

Extra Space Storage Inc.  
Form 10-Q  
August 09, 2006

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

---

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended June 30, 2006**

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

**For the transition period from                      to                      .**

**Commission File Number: 001-32269**

**EXTRA SPACE STORAGE INC.**

(Exact name of registrant as specified in its charter)

**Maryland**

(State or other jurisdiction of incorporation or  
organization)

**20-1076777**

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

**2795 East Cottonwood Parkway, Suite 400**

**Salt Lake City, Utah 84121**

(Address of principal executive offices)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

**The number of shares outstanding of the registrant's common stock, par value \$0.01 per share, as of August 4, 2006 was 52,006,118.**

---

EXTRA SPACE STORAGE INC.

TABLE OF CONTENTS

**STATEMENT ON FORWARD LOOKING INFORMATION**

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

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

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

**ITEM 4. CONTROLS AND PROCEDURES**

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

**ITEM 1A. RISK FACTORS**

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

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

**ITEM 5. OTHER INFORMATION**

**ITEM 6. EXHIBITS**

**SIGNATURES**

---

**STATEMENT ON FORWARD LOOKING INFORMATION**

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

Certain information set forth in this report contains forward-looking statements within the meaning of the federal securities laws. Forward-looking statements include statements concerning our plans, objectives, goals, strategies, future events, future revenues or performance, capital expenditures, financing needs, plans or intentions relating to acquisitions and other information that is not historical information. In some cases, forward-looking statements can be identified by terminology such as believes, expects, may, will, should, anticipates, or intends 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, 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 Annual Report on Form 10-K. Such factors include, but are not limited to:

changes in general economic conditions and in the markets in which we operate;

the effect of competition from new self-storage facilities or other storage alternatives, which would cause rents and occupancy rates to decline;

our ability to effectively compete in the industry in which we do business;

difficulties in our ability to evaluate, finance and integrate acquired and developed properties into our existing operations and to lease up those properties, which could adversely affect our profitability;

the impact of the regulatory environment as well as national, state, and local laws and regulations including, without limitation, those governing Real Estate Investment Trusts, which could increase our expenses and reduce our cash available for distribution;

difficulties in raising capital at reasonable rates, which could impede our ability to grow;

delays in the development and construction process, which could adversely affect our profitability; and

economic uncertainty due to the impact of war or terrorism which could adversely affect our business plan.

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

## Extra Space Storage Inc.

## Condensed Consolidated Balance Sheets

(in thousands, except share data)

|   | June 30, 2006<br>(unaudited) | December 31, 2005 |
|---|------------------------------|-------------------|
| <b>Assets:</b>  |                              |                   |
| Real estate assets, net   | \$ 1,322,527                 | \$ 1,212,678      |
| Investments in real estate ventures   | 90,569                       | 90,898            |
| Cash and cash equivalents   | 4,250                        | 28,653            |
| Restricted cash   | 18,384                       | 18,373            |
| Receivables from related parties and affiliated real estate joint ventures  | 11,793                       | 23,683            |
| Notes receivable  | 1,693                        | 12,109            |
| Other assets, net   | 28,753                       | 33,798            |
| Total assets  | \$ 1,477,969                 | \$ 1,420,192      |
| <b>Liabilities, Minority Interests, and Stockholders Equity:</b>  |                              |                   |
| Notes payable   | \$ 805,680                   | \$ 747,193        |
| Notes payable to trusts   | 119,590                      | 119,590           |
| Line of credit  | 25,000                       |                   |
| Accounts payable and accrued expenses   | 4,486                        | 13,261            |
| Other liabilities   | 27,326                       | 23,785            |
| Total liabilities   | 982,082                      | 903,829           |
| Minority interest in Operating Partnership  | 34,549                       | 36,010            |
| Other minority interests  | 225                          | 225               |
| Commitments and contingencies   |                              |                   |
| Stockholders equity:  |                              |                   |
| Preferred stock, \$0.01 par value, 50,000,000 shares authorized, no shares issued or outstanding  |                              |                   |
| Common stock, \$0.01 par value, 200,000,000 shares authorized, 51,813,459 and 51,765,795 shares issued and outstanding at June 30, 2006 and December 31, 2005, respectively | 518                          | 518               |
| Paid-in capital   | 624,465                      | 626,123           |
| Deferred stock compensation   |                              | (2,374)           |
| Accumulated deficit   | (163,870)                    | (144,139)         |
| Total stockholders equity   | 461,113                      | 480,128           |
| Total liabilities, minority interests, and stockholders equity  | \$ 1,477,969                 | \$ 1,420,192      |

See accompanying notes to unaudited condensed consolidated financial statements.



## Extra Space Storage Inc.

## Condensed Consolidated Statements of Operations

(in thousands, except share data)

(unaudited)

|  | Three months ended |                   | Six months ended |                   |
|--|--------------------|-------------------|------------------|-------------------|
|  | June 30, 2006      | June 30, 2005     | June 30, 2006    | June 30, 2005     |
| <b>Revenues:</b>   |                    |                   |                  |                   |
| Property rental  | \$ 42,020          | \$ 23,819         | \$ 81,195        | \$ 46,041         |
| Management and franchise fees  | 5,181              | 400               | 10,340           | 768               |
| Tenant insurance   | 971                |                   | 1,892            |                   |
| Development fees   | 175                | 262               | 225              | 529               |
| Other income   | 184                | 70                | 249              | 121               |
| Total revenues   | 48,531             | 24,551            | 93,901           | 47,459            |
| <b>Expenses:</b>   |                    |                   |                  |                   |
| Property operations  | 15,248             | 9,041             | 29,990           | 17,919            |
| Tenant insurance   | 589                |                   | 1,222            |                   |
| Unrecovered development/acquisition costs  | 24                 | 168               | 342              | 275               |
| General and administrative   | 8,747              | 3,320             | 17,992           | 6,297             |
| Depreciation and amortization  | 9,057              | 6,213             | 18,333           | 11,943            |
| Total expenses   | 33,665             | 18,742            | 67,879           | 36,434            |
| Income before interest, minority interest and equity in earnings of real estate ventures | 14,866             | 5,809             | 26,022           | 11,025            |
| Interest expense   | (12,784)           | (7,493)           | (24,769)         | (13,732)          |
| Interest income  | 148                | 66                | 630              | 76                |
| Minority interest - Operating Partnership  | (225)              | 110               | (279)            | 166               |
| Equity in earnings of real estate ventures   | 1,087              | 288               | 2,226            | 605               |
| <b>Net income (loss)</b>   | <b>\$ 3,092</b>    | <b>\$ (1,220)</b> | <b>\$ 3,830</b>  | <b>\$ (1,860)</b> |
| Net income (loss) per common share   |                    |                   |                  |                   |
| Basic  | \$ 0.06            | \$ (0.04)         | \$ 0.07          | \$ (0.06)         |
| Diluted  | \$ 0.06            | \$ (0.04)         | \$ 0.07          | \$ (0.06)         |
| Weighted average number of shares  |                    |                   |                  |                   |
| Basic  | 51,625,135         | 31,858,839        | 51,606,618       | 31,514,394        |
| Diluted  | 55,991,088         | 31,858,839        | 55,983,086       | 31,514,394        |
| <b>Cash dividends paid per common share</b>  | <b>\$ 0.23</b>     | <b>\$ 0.23</b>    | <b>\$ 0.46</b>   | <b>\$ 0.46</b>    |

See accompanying notes to unaudited condensed consolidated financial statements.

## Extra Space Storage Inc.

## Condensed Consolidated Statement of Stockholders Equity

(in thousands, except share data)

(unaudited)

|  | Common Stock<br>Shares | Common Stock<br>Par Value | Paid-in<br>Capital | Deferred<br>Compensation | Accumulated<br>Deficit | Total<br>Stockholders<br>Equity |
|--|------------------------|---------------------------|--------------------|--------------------------|------------------------|---------------------------------|
| <b>Balances at December 31,<br/>2005</b>                                   | 51,765,795             | \$ 518                    | \$ 626,123         | \$ (2,374)               | \$ (144,139)           | \$ 480,128                      |
| Reclassification of deferred<br>compensation upon adoption<br>of SFAS 123R |                        |                           | (2,374)            | 2,374                    |                        |                                 |
| Issuance of common stock<br>upon the exercise of options                   | 14,664                 |                           | 127                |                          |                        | 127                             |
| Issuance of common stock<br>to certain members of the<br>board             | 12,000                 |                           |                    |                          |                        |                                 |
| Non-vested stock grants  | 21,000                 |                           |                    |                          |                        |                                 |
| Compensation expense<br>related to stock-based<br>awards                   |                        |                           | 1,016              |                          |                        | 1,016                           |
| Other adjustments  |                        |                           | (427)              |                          |                        | (427)                           |
| Net income   |                        |                           |                    |                          | 3,830                  | 3,830                           |
| Dividends paid on common<br>stock  |                        |                           |                    |                          | (23,561)               | (23,561)                        |
| <b>Balances at June 30, 2006</b>   | 51,813,459             | \$ 518                    | \$ 624,465         | \$                       | \$ (163,870)           | \$ 461,113                      |

See accompanying notes to unaudited condensed consolidated financial statements.

