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)
x 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
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 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 x No o

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 x No o

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 | x | Accelerated filer | o |
| Non-accelerated filer | o | Smaller reporting company | o |
| | | Emerging growth company | o |

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

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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" or "intends," or the 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 (Unaudited) | December 31, 2017 |
|---|---|---|
| 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.

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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 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.

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

| | Noncontrolling Interests | | | | | | Extra Space Storage Inc. Stockholders' Equity | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Preferred Operating Partnership | | | | | | | | | | |
| | Series A | Series B | Series C | Series D | Operating Partnership | Other | Shares | Par Value | Additional Paid-in Capital | Accumulated Other Comprehensive Income | Acc Defi |
| 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 | $(2 |
| 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 | — | — |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| units for stock | | | | | | | | | | | |
| Redemption of Operating Partnership units for cash | — | — | — | — | (1,126) | — | — | — | (1,432) | — | — |
| 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 |

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 |

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

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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.

| | | Fair Value Measurements at Reporting Date Using | | |
|---|---|---|---|---|
| Description | September 30, 2018 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | 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.

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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 |
|---|---|---|

| | 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 |

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## 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) |
| Series B Units | 451,386 | 538,312 | 465,115 | 546,526 |
| Series C Units | 319,283 | 380,769 | 328,994 | 386,580 |

| | | | | |
|---|---|---|---|---|
| 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.

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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.

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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 |

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## 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."

| | | Consideration Paid | | | | | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Quarter | Number of Stores | Total | Cash Paid | Loan Assumed | Non-controlling interests | Investments in Real Estate Ventures | Net Liabilities/(Assets) Assumed | Value of OP Units Issued | Number of OP Units Issued | Real estate assets |
| Q3 2018 | 6 | $74,694 | $71,989 | $— | $ — | $ — | $ 2,705 | $— | — | $74,694 |
| Q2 2018 [1] | 17 | 237,284 | 148,650 | 87,500 | — | (1,024) | 281 | 1,877 | 21,768 | 237,284 |
| Q1 2018 [1] | 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 | $ | | | | | | | |