncontrolling interests	1,035	1,114

Total noncontrolling interests and equity		1,553,152		1,545,331
Total liabilities, noncontrolling interests and equity	$	3,229,096	$	3,223,477

See accompanying notes to unaudited condensed consolidated financial statements.

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Extra Space Storage Inc.

Condensed Consolidated Statements of Operations

(amounts in thousands, except share data)

(unaudited)

	For the Three Months Ended March 31, 2013	2012
Revenues:		
Property rental	$ 102,923	$ 75,844
Tenant reinsurance	10,221	8,557
Management fees	6,178	6,586
Total revenues	119,322	90,987
Expenses:		
Property operations	34,437	26,596
Tenant reinsurance	1,910	1,848
Acquisition related costs	452	609
General and administrative	12,769	12,640
Depreciation and amortization	23,025	16,524
Total expenses	72,593	58,217
Income from operations	46,729	32,770
Interest expense	(17,366)	(18,071)
Non-cash interest expense related to amortization of discount on exchangeable senior notes		(444)
Interest income	184	275
Interest income on note receivable from Preferred Operating Partnership unit holder	1,213	1,213
Income before equity in earnings of real estate ventures and income tax expense	30,760	15,743
Equity in earnings of unconsolidated real estate ventures	2,623	2,296
Equity in earnings of unconsolidated real estate ventures - gain on sale of real estate assets and purchase of joint venture partners interests	2,556	5,429
Income tax expense	(2,008)	(950)
Net income	33,931	22,518
Net income allocated to Preferred Operating Partnership noncontrolling interests	(1,717)	(1,649)
Net income allocated to Operating Partnership and other noncontrolling interests	(789)	(655)
Net income attributable to common stockholders	$ 31,425	$ 20,214
Net income per common share		
Basic	$ 0.28	$ 0.21
Diluted	$ 0.28	$ 0.21
Weighted average number of shares		
Basic	110,809,924	94,888,078
Diluted	114,967,087	99,927,352
Cash dividends paid per common share	$ 0.25	$ 0.20

See accompanying notes to unaudited condensed consolidated financial statements.

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Extra Space Storage Inc.

Condensed Consolidated Statements of Comprehensive Income

(amounts in thousands)

(unaudited)

	For the Three Months Ended March 31, 2013	For the Three Months Ended March 31, 2012
Net income	$ 33,931	$ 22,518
Other comprehensive income (loss):		
Change in fair value of interest rate swaps	1,571	(215)
Total comprehensive income	35,502	22,303
Less: comprehensive income attributable to noncontrolling interests	2,563	2,295
Comprehensive income attributable to common stockholders	$ 32,939	$ 20,008

See accompanying notes to unaudited condensed consolidated financial statements.

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Extra Space Storage Inc.

Condensed Consolidated Statement of Equity

(amounts in thousands, except share data)

(unaudited)

	Noncontrolling Interests			Extra Space Storage Inc. Stockholders Equity					
	Preferred Operating Partnership	Operating Partnership	Other	Shares	Par Value	Paid-in Capital	Accumulated Other Comprehensive Deficit	Accumulated Deficit	Total Equity
Balances at December 31, 2012	$ 29,918	$ 22,492	$ 1,114	110,737,205	$ 1,107	$ 1,740,037	$ (14,273)	$ (235,064)	$ 1,545,331
Issuance of common stock upon the exercise of options				124,371	1	1,634			1,635
Restricted stock grants issued				70,105	1				1
Restricted stock grants cancelled				(6,685)					
Compensation expense related to stock-based awards						1,023			1,023
Purchase of additional equity interest in existing consolidated joint venture			(75)			(125)			(200)
Redemption of Operating Partnership units for cash		(20)							(20)
Net income	1,717	777	12					31,425	33,931
Other comprehensive income	14	43					1,514		1,571
Distributions to Operating Partnership units held by noncontrolling interests	(1,685)	(689)							(2,374)
Distributions to other noncontrolling interests			(16)						(16)
Dividends paid on common stock at $0.25 per share								(27,730)	(27,730)
Balances at March 31, 2013	$ 29,964	$ 22,603	$ 1,035	110,924,996	$ 1,109	$ 1,742,569	$ (12,759)	$ (231,369)	$ 1,553,152

See accompanying notes to unaudited condensed consolidated financial statements.