## Extra Space Storage Inc.

## Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

|  | Six months ended |               |
|--|------------------|---------------|
|  | June 30, 2006    | June 30, 2005 |
| <b>Cash flows from operating activities:</b>   |                  |               |
| Net income (loss)  | \$ 3,830         | \$ (1,860)    |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                  |               |
| Depreciation and amortization  | 18,333           | 11,943        |
| Stock compensation expense   | 1,016            |               |
| Gain (loss) allocated to minority interests  | 279              | (166)         |
| Distributions from real estate ventures in excess of earnings                            | 2,280            | 131           |
| Changes in operating assets and liabilities:   |                  |               |
| Receivables from related parties   | 11,890           | (763)         |
| Other assets   | 6,895            | (6,743)       |
| Accounts payable   | (8,775)          | (2,163)       |
| Other liabilities  | 516              | 4,066         |
| Net cash provided by operating activities  | 36,264           | 4,445         |
| <b>Cash flows from investing activities:</b>   |                  |               |
| Acquisition of real estate assets  | (87,964)         | (69,961)      |
| Development and construction of real estate assets                                       | (15,118)         | (2,873)       |
| Proceeds from sale of real estate assets   | 728              |               |
| Investments in real estate ventures  | (4,835)          | (1,722)       |
| Change in restricted cash  | (11)             | (1,566)       |
| Principal payments received on notes receivable  | 118              |               |
| Purchase of equipment and fixtures   | (768)            | (483)         |
| Net cash used in investing activities  | (107,850)        | (76,605)      |
| <b>Cash flows from financing activities:</b>   |                  |               |
| Proceeds from notes payable, notes payable to trusts and line of credit                  | 97,602           | 122,726       |
| Principal payments on notes payable and line of credit                                   | (24,598)         | (43,299)      |
| Deferred financing costs   | (647)            | (2,713)       |
| Minority interest investments  |                  | 225           |
| Proceeds from issuance of common shares, net   |                  | 81,358        |
| Proceeds from exercise of stock options  | 127              |               |
| Dividends paid on common stock   | (23,561)         | (14,182)      |
| Distributions to Operating Partnership units held by minority interests                  | (1,740)          | (1,242)       |
| Net cash provided by financing activities  | 47,183           | 142,873       |
| Net increase (decrease) in cash and cash equivalents                                     | (24,403)         | 70,713        |
| Cash and cash equivalents, beginning of the period                                       | 28,653           | 24,329        |
| Cash and cash equivalents, end of the period   | \$ 4,250         | \$ 95,042     |
| <b>Supplemental schedule of cash flow information</b>                                    |                  |               |
| Interest paid, net of amounts capitalized  | \$ 23,173        | \$ 11,195     |

See accompanying notes to unaudited condensed consolidated financial statements.



**Extra Space Storage Inc.**

**Notes to Condensed Consolidated Financial Statements (unaudited)**

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

The Company invests in self-storage facilities by acquiring or developing wholly-owned facilities or by acquiring an equity interest in real estate entities. At June 30, 2006, the Company had direct and indirect equity interests in 556 storage facilities located in 32 states and Washington, D.C.

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

**2. BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2006 are not necessarily indicative of results that may be expected for the year ended December 31, 2006. The Condensed Consolidated Balance Sheet as of December 31, 2005, 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, 2005 as filed with the Securities and Exchange Commission (SEC).

**3. STOCK-BASED COMPENSATION**

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

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 123 (revised 2004), Share Based Payment, ( SFAS 123R ), which requires the measurement and recognition of compensation expense for all share-based payment awards to employees and directors based on estimated fair values. SFAS 123R supersedes SFAS No. 123, Accounting for Stock Based Compensation and Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ). The Company adopted SFAS 123R using the modified prospective application method of adoption which requires the Company to record compensation cost related to non-vested stock awards as of December 31, 2005 by recognizing the unamortized grant date fair value of these awards over their remaining service period with no change in historical reported earnings. Awards granted after December 31, 2005 are valued at fair value in accordance with provisions of SFAS 123R and recognized on a straight line basis over the service periods of each award. The forfeiture rate, which is estimated at a weighted average of 7.8% of unvested options outstanding as of June 30, 2006, is adjusted periodically based on the extent to which actual forfeitures differ, or are expected to differ, from the previous estimate.

Prior to 2006, the Company accounted for stock based compensation in accordance with APB 25 using the intrinsic value method, which did not require that compensation cost be recognized for the Company s stock options provided the option exercise price was established at 100% of the common stock fair value market on the date of grant. Under APB 25, the Company was required to record expense over the vesting period for the value of restricted common stock granted. Prior to 2006, the Company provided pro forma disclosure amounts in accordance with SFAS No. 148, Accounting for Stock Based Compensation Transition and Disclosure ( SFAS 148 ), as if the fair value method defined by SFAS 123 had been applied to its stock based compensation. The Company s net loss and net loss per share for the three and six months ended June 30,

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

2005 would have been greater if compensation cost related to stock options had been recorded in the financial statements based on fair value at the grant dates.

### *Options*

The Company has the following two stock options plans under which shares were available for grant at June 30, 2006: the 2004 Long-Term Incentive Compensation Plan, and the 2004 Non-Employee Directors Share Plan. Under the terms of the plans, the exercise price of an option shall be determined by the Compensation, Nominating and Governance Committee and reflected in the applicable award agreement. Each option becomes exercisable after the period or periods specified in the award agreement, which generally do not exceed 10 years from the date of grant (or five years in the case of an incentive stock option granted to a 10% stockholder, if permitted under the plans). Options are exercisable at such times and subject to such terms as determined by the Compensation, Nominating and Governance Committee, but under no circumstances may an option be exercised if such exercise would cause a violation of the ownership limit in the Company's charter. Unless otherwise determined by the Compensation, Nominating and Governance Committee at the time of grant, such stock options shall vest ratably over a four-year period beginning on the date of grant. The Company recorded \$250 and \$450, respectively, of compensation expense relating to outstanding options during the three and six months ended June 30, 2006. No compensation expense was recorded related to outstanding options during the three and six months ended June 30, 2005.

The following assumptions were used to estimate the fair value of options granted during the three and six months ended June 30, 2006 and 2005 using the Black-Scholes option-pricing model:

|                               | Three Months Ended |               | Six Months Ended |               |
|-------------------------------|--------------------|---------------|------------------|---------------|
|                               | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| Expected volatility           | 25%                | 21%           | 22%              | 21%           |
| Dividend yield                | 6.3%               | 7.1%          | 6.4%             | 7.1%          |
| Risk-free interest rate       | 4.9%               | 3.4%          | 4.7%             | 3.4%          |
| Average expected term (years) | 5                  | 5             | 5                | 5             |

The Black-Scholes model incorporates assumptions to value stock based awards. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option. The Company uses guideline companies to estimate the expected price volatility and average expected term. These amounts are not materially different from the Company's historical data on valuation and exercise timing.

The following table summarizes the Company's activities with respect to its stock option plans for the six months ended June 30, 2006:

| Options                        | Number of<br>Shares | Weighted-Average<br>Exercise Price Per<br>Share | Weighted-Average<br>Remaining<br>Contractual Term | Aggregate<br>Intrinsic Value |
|--------------------------------|---------------------|---|---|------------------------------|
| Outstanding at January 1, 2006 | 3,032,398           | \$ 13.89  |   |                              |

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

|  |           |    |       |      |    |       |
|--|-----------|----|-------|------|----|-------|
| Granted  | 168,677   |    | 15.45 |      |    |       |
| Exercised  | (38,350)  |    | 12.64 |      |    |       |
| Cancelled  | (84,314)  |    | 14.95 |      |    |       |
| Outstanding at June 30, 2006                               | 3,078,411 | \$ | 13.96 | 8.65 | \$ | 7,036 |
| Vested and expected to vest in the future at June 30, 2006 | 3,046,372 | \$ | 13.93 | 8.64 | \$ | 7,035 |
| Exercisable at June 30, 2006                               | 374,749   | \$ | 12.69 | 8.24 | \$ | 1,332 |

The aggregate intrinsic value in the table above represents the total value (the difference between the Company's closing stock price on the last trading day of the second quarter of 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2006. The amount of aggregate intrinsic value will change based on the fair market value of the Company's stock.



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

The aggregate intrinsic value of options exercised during the three and six months ended June 30, 2006 was \$23 and \$120, respectively. Exercise of options during the three and six months ended June 30, 2006 resulted in cash receipts of \$36 and \$127, respectively. There were no options exercised during the three and six months ended June 30, 2005.

### *Non-vested Common Stock*

On June 1, 2006, April 1, 2006 and during July 2005, the Company granted 15,000, 6,000 and 190,000 shares, respectively, of non-vested common stock to certain employees, without monetary consideration under the Company's 2004 Long-Term Incentive Compensation Plan. At the date of the grant, the recipient had all rights of a stockholder including the right to vote and receive dividends subject to restrictions on transfers and forfeiture provisions. The forfeiture and transfer restriction on the shares lapse over a three to four year period beginning on the date of grant. The Company did not grant shares of non-vested common stock during the three and six months ended June 30, 2005. The Company recorded approximately \$197 and \$383 of compensation expense related to outstanding shares of non-vested common stock held by employees during the three and six months ended June 30, 2006, respectively. The Company did not record any compensation expense relating to outstanding shares of non-vested common stock during the three and six months ended June 30, 2005.