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Extra Space Storage Inc.

Condensed Consolidated Statements of Cash Flows

(amounts in thousands)

(unaudited)

	For the Three Months Ended March 31, 2013	2012
Cash flows from operating activities:		
Net income	$ 33,931	$ 22,518
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	23,025	16,524
Amortization of deferred financing costs	1,510	2,246
Non-cash interest expense related to amortization of discount on exchangeable senior notes		444
Non-cash interest expense related to amortization of premium on notes payable	(565)	(316)
Compensation expense related to stock-based awards	1,023	957
Gain on purchase of joint venture partners interest	(2,556)	
Distributions from unconsolidated real estate ventures in excess of earnings	1,154	589
Changes in operating assets and liabilities:		
Receivables from related parties and affiliated real estate joint ventures	(277)	3,102
Other assets	1,051	2,979
Accounts payable and accrued expenses	(6,864)	(5,250)
Other liabilities	(316)	(3,003)
Net cash provided by operating activities	51,116	40,790
Cash flows from investing activities:		
Acquisition, development and redevelopment of real estate assets	(18,754)	(18,495)
Investments in unconsolidated real estate ventures	(589)	(356)
Return of investment in real estate ventures		1,492
Change in restricted cash	(3,181)	1,495
Purchase of equipment and fixtures	(821)	(531)
Net cash used in investing activities	(23,345)	(16,395)
Cash flows from financing activities:		
Proceeds from notes payable and lines of credit	81,776	206,970
Principal payments on notes payable and lines of credit	(74,912)	(198,048)
Deferred financing costs	(1,340)	(3,418)
Redemption of Operating Partnership units held by noncontrolling interest	(20)	
Net proceeds from exercise of stock options	1,635	2,444
Dividends paid on common stock	(27,730)	(19,002)
Distributions to noncontrolling interests	(2,390)	(2,250)
Net cash used in financing activities	(22,981)	(13,304)
Net increase in cash and cash equivalents	4,790	11,091
Cash and cash equivalents, beginning of the period	30,785	26,484
Cash and cash equivalents, end of the period	$ 35,575	$ 37,575

See accompanying notes to unaudited condensed consolidated financial statements.

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Extra Space Storage Inc.

Condensed Consolidated Statements of Cash Flows

(amounts in thousands)

(unaudited)

	For the Three Months Ended March 31,			
		2013		2012
Supplemental schedule of cash flow information				
Interest paid, net of amounts capitalized	$	15,909	$	14,705
Income taxes paid		589		473
Supplemental schedule of noncash investing and financing activities:				
Acquisitions of real estate assets				
Real estate assets, net	$	2,251	$	377
Operating Partnership units issued				(377)
Receivables from related parties and affiliated real estate joint ventures		(2,251)		
Sale of interest in unconsolidated real estate venture				
Other assets	$		$	3,349
Investments in unconsolidated real estate ventures				(3,349)

See accompanying notes to unaudited condensed consolidated financial statements.

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EXTRA SPACE STORAGE INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Amounts in thousands, except property and share data

1. ORGANIZATION

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

The Company invests in self-storage facilities by acquiring wholly-owned facilities or by acquiring an equity interest in real estate entities. At March 31, 2013, the Company had direct and indirect equity interests in 729 operating storage facilities. In addition, the Company managed 236 properties for third parties, bringing the total number of operating properties which it owns and/or manages to 965. These properties are located in 35 states, Washington, D.C. and Puerto Rico.