The fair value of non-vested common stock awards is determined based on the closing trading price of the Company's common stock on the grant date. A summary of the Company's non-vested shares activity for the six months ended June 30, 2006 was as follows:

|                                      | Shares   | Weighted-<br>Average Grant-<br>Date Fair Value |
|--------------------------------------|----------|--|
| Non-vested shares at January 1, 2006 | 173,750  | \$ 15.66                                       |
| Granted                              | 21,000   | \$ 15.91                                       |
| Vested                               | (10,000) | \$ 15.66                                       |
| Forfeited                            |          |  |
| Non-vested shares at June 30, 2006   | 184,750  | \$ 15.69                                       |

At June 30, 2006, there was \$2,325 of total unrecognized compensation expense related to non-vested shares granted to employees under the Company's 2004 Long-Term Incentive Compensation Plan. That cost is expected to be recognized over a weighted-average period of 2.6 years. The valuation model applied in this calculation utilizes subjective assumptions that could potentially change over time, including the expected forfeiture rate. Therefore, the amount of unrecognized compensation expense at June 30, 2006 noted above does not necessarily represent the expense that will ultimately be realized by the Company in the Statement of Operations. Unrecognized compensation expense related to non-vested shares of restricted common stock awards granted to employees was recorded as deferred compensation in stockholder's equity at December 31, 2005. As part of the adoption of SFAS 123R, \$2,374 of unrecognized compensation expense was reclassified as a component of paid-in capital.

### *Other Grants*

On May 15, 2006, the Company's Board of Directors approved the issuance of 12,000 shares of common stock with a market value of \$183 to its certain directors for services. The Company recorded stock compensation in its statements of operations for the aggregate market value of the stock at the date of grant.

*Summary*

As a result of adopting SFAS 123R, the net income set forth in the Unaudited Condensed Consolidated Financial Statements of Operations for the three and six months ended June 30, 2006, was \$250 and \$450 lower, respectively, than if the Company had continued to account for stock based compensation under APB 25. Pro forma net loss as if the fair value based method had been applied to all awards for the three and six months ended June 30, 2005 is as follows:

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

|  | Three months ended<br>June 30, 2005 |         | Six months<br>ended June 30,<br>2005 |         |
|--|-------------------------------------|---------|--------------------------------------|---------|
| Net loss as reported                     | \$                                  | (1,220) | \$                                   | (1,860) |
| Deduct: stock-based compensation expense |                                     | (136)   |                                      | (222)   |
| Pro forma net loss                       |                                     | (1,356) |                                      | (2,082) |
| Net loss per share - basic and diluted   |                                     |         |                                      |         |
| Basic and diluted - as reported          | \$                                  | (0.04)  | \$                                   | (0.06)  |
| Basic and diluted - pro forma            | \$                                  | (0.04)  | \$                                   | (0.07)  |

#### 4. NET INCOME (LOSS) PER SHARE

Basic earnings (loss) per common share is computed by dividing the net income (loss) by the weighted average common shares outstanding, less non-vested restricted stock. Diluted earnings (loss) per common share measures the performance of the Company over the reporting period while giving effect to all potential common shares that were dilutive and outstanding during the period. The denominator includes the number of additional common shares that would have been outstanding if the potential common shares that were dilutive had been issued and is calculated using the treasury stock method. Potential common shares are securities (such as options, warrants, convertible debt, and convertible Operating Partnership units) that do not have a current right to participate in earnings but could do so in the future by virtue of their option or conversion right. In computing the dilutive effect of convertible securities, net income or loss is adjusted to add back any changes in earnings (loss) 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 (loss) per share, only potential common shares that are dilutive, those that reduce earnings per share, are included. Since the Company generated a loss for the three and six months ended June 30, 2005, the impact of inclusion of the potential conversion of securities into common shares is anti-dilutive and therefore diluted earnings per share is the same as basic earnings per share. Excluded from the computation of diluted common shares outstanding at June 30, 2005 are 1,827,000 stock options and 2,730,050 convertible Operating Partnership units.

#### 5. REAL ESTATE ASSETS

The components of real estate assets are summarized as follows:

|   | June 30, 2006 |           | December 31, 2005 |           |
|---|---------------|-----------|-------------------|-----------|
| Land  | \$            | 333,605   | \$                | 304,892   |
| Buildings and improvements                      |               | 1,011,869 |                   | 929,745   |
| Intangible assets - tenant relationships        |               | 24,200    |                   | 22,174    |
| Intangible lease rights                         |               | 3,400     |                   | 3,400     |
|   |               | 1,373,074 |                   | 1,260,211 |
| Less: accumulated depreciation and amortization |               | (75,707)  |                   | (58,252)  |
| Net operating real estate assets                |               | 1,297,367 |                   | 1,201,959 |
| Real estate under development                   |               | 25,160    |                   | 10,719    |
| Net real estate assets                          | \$            | 1,322,527 | \$                | 1,212,678 |

On January 30, 2006, the Company sold an excess parcel of vacant land in Lanham, Pennsylvania for \$728. There was no gain or loss recognized on the sale.

## 6. PROPERTY ACQUISITIONS

On June 30, 2006, the Company purchased one self-storage facility located in Phoenix, Arizona from a third party for cash of \$4,100.

On May 18, 2006, the Company acquired its partner's joint venture interest in a property located in Peoria, Arizona for

cash of \$1,071.

On May 4, 2006, the Company purchased one self-storage facility located in Dallas, Texas from a franchisee for cash of \$14,521.

On May 1, 2006, the Company purchased one self-storage facility located in North Hollywood, California from Extra Space Development, which is a related party, owned by certain members of the Company's management team and a director, for cash of \$12,403 and assumed net liabilities of \$97. The independent members of the Company's board of directors approved this acquisition after obtaining two independent appraisals.

On April 12, 2006, the Company completed a transaction with joint venture entities in which the Company held partnership interests. The Company purchased five properties located in Kansas, Tennessee and Texas, and sold its joint venture interest in three properties located in Texas. The joint ventures were dissolved and proceeds were distributed to joint venture partners. As part of this transaction, the Company also received payment on notes receivable relating to these properties. The Company paid cash of \$3,020, settled franchise notes receivable of \$10,298, assumed a note payable of \$7,926 and net liabilities of \$340. No gain or loss was recognized on this transaction.

On March 30, 2006, the Company purchased one self-storage facility located in Bensalem, Pennsylvania from a third party for cash of \$3,814.

On February 15, 2006, the Company purchased three self-storage facilities located in Lakewood and Tacoma, Washington from a third party for cash of \$17,866.

On January 17, 2006, the Company purchased one self-storage facility located in Dacula, Georgia from a franchisee for cash of \$5,148.

On January 13, 2006, the Company purchased one self-storage facility located in Venice, Florida from a franchisee for cash of \$8,003.

On January 6, 2006, the Company purchased one self-storage facility located in Deland, Florida from a franchisee for cash of \$5,414.

## 7. INVESTMENTS IN REAL ESTATE VENTURES

Investments in real estate ventures at June 30, 2006 and December 31, 2005 consisted of the following:

| Excess Profit | Equity | Investment balance at |
|---------------|--------|-----------------------|
|---------------|--------|-----------------------|

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

|   | Participation % | Ownership % | June 30, 2006 | December 31, 2005 |
|---|-----------------|-------------|---------------|-------------------|
| Extra Space West One LLC ( ESW )                      | 40%             | 5%          | \$ 2,000      | \$ 2,070          |
| Extra Space Northern Properties Six,<br>LLC ( ESNPS ) | 35%             | 10%         | \$ 1,846      | 1,929             |
| PRISA Self Storage LLC ( PRISA )                      | 17%             | 2%          | \$ 13,636     | 13,824            |
| PRISA II Self Storage LLC ( PRISA II )                | 17%             | 2%          | \$ 11,012     | 11,187            |
| PRISA III Self Storage LLC ( PRISA III )              | 20%             | 5%          | \$ 4,717      | 4,954             |
| VRS Self Storage LLC ( VRS )                          | 20%             | 5%          | \$ 4,616      | 4,740             |
| WCOT Self Storage LLC ( WCOT )                        | 20%             | 5%          | \$ 4,899      | 5,052             |
| Storage Portfolio I, LLC ( Teachers )                 | 40%             | 25%         | \$ 20,102     | 20,346            |
| Storage Portfolio Bravo II ( Heitman )                | 45%             | 20%         | \$ 15,529     | 15,753            |
| Other minority owned properties                       | 10-50%          | 10-50%      | \$ 12,212     | 11,043            |
|   |                 |             | \$ 90,569     | \$ 90,898         |

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

The components of equity in earnings of real estate ventures consist of the following:

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

|   | Three months ended |               | Six months ended |               |
|---|--------------------|---------------|------------------|---------------|
|   | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| Equity in earnings of ESW                             | \$ 341             | \$ 270        | \$ 681           | \$ 557        |
| Equity in earnings of ESNPS                           | 38                 | 17            | 74               | 51            |
| Equity in earnings of PRISA                           | 132                |               | 256              |               |
| Equity in earnings of PRISA II                        | 115                |               | 221              |               |
| Equity in earnings of PRISA III                       | 30                 |               | 53               |               |
| Equity in earnings of VRS                             | 41                 |               | 75               |               |
| Equity in earnings of WCOT                            | 40                 |               | 73               |               |
| Equity in earnings of Teachers                        | 301                |               | 601              |               |
| Equity in earnings of Heitman                         | 242                |               | 473              |               |
| Equity in earnings of other minority owned properties | (193)              | 1             | (281)            | (3)           |
|   | \$ 1,087           | \$ 288        | \$ 2,226         | \$ 605        |

Equity in earnings of Teachers and Heitman includes the amortization of the Company's excess purchase price of approximately \$19 million of these equity investments over its original basis. The excess basis is amortized over 40 years.