The Company operates in three distinct segments: (1) rental operations; (2) tenant reinsurance; and (3) property management, acquisition and development. The rental operations activities include rental operations of self-storage facilities. No single tenant accounts for more than 5% of rental income. Tenant reinsurance activities include the reinsurance of risks relating to the loss of goods stored by tenants in the Company s self-storage facilities. The Company s property management, acquisition and development activities include managing, acquiring, developing and selling self-storage facilities.

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 months ended March 31, 2013, are not necessarily indicative of results that may be expected for the year ending December 31, 2013. The condensed consolidated balance sheet as of December 31, 2012, 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, 2012, as filed with the Securities and Exchange Commission.

Recently Issued Accounting Standards

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-02 Comprehensive Income Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income , which supersedes and replaces the presentation requirements for reclassifications out of accumulated other comprehensive income in ASUs 2011-05 and 2011-12. The amendment requires that an entity must report the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, an entity is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. ASU 2013-02 was effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Company adopted the amended standards beginning January 1, 2013 and presents accumulated other comprehensive income in accordance with the requirements of the standard.

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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 Financial Accounting Standards Board 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 March 31, 2013, 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 March 31, 2013, aggregated by the level in the fair value hierarchy within which those measurements fall.

		Fair Value Measurements at Reporting Date Using		
Description	March 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Other liabilities - Cash Flow Hedge Swap Agreements	$ (13,657)	$	$ (13,657)	$

There were no transfers of assets and liabilities between Level 1 and Level 2 during the three months ended March 31, 2013. The Company did not have any significant assets or liabilities that are re-measured on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2013.

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 self-storage facility at least annually to determine if any such events or circumstances have occurred or exist. The Company focuses on facilities where occupancy and/or rental income have decreased by a significant amount. For these facilities, the Company determines whether the decrease is temporary or permanent, and whether the facility will likely recover the lost occupancy and/or revenue in the short term. In addition, the Company carefully reviews facilities 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.

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, then a valuation allowance is established. The operations of assets held for sale or sold during the period are generally presented as discontinued operations for all periods presented.

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The Company assesses whether there are any indicators that the value of its investments in unconsolidated real estate ventures may be impaired annually and when events or circumstances indicate 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 over the fair value of the investment.

In connection with the Company s acquisition of self-storage facilities, the purchase price is allocated to the tangible and intangible assets and liabilities acquired based on their 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 facilities. 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 expensed as incurred.

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 March 31, 2013 and December 31, 2012 approximate fair value. The fair value of the Company s note receivable from Preferred Operating Partnership unit holder is based on the discounted estimated future cash flows of the note (categorized within Level 3 of the fair value hierarchy); the discount rate used approximates 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 approximate current market rates for loans, or groups of loans, with similar maturities and credit quality.

The fair values of the Company s fixed-rate assets and liabilities are as follows:

	March 31, 2013		December 31, 2012	
	Fair Value	**Carrying Value**	**Fair Value**	**Carrying Value**
Note receivable from Preferred Operating Partnership unit holder	$ 107,215	$ 100,000	$ 108,138	$ 100,000
Fixed rate notes payable and notes payable to trusts	$ 1,317,283	$ 1,268,633	$ 1,342,957	$ 1,275,605

4. NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income by the weighted average common shares outstanding, including unvested share-based payment awards that contain a non-forfeitable right to dividends or dividend equivalents. 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 treasury stock or as if-converted method. Potential common shares are securities (such as options, convertible debt, exchangeable Series A Participating Redeemable Preferred Operating Partnership units (Preferred OP units) and exchangeable Operating Partnership units (OP units)) that do not have a current right to participate in earnings but could do so in the future by virtue of their option or conversion right. In computing the dilutive effect of convertible securities, net income is adjusted to add back any changes in earnings in the period associated with the convertible security. The numerator also is adjusted for the effects of any other non-discretionary changes in income or loss that would result from the assumed conversion of those potential common shares. In computing diluted earnings per share, only potential common shares that are dilutive (those that reduce earnings per share) are included.