## 8. NOTES RECEIVABLE

In July 2005, the Company along with joint-venture partner Prudential Insurance Company of America, a New Jersey corporation (together with its affiliates Prudential) acquired Storage USA Partnership, L.P. (Storage USA) from GE Commercial Finance for approximately \$2.3 billion in cash. Notes receivable relate to construction advances Storage USA had offered to certain franchisees. All related franchised properties are now in their operating phase. The notes are collateralized by the franchised properties and have terms up to five years. Interest payments are generally due monthly on the notes during the first two years of the term, with amortization of principal generally commencing in the third year based upon a 25-year schedule with the balance due at the due date. The loans bear interest based on a spread over the prime interest rate of 0.5% to 1.0%. Typically, advances represented 70%- 90% of the anticipated cost of the project. As of June 30, 2006, only one note receivable remained outstanding. All other notes receivable have been repaid.

Management periodically assesses historical payment history, payment status, prevailing economic and business conditions, specific loan terms and other relevant factors to determine whether any notes receivable should be placed on non-accrual status or otherwise adjusted for impairment. At June 30, 2006 none of the notes receivable were considered impaired.

## 9. OTHER ASSETS

The components of other assets are summarized as follows:

|                        | June 30, 2006 | December 31, 2005 |
|------------------------|---------------|-------------------|
| Equipment and fixtures | \$ 10,157     | \$ 9,389          |

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

|                                      |           |           |
|--------------------------------------|-----------|-----------|
| Less: accumulated depreciation       | (5,760)   | (4,977)   |
| Deferred financing costs, net        | 11,290    | 12,151    |
| Deferred advertising costs, net      | 50        | 128       |
| Prepaid expenses and escrow deposits | 3,942     | 5,114     |
| Accounts receivable, net             | 5,258     | 8,179     |
| Investments in Trusts                | 3,590     | 3,590     |
| Other                                | 226       | 224       |
|                                      | \$ 28,753 | \$ 33,798 |

**10. NOTES PAYABLE**

The components of notes payable are summarized as follows:



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

|  | June 30, 2006 | December 31, 2005 |
|--|---------------|-------------------|
| Mortgage and construction loans with banks bearing interest at fixed rates between 4.65% and 7.50%. The loans are collateralized by mortgages on real estate assets and the assignment of rents. Principal and interest payments are made monthly with all outstanding principal and interest due between March 1, 2008 and July 1, 2016.  | \$ 727,286    | \$ 652,980        |
| Mortgage and construction loans with banks bearing floating interest rates (including loans subject to interest rate swaps) based on LIBOR and Prime. Interest rates based on LIBOR are between LIBOR plus 1.75% (7.08% and 6.14% at June 30, 2006 and December 31, 2005, respectively) and LIBOR plus 2.25% (7.58% and 6.64% at June 30, 2006 and December 31, 2005, respectively). Interest rates based on Prime are at Prime plus 0.5% (8.75% and 7.75% at June 30, 2006 and December 31, 2005, respectively). The loans are collateralized by mortgages on real estate assets and the assignment of rents. Principal and interest payments are made monthly with all outstanding principal and interest due between August 2, 2006 and April 27, 2009. | 78,394        | 94,213            |
|  | \$ 805,680    | \$ 747,193        |

Real estate assets are pledged as collateral for the notes payable. The Company is subject to certain restrictive covenants relating to the outstanding notes payable. The Company was in compliance with all covenants at June 30, 2006.

In October 2004, the Company entered into a reverse interest rate swap agreement ( Swap Agreement ) to float \$61,770 of 4.30% fixed interest rate secured notes due in June 2009. Under this Swap Agreement, the Company will receive interest at a fixed rate of 4.30% and pay interest at a variable rate equal to LIBOR plus 0.66%. The Swap Agreement matures at the same time the notes are due. This Swap Agreement is a fair value hedge, as defined by SFAS No. 133, and the fair value of the Swap Agreement is recorded as an asset or liability, with an offsetting adjustment to the carrying value of the related note payable. Monthly variable interest payments are recognized as an increase or decrease in interest expense.

The estimated fair value of the Swap Agreement at June 30, 2006 and December 31, 2005 was reflected as an other liability of \$3,080 and \$2,151, respectively. For the three and six months ended June 30, 2006 and 2005, interest expense has been increased by \$186 and \$282 and reduced by \$148 and \$312, respectively, as a result of the Swap Agreement.

### 11. NOTES PAYABLE TO TRUSTS

During July 2005, ESS Statutory Trust III (the Trust III ), a newly formed Delaware statutory trust and a wholly-owned, unconsolidated subsidiary of the Operating Partnership, issued an aggregate of \$40.0 million of preferred securities which mature on July 31, 2035. In addition, the Trust III issued 1,238 of Trust III common securities to the Operating Partnership for a purchase price of \$1.2 million. On July 27, 2005, the proceeds from the sale of the preferred and common securities of \$41.2 million were loaned in the form of a note to the Operating Partnership ( Note 3 ). Note 3 has a fixed rate of 6.91% through July 31, 2010, and then will be payable at a variable rate equal to the three-month LIBOR plus 2.40% per annum. The interest on Note 3, payable quarterly, will be used by the Trust III to pay dividends on the trust preferred securities. The trust preferred securities may be redeemed by the Trust III with no prepayment premium after July 27, 2010.

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

During May 2005, ESS Statutory Trust II (the Trust II), a newly formed Delaware statutory trust and a wholly-owned, unconsolidated subsidiary of the Operating Partnership, issued an aggregate of \$41.0 million of preferred securities which mature on June 30, 2035. In addition, the Trust II issued 1,269 of Trust II common securities to the Operating Partnership for a purchase price of \$1.3 million. On May 24, 2005, the proceeds from the sale of the preferred and common securities of \$42.3 million were loaned in the form of a note to the Operating Partnership ( Note 2 ). Note 2 has a fixed rate of 6.67% through June 30, 2010, and then will be payable at a variable rate equal to the three-month LIBOR plus 2.40% per annum. The interest on Note 2, payable quarterly, will be used by the Trust II to pay dividends on the trust preferred securities. The trust preferred securities may be redeemed by the Trust II with no prepayment premium after June 30, 2010.

During April 2005, ESS Statutory Trust I (the Trust), a newly formed Delaware statutory trust and a wholly-owned, unconsolidated subsidiary of the Operating Partnership, issued an aggregate of \$35.0 million of trust preferred securities which mature on June 30, 2035. In addition, the Trust issued 1,083 of Trust common securities to the Operating Partnership for a purchase price of \$1.1 million. On April 8, 2005, the proceeds from the sale of the trust preferred and common securities of \$36.1 million were loaned in the form of a note to the Operating Partnership (the Note). The Note has a variable rate equal to the three-month LIBOR plus 2.25% per annum. The interest on the Note, payable quarterly, will be used by the Trust to pay dividends on the trust preferred securities. The trust preferred securities may be redeemed by the Trust with no prepayment premium after June 30, 2010.

The Company follows FASB Interpretation No. 46R, Consolidation of Variable Interest Entities (FIN 46R), which addresses the consolidation of variable interest entities (VIEs). Under FIN 46R, Trust, Trust II and Trust III are VIEs that are not consolidated because the Company is not the primary beneficiary. A debt obligation has been recorded in the form of notes as discussed above for the proceeds, which are owed to the Trust, the Trust II, and the Trust III by the Company.

## 12. LINE OF CREDIT

The Company, as guarantor, and its Operating Partnership have entered into a \$100.0 million revolving line of credit, which includes a \$10.0 million swingline subfacility (the Credit Facility).

The Credit Facility has an interest rate of 175 basis points over LIBOR (7.08% and 6.14% at June 30, 2006 and December 31, 2005, respectively). The Operating Partnership intends to use the proceeds of the Credit Facility for general corporate purposes. As of June 30, 2006, the Credit Facility had approximately \$75.7 million of capacity based on the assets collateralizing the Credit Facility. The outstanding principal balance on the line of credit at June 30, 2006 and December 2005 was \$25 million and \$0, respectively. The maturity date on the line of credit is September 2007. The Credit Facility is collateralized by mortgages on certain real estate assets.

## 13. OTHER LIABILITIES

The components of other liabilities are summarized as follows:

|  | June 30, 2006 | December 31, 2005 |
|--|---------------|-------------------|
| Deferred rental income                 | \$ 8,820      | \$ 7,322          |
| Accrued interest                       | 3,736         | 3,413             |
| Accrued taxes and security deposits    | 3,894         | 1,618             |
| Fair value of interest rate swap       | 3,080         | 2,151             |
| Storage USA lease obligation liability | 2,954         | 3,068             |
| Property insurance payable             |               | 2,299             |
| Other liabilities                      | 4,842         | 3,914             |
|  | \$ 27,326     | \$ 23,785         |

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

As a result of the acquisition of Storage USA, the Company recorded restructuring liabilities of \$4,638 relating to the assumption of a lease for a facility that will no longer be used in the Company's operations and \$2,441 for severance costs related to terminated employees of the prior business.

The following table sets forth the restructuring activity during the six months ended June 30, 2006:

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

|                         | Accrued restructuring liabilities at December 31, 2005 |              | Cash Paid         | Adjustments | Accrued restructuring liabilities at June 30, 2006 |                 |
|-------------------------|--|--------------|-------------------|-------------|--|-----------------|
| Facility exit costs     | \$   | 3,068        | \$ (114)          | \$          | \$   | 2,954           |
| Severance costs         |  | 380          | (1,374)           |             | 1,167  | 173             |
| <b>Total</b>            | <b>\$</b>  | <b>3,448</b> | <b>\$ (1,488)</b> | <b>\$</b>   | <b>1,167</b>                                       | <b>\$ 3,127</b> |
| Allocated to:           |  |              |                   |             |  |                 |
| Continuing operations   | \$   | 3,448        | \$ (1,488)        | \$          | 1,167  | \$ 3,127        |
| Discontinued operations | \$   | 3,448        | \$ (1,488)        | \$          | 1,167  | \$ 3,127        |

**14. RELATED PARTY AND AFFILIATED REAL ESTATE JOINT VENTURE TRANSACTIONS**

The Company provides management and development services for certain joint ventures, franchise, third party and other related party properties. Management agreements provide generally for management fees of 6% of gross rental revenues for the management of operations at the self-storage facilities. The Company earns development fees of 4%-6% of budgeted costs on developmental projects and acquisition fees of 1% of the gross purchase price or the completed costs of development of acquired properties.

Related party and real estate joint ventures balances as of June 30, 2006 and December 31, 2005 are summarized as follows:

|   | June 30, 2006 |               | December 31, 2005 |               |
|---|---------------|---------------|-------------------|---------------|
| Development fees receivable                                     | \$            | 2,586         | \$                | 2,552         |
| Other receivables from properties                               |               | 7,594         |                   | 15,379        |
| Receivables from Prudential relating to Storage USA acquisition |               | 574           |                   | 4,713         |
| Other receivables from related parties                          |               | 1,039         |                   | 1,039         |
|   | <b>\$</b>     | <b>11,793</b> | <b>\$</b>         | <b>23,683</b> |

Other receivables from properties consist of amounts due for expenses paid on behalf of the properties that the Company manages and management fees. Receivables from Prudential relating to the Storage USA acquisition represent amounts receivable from Prudential for general and administrative expenses, severance paid, and lease expenses paid relating to the Storage USA acquisition. The Company believes that all of these related party receivables are fully collectible. The Company did not have any payables to related parties at June 30, 2006 or December 31, 2005.

Management fee revenue for related party and affiliated real estate joint ventures for the three and six months ended June 30, 2006 and 2005 is summarized as follows:

|     |                                       | Three months ended |               | Six months ended |               |
|-----|---------------------------------------|--------------------|---------------|------------------|---------------|
|     |                                       | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| ESW | Affiliated real estate joint ventures | \$ 103             | \$ 97         | \$ 204           | \$ 191        |

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

|                                      |                                       |          |        |           |        |
|--------------------------------------|---------------------------------------|----------|--------|-----------|--------|
| ESNPS                                | Affiliated real estate joint ventures | 104      | 96     | 206       | 192    |
| PRISA                                | Affiliated real estate joint ventures | 1,259    |        | 2,491     |        |
| PRISA II                             | Affiliated real estate joint ventures | 1,018    |        | 2,018     |        |
| PRISA III                            | Affiliated real estate joint ventures | 456      |        | 908       |        |
| VRS                                  | Affiliated real estate joint ventures | 280      |        | 553       |        |
| WCOT                                 | Affiliated real estate joint ventures | 364      |        | 723       |        |
| Teachers                             | Affiliated real estate joint ventures | 303      |        | 601       |        |
| Heitman                              | Affiliated real estate joint ventures | 261      |        | 517       |        |
| ESD                                  | Related party                         | 110      | 58     | 206       | 109    |
| Other, franchisees and third parties | Affiliated real estate joint ventures | 923      | 149    | 1,913     | 276    |
|                                      |                                       | \$ 5,181 | \$ 400 | \$ 10,340 | \$ 768 |

Development fee revenue for related party and affiliated real estate joint ventures for the three and six months ended June 30, 2006 and 2005 is summarized as follows:

|         |                                       | Three months ended |               | Six months ended |               |
|---------|---------------------------------------|--------------------|---------------|------------------|---------------|
|         |                                       | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| Everest | Affiliated real estate joint ventures | \$ 104             | \$            | \$ 111           | \$ 208        |
| Yancy   | Affiliated real estate joint ventures | 18                 | 147           | 36               | 146           |
| Other   | Affiliated real estate joint ventures |                    | 50            |                  | 79            |
| ESD     | Related party                         | 53                 | 65            | 78               | 96            |
|         |                                       | \$ 175             | \$ 262        | \$ 225           | \$ 529        |

## 15. MINORITY 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 93.12% majority ownership interest therein as of June 30, 2006. The remaining ownership interests in the Operating Partnership of 6.88% are held by certain former owners of assets acquired by the Operating Partnership, which include a director and officers of the Company.

The minority interest in the Operating Partnership represents Operating Partnership 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 either Operating Partnership units or Contingent Conversion Units ( CCUs ). Limited partners who received Operating Partnership units in the formation transactions have the right to require the Operating Partnership to redeem part or all of their Operating Partnership units for cash based upon the fair market value of an equivalent number of shares of the Company's common stock at the time of the redemption. Alternatively, the Company may, at its option, elect to acquire those Operating Partnership units in exchange for shares of its common stock on a one-for-one basis, subject to anti-dilution adjustments provided in the Operating Partnership agreement.

During July 2005, the Operating Partnership issued 1,470,149 Operating Partnership units valued at \$21.6 million in conjunction with the acquisition of Storage USA. During September 2005 and November 2005, 350,000 and 50,000 Operating Partnership units were redeemed in exchange for common stock, respectively. As of June 30, 2006, the Operating Partnership had 3,825,787 and 200,046 Operating Partnership units and CCUs outstanding, respectively.

Unlike the Operating Partnership units, CCUs do not carry any voting rights. Upon the achievement of certain performance thresholds relating to 14 early-stage lease-up properties, all or a portion of the CCUs will be automatically converted into shares of the Company's common stock. Initially, each CCU will be convertible on a one-for-one basis into shares of common stock, subject to customary anti-dilution adjustments. Beginning with the quarter ended March 31, 2006, and ending with the quarter ending December 31, 2008, the Company will calculate the net operating income from the 14 wholly-owned early-stage lease-up properties over the 12-month period ending in such quarter. Within 35 days following the end of each quarter referred to above, some or all of the CCUs will be converted so that the total percentage (not to exceed 100%) of CCUs issued in connection with the formation transactions that have been converted to common stock will be equal to the percentage determined by dividing the net operating income for such period in excess of \$5.1 million by \$4.6 million. If any CCU remains unconverted through the calculation made in respect of the 12-month period ending December 31, 2008, such outstanding CCUs will be cancelled and restored to the status of authorized but unissued shares of common stock. As of June 30, 2006, there were no CCUs converted to common stock as the 14 early-stage lease-up properties had not achieved the performance thresholds.

While any CCUs remain outstanding, a majority of the Company's independent directors must review and approve the net operating income calculation for each measurement period and also must approve any sales of any of the 14 wholly-owned early-stage lease-up properties.

## 16. STOCKHOLDERS' EQUITY

The Company's charter provides that it can issue up to 200,000,000 shares of common stock, \$0.01 par value per share, 4,100,000 Contingent Conversion Shares (CCS), \$0.01 par value per share, and 50,000,000 shares of preferred stock, \$0.01 par value per share. As of June 30, 2006, 51,813,459 shares of common stock were issued and outstanding, 3,888,843 shares of CCSs were issued and outstanding and no shares of preferred stock were issued and outstanding. All stockholders of the



Company's common stock are entitled to receive dividends and to one vote on all matters submitted to a vote of stockholders.