The Company s Operating Partnership had $87,663 of exchangeable senior notes (the Notes) that were surrendered for exchange in April 2012. Prior to their exchange, the Notes could potentially have had a dilutive effect on the Company s earnings per share calculations. The Notes were exchangeable by holders into shares of the Company s common stock under certain circumstances per the terms of the indenture governing the Notes and at the time prior to surrender had an exchange price of $23.20 per share. The Company had irrevocably agreed to pay only cash for the accreted principal amount of the Notes relative to its exchange obligations, but retained the right to satisfy the exchange obligations in excess of the accreted principal amount in cash and/or common stock. Though the Company retained that right, Accounting Standards Codification (ASC) 260, *Earnings Per Share,* required an

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assumption that shares would be used to pay the exchange obligations in excess of the accreted principal amount, and required 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 months ended March 31, 2012, 455,552 shares related to the Notes were included in the computation for diluted earnings per share as the stock price during this period exceeded the exchange price. No shares were included for the three months ended March 31, 2013 as the Notes were no longer outstanding.

For the purposes of computing the diluted impact on earnings per share of the potential conversion of Preferred OP units into common shares, 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 $115,000 of the instrument in cash (or net settle a portion of the Preferred OP units against the related outstanding note receivable), only the amount of the instrument in excess of $115,000 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.

For the three months ended March 31, 2013 and 2012, options to purchase 24,950 and 32,612 shares of common stock, respectively, were excluded from the computation of earnings per share as their effect would have been anti-dilutive. All restricted stock grants have been included in basic and diluted shares outstanding because such shares earn a non-forfeitable dividend and carry voting rights.

The computation of net income per common share is as follows:

	For the Three Months Ended March 31,	
	2013	**2012**
Net income attributable to common stockholders	$ 31,425	$ 20,214
Add: Income allocated to noncontrolling interest - Preferred Operating Partnership and Operating Partnership	2,494	2,300
Subtract: Fixed component of income allocated to noncontrolling interest - Preferred Operating Partnership	(1,438)	(1,438)
Net income for diluted computations	$ 32,481	$ 21,076
Weighted average common shares outstanding:		
Average number of common shares outstanding - basic	110,809,924	94,888,078
Operating Partnership units	2,755,650	3,064,128
Preferred Operating Partnership units	989,980	989,980
Shares related to Exchangeable senior notes and dilutive and cancelled stock options	411,533	985,166
Average number of common shares outstanding - diluted	114,967,087	99,927,352
Net income per common share		
Basic	$ 0.28	$ 0.21
Diluted	$ 0.28	$ 0.21

5. PROPERTY ACQUISITIONS

The following table summarizes the Company s acquisitions of operating properties for the three months ended March 31, 2013, and does not include purchases of land or improvements made to existing assets:

			Consideration Paid						Acquisition Date Fair Value				
Property Location	**Number of Properties**	**Date of Acquisition**	**Total**	**Cash Paid**	**Non-cash gain**	**Notes Issued to/from Seller**	**Previous equity interest**	**Net Liabilities/ (Assets) Assumed**	**Land**	**Building**	**Intangible**	**Closing costs - expensed**	**Notes**
Maryland	1	2/13/2013	$ 12,321	$ 8,029	$ 2,215	$	$ 2,273	$ (196)	$ 1,266	$ 10,789	$ 260	$ 6	(1)
Illinois	1	2/13/2013	11,083	7,592	341	2,251	1,173	(274)	1,318	9,485	190	90	(1)
2013 Totals	**2**		**$ 23,404**	**$ 15,621**	**$ 2,556**	**$ 2,251**	**$ 3,446**	**$ (470)**	**$ 2,584**	**$ 20,274**	**$ 450**	**$ 96**	

(1) Acquired from an affiliated joint venture

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6. VARIABLE INTERESTS

The Company has an interest in one unconsolidated joint venture with an unrelated third party which is a variable interest entity (VIE). The Company holds an 18% equity interest in the VIE joint venture (VIE JV), and has 50% of the voting rights in the VIE JV. Qualification as a VIE was based on the determination that the equity investments at risk for this joint venture were not sufficient based on a qualitative and quantitative analysis performed by the Company. The Company performed a qualitative analysis for this joint venture to determine which party was the primary beneficiary. The Company determined that, since the powers to direct the activities most significant to the economic performance of this entity are shared equally by the Company and its joint venture partner, there is no primary beneficiary. Accordingly, this interest is recorded using the equity method.

The VIE JV owns a single self-storage property. This joint venture is financed through a combination of (1) equity contributions from the Company and its joint venture partner, (2) a mortgage note payable and (3) payables to the Company. The payables to the Company consist of amounts owed for expenses paid on behalf of the joint venture by the Company as manager and a mortgage note payable to the Company. The Company performs management services for the VIE JV in exchange for a management fee of approximately 6% of cash collected by the property. Except as disclosed, the Company has not provided financial or other support during the periods presented to the VIE JV that it was not previously contractually obligated to provide.

The Company guarantees the mortgage note payable for the VIE JV. The Company s maximum exposure to loss for this joint venture as of March 31, 2013 is the total of the guaranteed loan balance, payables due to the Company and the Company s investment balance in the joint venture. The Company believes that the risk of incurring a material loss as a result of having to perform on the loan guarantee is unlikely and, therefore, no liability has been recorded related to this guarantee. Additionally, repossessing and/or selling the self-storage facility and land that collateralize the loan could provide funds sufficient to reimburse the Company.

The following table compares the Company s liability balance to the VIE JV and the maximum exposure to loss as of March 31, 2013, after netting such liability balance:

	Liability Balance	Investment Balance	Guaranteed Loan	Payables to Company	Exposure to Loss	Difference
Extra Space of Sacramento One LLC	$	$ (1,041)	$ 4,307	$ 6,072	$ 9,338	$ (9,338)

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 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 to be 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 the notes payable that the Trusts owe to third parties for their investments in the Trusts preferred securities.

The following is a tabular comparison of the 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 March 31, 2013:

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	Notes payable to Trusts	Investment Balance	Maximum exposure to loss	Difference
Trust	$ 36,083	$ 1,083	$ 35,000	$
Trust II	42,269	1,269	41,000	
Trust III	41,238	1,238	40,000	
	$ 119,590	$ 3,590	$ 116,000	$

The Company had no consolidated VIEs during the three months ended March 31, 2013 or 2012.

7. 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.

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 this objective, 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 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 noncontolling interests. During the three months ended March 31, 2013 and 2012, such derivatives were used to hedge the variable cash flows associated with existing variable-rate debt.

The following table summarizes the terms of the Company s 19 derivative financial instruments as of March 31, 2013:

Hedge Product	Current Notional Amounts	Strike	Effective Dates	Maturity Dates
Swap Agreements	$4,873 - $97,211	2.79% - 6.98%	2/1/2009 - 3/21/2013	6/30/2013 - 4/1/2021

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			
	March 31, 2013		December 31, 2012	
Derivatives Designated as Hedging Instruments:	**Balance Sheet Location**	**Fair Value**	**Balance Sheet Location**	**Fair Value**
Swap Agreements	Other liabilities	$ (13,657)	Other liabilities	$ (15,228)

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Effect of Derivative Instruments

The tables below present 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 REIT:

Type	Classification of Income (Expense)	For the Three Months Ended March 31, 2013	2012
Swap Agreements	Interest expense	$ (2,153)	$ (1,118)

Type	Gain (loss) recognized in OCI March 31, 2013	Location of amounts reclassified from OCI into income	Gain (loss) reclassified from OCI For the Three Months Ended March 31, 2013
Swap Agreements	$ (582)	Interest expense	$ (2,153)

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.

As of March 31, 2013, 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 $13,953. As of March 31, 2013, the Company had not posted any collateral related to these agreements. If the Company had breached any of these provisions as of March 31, 2013, it could have been required to settle its obligations under the agreements at their termination value of $13,953.