Unlike the Company's shares of common stock, CCSs do not carry any voting rights. Upon the achievement of certain performance thresholds relating to 14 early-stage lease-up properties, all or a portion of the CCSs will be automatically converted into shares of the Company's common stock. Initially, each CCS will be convertible on a one-for-one basis into shares of common stock, subject to customary anti-dilution adjustments. Beginning with the quarter ended March 31, 2006, and ending with the quarter ending December 31, 2008, the Company will calculate the net operating income from the 14 wholly-owned early-stage lease-up properties over the 12-month period ending in such quarter. Within 35 days following the end of each quarter referred to above, some or all of the CCSs will be converted so that the total percentage (not to exceed 100%) of CCS issued in connection with the formation transactions that have been converted to common stock will be equal to the percentage determined by dividing the net operating income for such period in excess of \$5.1 million by \$4.6 million. If any CCS remains unconverted through the calculation made in respect of the 12-month period ending December 31, 2008, such outstanding CCSs will be cancelled and restored to the status of authorized but unissued shares of common stock. As of June 30, 2006, there were no CCSs converted to common stock as the 14 early-stage lease-up properties had not achieved the performance thresholds.

While any CCSs remain outstanding, a majority of the Company's independent directors must review and approve the net operating income calculation for each measurement period and also must approve any sales of any of the 14 wholly-owned early-stage lease-up properties.

## 17. SEGMENT INFORMATION

The Company operates in two distinct segments: (1) property management and development and (2) rental operations. Financial information for the Company's business segments is set forth below:

|                                     | June 30, 2006 | December 31, 2005 |
|-------------------------------------|---------------|-------------------|
| <b>Balance Sheet</b>                |               |                   |
| Investment in real estate ventures  |               |                   |
| Rental operations                   | \$ 90,569     | \$ 90,898         |
| <b>Total assets</b>                 |               |                   |
| Property management and development | 129,578       | 179,770           |
| Property operations                 | 1,348,391     | 1,240,422         |
|                                     | \$ 1,477,969  | \$ 1,420,192      |

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

|  | Three months ended |               | Six months ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| <b>Statement of Operations</b>   |                    |               |                  |               |
| Total revenues   |                    |               |                  |               |
| Property management and development  | \$ 6,511           | \$ 732        | \$ 12,706        | \$ 1,418      |
| Rental operations  | 42,020             | 23,819        | 81,195           | 46,041        |
|  | \$ 48,531          | \$ 24,551     | \$ 93,901        | \$ 47,459     |
| Operating expenses, including depreciation and amortization                                      |                    |               |                  |               |
| Property management and development  | \$ 9,561           | \$ 3,557      | \$ 19,940        | \$ 6,693      |
| Rental operations  | 24,104             | 15,185        | 47,939           | 29,741        |
|  | \$ 33,665          | \$ 18,742     | \$ 67,879        | \$ 36,434     |
| Income (loss) before interest, minority interests and equity in earnings of real estate ventures |                    |               |                  |               |
| Property management and development  | \$ (3,050)         | \$ (2,825)    | \$ (7,234)       | \$ (5,275)    |
| Rental operations  | 17,916             | 8,634         | 33,256           | 16,300        |
|  | \$ 14,866          | \$ 5,809      | \$ 26,022        | \$ 11,025     |
| Interest expense   |                    |               |                  |               |
| Property management and development  | \$ (186)           | \$ (94)       | \$ (386)         | \$ (139)      |
| Rental operations  | (12,598)           | (7,399)       | (24,383)         | (13,593)      |
|  | \$ (12,784)        | \$ (7,493)    | \$ (24,769)      | \$ (13,732)   |
| Interest income  |                    |               |                  |               |
| Property management and development  | \$ 148             | \$ 66         | \$ 630           | \$ 76         |
| Minority interest - Operating Partnership  |                    |               |                  |               |
| Property management and development  | \$ (225)           | \$ 110        | \$ (279)         | \$ 166        |
| Equity in earnings of real estate ventures   |                    |               |                  |               |
| Rental operations  | \$ 1,087           | \$ 288        | \$ 2,226         | \$ 605        |
| Net income (loss)  |                    |               |                  |               |
| Property management and development  | \$ (2,226)         | \$ (2,455)    | \$ (5,044)       | \$ (4,567)    |
| Rental operations  | 5,318              | 1,235         | 8,874            | 2,707         |
|  | \$ 3,092           | \$ (1,220)    | \$ 3,830         | \$ (1,860)    |
| Depreciation and amortization expense  |                    |               |                  |               |
| Property management and development  | \$ 201             | \$ 69         | \$ 384           | \$ 121        |
| Rental operations  | 8,856              | 6,144         | 17,949           | 11,822        |
|  | \$ 9,057           | \$ 6,213      | \$ 18,333        | \$ 11,943     |
| <b>Statement of Cash Flows</b>   |                    |               |                  |               |
| Acquisition of real estate assets  |                    |               |                  |               |
| Property management and development  | \$ (45,054)        | \$ (14,634)   | \$ (87,964)      | \$ (69,961)   |
| Development and construction of real estate assets   |                    |               |                  |               |
| Property management and development  | \$ (9,575)         | \$ (1,806)    | \$ (15,118)      | \$ (2,873)    |

## 18. COMMITMENTS AND CONTINGENCIES

The Company has guaranteed two construction loans for unconsolidated partnerships that own development properties in Baltimore, Maryland and Chicago, Illinois. These properties are owned by joint ventures in which the Company has 10% equity interests. These guarantees were entered into in November 2004 and July 2005, respectively. At June 30, 2006, the total amount of guaranteed mortgage debt relating to these joint ventures was \$12,079. These mortgage loans mature December 1, 2007 and July 28, 2008, respectively. If the joint ventures default on the loans, the Company may be forced to repay the loans. Repossessing and/or selling the self-storage facilities and land that collateralize the loans could provide funds sufficient to reimburse the Company. The estimated fair market value of the encumbered assets at June 30, 2006 was \$20,397. The Company has recorded no liability in relation to this guarantee as of June 30, 2006. The fair value of the guarantee is not material. To date, the joint ventures have not defaulted on their mortgage debt. The Company believes the risk of having to perform on the guarantee is remote.

The Company has been involved in routine litigation arising in the ordinary course of business. As of June 30, 2006, the Company was not involved in any material litigation nor, to its knowledge, was any material litigation threatened against it, or its properties.

## 19. SUBSEQUENT EVENTS

On July 28, 2006, the Company purchased one self-storage facility located in Lancaster, California for approximately \$7.3 million.

On August 8, 2006, the Company purchased one self-storage facility located in Alpharetta, Georgia for approximately \$5.1 million.

## 20. ACCOUNTING AND DISCLOSURE CHANGES

In June 2005, the Emerging Issues Task Force ( EITF ) released Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights ( EITF 04-05 ). EITF 04-05 creates a framework for evaluating whether a general partner or a group of general partners controls a limited partnership and therefore should consolidate the partnership. EITF 04-05 states that the presumption of general partner control would be overcome only when the limited partners have certain specific rights as outlined in EITF 04-05. EITF 04-05 is effective immediately for all newly formed limited partnerships and for existing limited partnership agreements that are modified. EITF 04-05 is not expected to have a material impact on our results of operations or financial position.

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

### **CAUTIONARY LANGUAGE**

The following discussion and analysis should be read in conjunction with our *Unaudited Condensed Consolidated Financial Statements* and the *Notes to Unaudited Condensed Consolidated Financial Statements* contained in this report and the *Consolidated Financial Statements, Notes to Consolidated Financial Statements* and *Management's Discussion and Analysis of Financial Condition and Results of Operations* contained in our Form 10-K for the year ended December 31, 2005. The Company makes statements in this section that are forward-looking statements within the meaning of the federal securities laws. For a complete discussion of forward-looking statements, see the section in this Form 10-Q entitled *Statement on Forward-Looking Information*. Amounts are in thousands (except per share data and unless otherwise stated).

### **CRITICAL ACCOUNTING POLICIES**

Our discussion and analysis of our financial condition and results of operations are based on our unaudited Condensed Consolidated Financial Statements contained elsewhere in this report, which have been prepared in accordance with U.S. generally accepted accounting principles (GAAP). Our notes to the Audited Consolidated Financial Statements contained in our Form 10-K for the year ended December 31, 2005 describe the significant accounting policies essential to our unaudited Condensed Consolidated Financial Statements. Preparation of our financial statements requires estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions which we have used are appropriate and correct based on information available at the time that they were made. These estimates, judgments and assumptions can affect our reported assets and liabilities as of the date of the financial statements, as well as the reported revenue and expense during the period presented. If there are material differences between these estimates, judgments and assumptions and actual facts, our financial statements may be affected.

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

### **OVERVIEW**

We are a fully integrated, self-administered and self-managed real estate investment trust formed to continue the business commenced in 1977 by our predecessor companies to own, operate, acquire, develop and redevelop professionally managed self-storage properties. We derive a majority of our revenues from rents received from tenants under existing leases at each of our self-storage properties. Additional revenue is derived from management and franchise fees from our joint venture and franchise properties. We operate in competitive markets where consumers have multiple self-storage properties from which to choose. Competition has and will continue to impact our results. We experience minor seasonal fluctuations in occupancy levels, with occupancy levels higher in the summer months due to increased rental activity.