8. NONCONTROLLING INTEREST REPRESENTED BY PREFERRED OPERATING PARTNERSHIP UNITS

On June 15, 2007, the Operating Partnership entered into a Contribution Agreement with various limited partnerships affiliated with AAAAA Rent-A-Space to acquire ten self-storage facilities (the Properties) in exchange for 989,980 Preferred OP units of the Operating Partnership. The self-storage facilities are located in California and Hawaii.

On June 25, 2007, the Operating Partnership loaned the holders of the Preferred OP units $100,000. The note receivable bears interest at 4.85% and is due September 1, 2017. The loan is secured by the borrower s Preferred OP units. The holders of the Preferred OP units can convert up to 114,500 Preferred OP units prior to the maturity date of the loan. If any redemption in excess of 114,500 Preferred OP units occurs prior to the maturity date, the holder of the Preferred OP units is required to repay the loan as of the date of that Preferred OP unit redemption. Preferred OP 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 Preferred OP units.

The Operating Partnership entered into a Second Amended and Restated Agreement of Limited Partnership (as subsequently amended, the Partnership Agreement) which provides for the designation and issuance of the Preferred OP units. The Preferred OP units will have priority over all other partnership interests of the Operating Partnership with respect to distributions and liquidation.

Under the Partnership Agreement, Preferred OP units in the amount of $115,000 bear a fixed priority return of 5% and have a fixed liquidation value of $115,000. The remaining balance participates in distributions with, and has a liquidation value equal to, that of the common OP units. The Preferred OP units became redeemable at the option of the holder on September 1, 2008, which redemption obligation may be satisfied, at the Company s option, in cash or shares of its common stock.

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

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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 Preferred OP units and classifies the noncontrolling interest represented by the Preferred 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, or (2) its redemption value as of the end of the period in which the determination is made.

9. NONCONTROLLING INTEREST IN OPERATING PARTNERSHIP

The Company s interest in its properties is held through the Operating Partnership. ESS Holding Business Trust I, a wholly-owned subsidiary of the Company, is the sole general partner of the Operating Partnership. The Company, through ESS Holding Business Trust II, a wholly-owned subsidiary of the Company, is also a limited partner of the Operating Partnership. Between its general partner and limited partner interests, the Company held a 96.7% majority ownership interest therein as of March 31, 2013. The remaining ownership interests in the Operating Partnership (including Preferred OP units) of 3.3% are held by certain former owners of assets acquired by the Operating Partnership. As of March 31, 2013, the Operating Partnership had 2,755,650 common OP units outstanding.

The noncontrolling interest in the Operating Partnership represents common OP units that are not owned by the Company. In conjunction with the formation of the Company, and as a result of subsequent acquisitions, certain persons and entities contributing interests in properties to the Operating Partnership received limited partnership units in the form of OP units. Limited partners who received OP units in the formation transactions or in exchange for contributions for interests in properties have the right to require the Operating Partnership to redeem part or all of their common OP units for cash based upon the fair market value of an equivalent number of shares of the Company s common stock (ten-day average) at the time of the redemption. Alternatively, the Company may, at its option, elect to acquire those OP units in exchange for shares of its common stock on a one-for-one basis, subject to anti-dilution adjustments provided in the Partnership Agreement. The ten-day average closing stock price at March 31, 2013, was $38.82 and there were 2,755,650 common OP units outstanding. Assuming that all of the unit holders exercised their right to redeem all of their common OP units on March 31, 2013, and the Company elected to pay the noncontrolling members cash, the Company would have paid $106,974 in cash consideration to redeem the OP units.

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 common OP units and classifies the noncontrolling interest in the Operating Partnership 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, or (2) its redemption value as of the end of the period in which the determination is made.

10. OTHER NONCONTROLLING INTERESTS

Other noncontrolling interests represent the ownership interests of various third parties in three consolidated self-storage properties as of March 31, 2013. Two of these consolidated properties were undeveloped at March 31, 2013. The ownership interests of the third-party owners range from 3.3% to 27.6%. Other noncontrolling interests are included in the stockholders equity section of the Company s condensed consolidated balance sheet. The income or losses attributable to these third-party owners based on percentages outlined in the related agreements are reflected in net income allocated to Operating Partnership and other noncontrolling interests in the condensed consolidated statement of operations.