Our operating results depend materially on our ability to lease available self-storage space and on the ability of our tenants to make required rental payments. We believe we are able to respond quickly and effectively to changes in local, regional and national economic conditions by centrally adjusting rental rates through the combination of our internal revenue management team and our industry-leading technology systems.

We continue to evaluate a range of growth initiatives and opportunities. These include:

Maximize the performance of properties through strategic, efficient and proactive management. We plan to pursue revenue generating and expense minimizing opportunities in our operations. Our revenue management team will seek to maximize revenue by responding to changing market conditions through our technology system's ability to provide real-time, interactive rental rate and discount management. Our scale allows greater ability than many of our competitors to implement national, regional and local marketing programs, which we believe will attract more customers to our stores at a lower net cost.

Focus on the acquisition of self-storage properties from strategic partners and third parties. Our acquisitions team will continue to pursue the acquisition of single properties and multi-property portfolios that we believe can provide stockholder value. Our July 2005 acquisition of Storage USA has bolstered our reputation as a reliable, ethical buyer, which we believe enhances

our ability to negotiate and close non-brokered, private deals. In addition, our status as an umbrella partnership real estate investment trust enables flexibility when structuring deals.

Develop new self-storage properties. We have several joint venture and wholly-owned development properties and will continue to develop new self-storage properties in our core markets. Our development pipeline for the remainder of 2006 through 2007 includes 15 of these projects. The construction of most of these properties has already begun.

Expand the Company's management business. We see the management business as a future development and acquisition pipeline and expect to pursue strategic relationships with owners that should strengthen our acquisition pipeline through agreements, such as first right of refusal agreements.

## PROPERTIES

To expand our business, on July 14, 2005, the Company, through our subsidiary Extra Space Storage LLC ( ESS LLC ) and our operating partnership, Extra Space Storage LP (the Operating Partnership ), closed the acquisition (the Transaction ) of various entities that collectively comprise the Storage USA self-storage business pursuant to the Purchase and Sale Agreement, dated May 5, 2005, between ESS LLC, the Operating Partnership, Security Capital Self Storage Incorporated, a Delaware corporation, PRISA Self Storage LLC, a Delaware limited liability company, PRISA II Self Storage LLC, a Delaware limited liability company, PRISA III Self Storage LLC, a Delaware limited liability company, VRS Self Storage LLC, a Delaware limited liability company, WCOT Self Storage LLC, a Delaware limited liability company, and the Prudential Insurance Company of America, a New Jersey corporation (together with its affiliates, Prudential ).

In connection with the Transaction, we acquired 61 wholly-owned self storage properties, acquired Storage USA Partnership L.P.'s ( Storage USA ) equity interest in joint ventures that collectively owned 78 properties and assumed the management of 60 franchises and third party owned properties. In addition, 259 self-storage properties were acquired in the Transaction by five separate limited liability companies owned by five subsidiaries of the Company and Prudential. The limited liability company agreements govern the rights and responsibilities of each such limited liability company. The Company also acquired \$37.7 million of notes receivable due from franchisees.

As of June 30, 2006, we owned and operated 556 properties located in 32 states and Washington, D.C. Of these properties, 208 are wholly owned and 348 are held in joint ventures with third parties. The properties owned and operated before the Storage USA acquisition are operated under the registered Extra Space Storage brand name. We are currently implementing a re-branding program which will convert all of the Storage USA stores to the Extra Space Storage brand. The majority of this program is scheduled to be finished by December 31, 2006. As of June 30, 2006, we owned or had an ownership interest in approximately 40.4 million square feet of rentable space configured in approximately 380,000 individual self-storage units. Nearly 70% of the total number of properties are clustered around the larger population centers of Atlanta, Baltimore, Boston, Chicago, Las Vegas, Los Angeles, Miami, New York City, Orlando, Philadelphia, Phoenix, St. Petersburg/Tampa, San Francisco and Washington, D.C. These markets contain above-average population and income demographics and high barriers to entry for new self-storage properties. The clustering of assets around these population centers enables us to reduce our operating costs through economies of scale. The Storage USA acquisition has given us increased scale in many core markets as well as a solid presence in many markets where we had no previous scale.

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

We consider a property to be in the lease-up stage after it has been issued a certificate of occupancy, but before it has achieved stabilization. We consider a property to be stabilized once it has achieved either an 80% average occupancy rate for one year or has been open for three years.

As of June 30, 2006, greater than 100,000 tenants were leasing storage units at our 208 wholly-owned properties, primarily on a month-to-month basis, providing the flexibility to increase rental rates over time as market conditions permit. Although leases are short-term in duration, the typical tenant tends to remain at our properties for an extended period of time. For properties that were stabilized as of June 30, 2006, the median length of stay was approximately 11 months.

The following table sets forth additional information regarding the occupancy of our stabilized properties on a state-by-state basis as of June 30, 2006 and 2005. The information as of June 30, 2005 is on a pro forma basis as though all the properties owned at June 30, 2006 were under the Company's control as of June 30, 2005.

**Stabilized Property Data Based on Location**

| Location                                 | Number of Properties | Company Number of Units as of June 30, 2006 (1) | Pro forma Number of Units as of June 30, 2005 | Company Net Rentable Square Feet as of June 30, 2006 (2) | Pro forma Net Rentable Square Feet as of June 30, 2005 | Company Square Foot Occupancy % June 30, 2006 | Pro forma Square Foot Occupancy % June 30, 2005 |
|--|----------------------|---|---|--|--|---|---|
| <b>Wholly-Owned Properties</b>           |                      |   |   |  |  |   |   |
| Arizona                                  | 3                    | 1,680   | 1,671   | 221,925  | 220,825  | 98.2%   | 96.4%   |
| California                               | 30                   | 19,635  | 19,593  | 2,134,613  | 2,127,925  | 89.2%   | 87.6%   |
| Colorado                                 | 5                    | 2,394   | 2,411   | 293,591  | 302,506  | 91.6%   | 86.5%   |
| Florida                                  | 24                   | 16,149  | 15,912  | 1,734,711  | 1,716,856  | 92.7%   | 93.2%   |
| Georgia                                  | 8                    | 4,500   | 4,437   | 585,573  | 528,731  | 90.6%   | 88.4%   |
| Illinois                                 | 3                    | 2,147   | 2,138   | 196,937  | 197,201  | 80.8%   | 85.2%   |
| Kansas                                   | 1                    | 503   | 502   | 49,955   | 50,340   | 93.4%   | 79.2%   |
| Kentucky                                 | 3                    | 1,579   | 1,574   | 194,290  | 194,315  | 88.6%   | 84.9%   |
| Louisiana                                | 2                    | 1,410   | 1,411   | 147,490  | 147,900  | 95.5%   | 88.0%   |
| Maryland                                 | 5                    | 4,514   | 4,537   | 482,202  | 488,584  | 84.7%   | 80.4%   |
| Massachusetts                            | 22                   | 12,037  | 12,020  | 1,310,966  | 1,305,921  | 85.1%   | 83.9%   |
| Michigan                                 | 2                    | 1,043   | 1,040   | 135,312  | 134,672  | 84.8%   | 76.5%   |
| Missouri                                 | 3                    | 1,349   | 1,335   | 169,187  | 167,397  | 85.2%   | 81.8%   |
| Nevada                                   | 1                    | 462   | 463   | 56,500   | 41,100   | 90.4%   | 89.8%   |
| New Hampshire                            | 2                    | 1,006   | 1,015   | 125,309  | 117,268  | 82.5%   | 82.1%   |
| New Jersey                               | 19                   | 15,475  | 15,471  | 1,503,812  | 1,497,770  | 86.8%   | 88.2%   |
| New York                                 | 6                    | 6,057   | 5,958   | 388,259  | 388,631  | 82.6%   | 84.5%   |
| Ohio                                     | 4                    | 2,048   | 2,074   | 276,355  | 277,002  | 86.2%   | 81.1%   |
| Oregon                                   | 1                    | 767   | 762   | 103,610  | 104,770  | 94.1%   | 91.8%   |
| Pennsylvania                             | 8                    | 6,128   | 5,914   | 637,294  | 610,774  | 81.8%   | 83.8%   |
| Rhode Island                             | 1                    | 730   | 713   | 75,816   | 75,811   | 84.0%   | 85.4%   |
| South Carolina                           | 4                    | 2,068   | 2,088   | 245,684  | 246,969  | 94.7%   | 91.3%   |
| Tennessee                                | 5                    | 3,144   | 3,118   | 409,377  | 406,832  | 92.1%   | 88.4%   |
| Texas                                    | 15                   | 9,622   | 9,212   | 1,022,835  | 987,765  | 89.2%   | 86.7%   |
| Utah                                     | 3                    | 1,524   | 1,520   | 209,965  | 209,150  | 92.8%   | 88.0%   |
| Virginia                                 | 2                    | 1,218   | 1,222   | 125,457  | 125,989  | 91.7%   | 91.1%   |
| Washington                               | 3                    | 2,030   | 2,017   | 244,595  | 241,895  | 96.3%   | 92.1%   |
| <b>Total Wholly-Owned Stabilized</b>     | <b>185</b>           | <b>121,219</b>                                  | <b>120,128</b>                                | <b>13,081,620</b>  | <b>12,914,899</b>                                      | <b>88.7%</b>                                  | <b>87.3%</b>                                    |
| <b>Properties Held in Joint-Ventures</b> |                      |   |   |  |  |   |   |
| Alabama                                  | 4                    | 2,324   | 2,318   | 281,628  | 281,275  | 86.5%   | 84.6%   |
| Arizona                                  | 12                   | 7,457   | 7,399   | 806,791  | 807,157  | 94.3%   | 92.0%   |
| California                               | 72                   | 51,931  | 52,076  | 5,316,072  | 5,331,241  | 89.5%   | 88.4%   |
| Colorado                                 | 3                    | 1,905   | 1,906   | 215,813  | 216,232  | 86.0%   | 87.8%   |
| Connecticut                              | 9                    | 6,515   | 6,538   | 751,679  | 758,064  | 76.0%   | 73.6%   |
| Delaware                                 | 1                    | 589   | 589   | 71,655   | 71,655   | 85.5%   | 84.3%   |
| Florida                                  | 24                   | 20,355  | 20,417  | 2,079,353  | 2,065,559  | 88.7%   | 86.1%   |
| Georgia                                  | 3                    | 1,916   | 1,912   | 251,530  | 251,772  | 82.9%   | 82.4%   |
| Illinois                                 | 5                    | 3,342   | 3,320   | 362,472  | 357,382  | 78.7%   | 73.4%   |
| Indiana                                  | 9                    | 3,733   | 3,736   | 468,563  | 470,029  | 90.2%   | 88.1%   |
| Kansas                                   | 3                    | 1,210   | 1,210   | 163,950  | 164,545  | 85.4%   | 76.3%   |
| Kentucky                                 | 4                    | 2,270   | 2,234   | 268,289  | 267,307  | 84.6%   | 84.9%   |
| Maryland                                 | 14                   | 10,916  | 10,912  | 1,076,827  | 1,077,516  | 85.1%   | 83.7%   |
| Massachusetts                            | 17                   | 9,255   | 9,287   | 1,051,512  | 1,050,252  | 80.8%   | 78.6%   |
| Michigan                                 | 10                   | 5,959   | 5,955   | 786,252  | 786,473  | 79.3%   | 80.2%   |
| Missouri                                 | 5                    | 2,774   | 2,745   | 325,615  | 324,150  | 87.6%   | 83.6%   |
| Nevada                                   | 7                    | 4,632   | 4,624   | 621,772  | 622,880  | 92.1%   | 95.6%   |
| New Hampshire                            | 3                    | 1,330   | 1,331   | 138,964  | 139,229  | 85.5%   | 91.8%   |
| New Jersey                               | 18                   | 13,144  | 13,131  | 1,385,396  | 1,391,326  | 88.4%   | 87.9%   |