In February 2013, the Company purchased one of its joint venture partner s 1.7% capital interest and 17% profit interest in one of these consolidated properties for $200. As a result, the Company s capital interest percentage in this joint venture increased from 95% to 96.7%. Since the Company retained its controlling financial interest in the subsidiary, this transaction was accounted for as an equity transaction. The carrying amount of the noncontrolling interest was reduced to reflect the purchase, and the difference between

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the price paid by the Company and the adjustment to the carrying value of the noncontrolling interest was recorded as an adjustment to equity attributable to the parent.

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11. EQUITY IN EARNINGS OF UNCONSOLIDATED REAL ESTATE VENTURES GAIN ON SALE OF REAL ESTATE ASSETS AND PURCHASE OF JOINT VENTURE PARTNERS INTERESTS

On February 13, 2013, the Company acquired its joint venture partner s 48% equity interest in Extra Space of Eastern Avenue LLC (Eastern Avenue) for approximately $5,979, which owned one self-storage property located in Maryland. Prior to the acquisition, the remaining 52% interest was owned by the Company, which accounted for its investment in Eastern Avenue using the equity method. The Company recorded a non-cash gain of $2,215 related to this transaction, which represents the increase in fair value of the Company s interest in Eastern Avenue from its formation to the acquisition date.

On February 13, 2013, the Company acquired its joint venture partner s 61% equity interest in Extra Space of Montrose Avenue LLC (Montrose) for approximately $6,878, which owned one self-storage property located in Illinois. Prior to the acquisition, the remaining 39% interest was owned by the Company, which accounted for its investment in Montrose using the equity method. The Company recorded a non-cash gain of $341 related to this transaction, which represents the increase in fair value of the Company s interest in the joint venture from its formation to the acquisition date.

On February 17, 2012, a joint venture in which the Company held a 40% equity interest sold its only self-storage property, which was located in New York. As a result of the sale, the joint venture was dissolved, and the Company received cash proceeds which resulted in a gain of $5,429.

On January 15, 2012, the Company sold its 40% equity interest in U-Storage de Mexico S.A. and related entities to its joint venture partners for $4,841. The Company received cash of $1,492 and a note receivable of $3,349. No gain or loss was recorded on the sale. At March 31, 2013, the balance of the note receivable was $1,500. The note receivable is due December 31, 2014.

12. SEGMENT INFORMATION

The Company operates in three distinct segments: (1) rental operations; (2) tenant reinsurance; and (3) property management, acquisition and development. Management fees collected for wholly-owned properties are eliminated in consolidation. Financial information for the Company s business segments is presented below:

	March 31, 2013	December 31, 2012
Balance Sheet		
Investments in unconsolidated real estate ventures		
Rental operations	$ 102,102	$ 106,313
Total assets		
Rental operations	$ 3,002,322	$ 2,996,453
Tenant reinsurance	24,255	27,645
Property management, acquisition and development	202,519	199,379
	$ 3,229,096	$ 3,223,477

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	For the Three Months Ended March 31, 2013	2012
Statement of Operations		
Total revenues		
Rental operations	$ 102,923	$ 75,844
Tenant reinsurance	10,221	8,557
Property management, acquisition and development	6,178	6,586
	119,322	90,987
Operating expenses, including depreciation and amortization		
Rental operations	55,968	42,125
Tenant reinsurance	1,910	1,848
Property management, acquisition and development	14,715	14,244
	72,593	58,217
Income (loss) from operations		
Rental operations	46,955	33,719
Tenant reinsurance	8,311	6,709
Property management, acquisition and development	(8,537)	(7,658)
	46,729	32,770
Interest expense		
Rental operations	(16,980)	(17,784)
Property management, acquisition and development	(386)	(731)
	(17,366)	