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

|  |            |                |                |                   |                   |              |              |
|--|------------|----------------|----------------|-------------------|-------------------|--------------|--------------|
| New Mexico                                 | 9          | 4,727          | 4,473          | 528,864           | 519,484           | 87.1%        | 93.0%        |
| New York                                   | 21         | 23,598         | 23,576         | 1,741,554         | 1,750,817         | 83.8%        | 79.2%        |
| Ohio                                       | 12         | 5,586          | 5,574          | 826,787           | 826,151           | 81.0%        | 82.2%        |
| Oregon                                     | 2          | 1,286          | 1,275          | 137,140           | 136,240           | 95.3%        | 90.9%        |
| Pennsylvania                               | 10         | 6,816          | 6,792          | 732,300           | 726,999           | 84.6%        | 84.3%        |
| Rhode Island                               | 1          | 611            | 611            | 74,005            | 74,005            | 68.3%        | 69.8%        |
| Tennessee                                  | 23         | 12,195         | 12,166         | 1,586,653         | 1,589,258         | 87.7%        | 85.5%        |
| Texas                                      | 20         | 13,254         | 13,214         | 1,670,795         | 1,663,100         | 80.3%        | 78.9%        |
| Utah                                       | 1          | 524            | 518            | 59,700            | 59,300            | 93.5%        | 88.7%        |
| Virginia                                   | 15         | 10,359         | 10,344         | 1,106,770         | 1,106,041         | 87.1%        | 86.4%        |
| Washington                                 | 1          | 551            | 551            | 62,730            | 62,730            | 89.8%        | 95.9%        |
| Washington,<br>D.C.                        | 1          | 1,536          | 1,534          | 101,990           | 105,592           | 86.2%        | 83.3%        |
| <b>Total Stabilized<br/>Joint-Ventures</b> | <b>339</b> | <b>232,600</b> | <b>232,268</b> | <b>25,053,421</b> | <b>25,053,761</b> | <b>86.2%</b> | <b>84.8%</b> |
| <b>Total Stabilized</b>                    | <b>524</b> | <b>353,819</b> | <b>352,396</b> | <b>38,135,041</b> | <b>37,968,660</b> | <b>87.0%</b> | <b>85.7%</b> |

(1) Represents unit count as of June 30, 2006, which may differ from June 30, 2005 unit count due to unit conversions or expansions.

(2) Represents net rentable square feet as of June 30, 2006, which may differ from June 30, 2005 net rentable square feet due to unit conversions or expansions.

The following table sets forth additional information regarding the occupancy of our lease-up properties on a state-by-state basis as of June 30, 2006 and 2005. The information as of June 30, 2005 is on a pro forma basis as though all the properties owned at June 30, 2006 were under our control as of June 30, 2005.

**Lease-up Property Data Based on Location**

| Location                                 | Number of Properties | Company Number of Units as of June 30, 2006 (1) | Pro forma Number of Units as of June 30, 2005 | Company Net Rentable Square Feet as of June 30, 2006 (2) | Pro forma Net Rentable Square Feet as of June 30, 2005 | Company Square Foot Occupancy % June 30, 2006 | Pro forma Square Foot Occupancy % June 30, 2005 |
|--|----------------------|---|---|--|--|---|---|
| <b>Wholly-Owned Properties</b>           |                      |   |   |  |  |   |   |
| Arizona                                  | 1                    | 599   |   | 67,375   |  | 32.5%   | 0.0%  |
| California                               | 3                    | 2,204   | 1,564   | 237,655  | 154,255  | 45.4%   | 42.9%   |
| Connecticut                              | 2                    | 1,359   | 1,364   | 123,190  | 123,465  | 69.2%   | 63.0%   |
| Florida                                  | 2                    | 1,017   | 1,023   | 127,640  | 126,000  | 78.5%   | 73.5%   |
| Illinois                                 | 2                    | 1,132   | 1,139   | 144,370  | 144,690  | 77.7%   | 67.2%   |
| Massachusetts                            | 5                    | 3,330   | 3,340   | 318,083  | 322,335  | 69.7%   | 60.5%   |
| Nevada                                   | 1                    | 780   | 795   | 74,635   | 75,485   | 83.7%   | 83.6%   |
| New Jersey                               | 3                    | 2,427   | 2,542   | 223,130  | 225,677  | 81.1%   | 74.5%   |
| New York                                 | 1                    | 908   | 912   | 67,860   | 69,211   | 81.5%   | 69.4%   |
| Pennsylvania                             | 1                    | 425   | 423   | 47,410   | 47,680   | 59.6%   | 42.5%   |
| Virginia                                 | 1                    | 727   | 726   | 75,700   | 75,525   | 83.5%   | 68.5%   |
| Washington                               | 1                    | 529   | 529   | 61,250   | 61,250   | 80.2%   | 5.8%  |
| <b>Total Wholly-Owned Lease-up</b>       | <b>23</b>            | <b>15,437</b>                                   | <b>14,357</b>                                 | <b>1,568,298</b>   | <b>1,425,573</b>                                       | <b>69.4%</b>                                  | <b>62.0%</b>                                    |
| <b>Properties Held in Joint-Ventures</b> |                      |   |   |  |  |   |   |
| Illinois                                 | 2                    | 1,646   | 675   | 149,904  | 72,370   | 34.8%   | 68.6%   |
| Maryland                                 | 1                    | 957   |   | 73,649   |  | 12.3%   | 0.0%  |
| New Jersey                               | 3                    | 2,550   | 2,168   | 265,185  | 239,235  | 81.2%   | 72.9%   |
| New York                                 | 1                    | 622   | 620   | 64,555   | 64,430   | 79.9%   | 62.1%   |
| Pennsylvania                             | 1                    | 774   | 780   | 76,773   | 76,838   | 80.0%   | 42.6%   |
| Virginia                                 | 1                    | 878   | 877   | 84,383   | 85,025   | 58.4%   | 38.2%   |
| <b>Total Lease-up Joint Ventures</b>     | <b>9</b>             | <b>7,427</b>                                    | <b>5,120</b>                                  | <b>714,449</b>   | <b>537,898</b>   | <b>61.4%</b>                                  | <b>61.2%</b>                                    |
| <b>Total Lease-up Properties</b>         | <b>32</b>            | <b>22,864</b>                                   | <b>19,477</b>                                 | <b>2,282,747</b>   | <b>1,963,471</b>                                       | <b>66.9%</b>                                  | <b>61.8%</b>                                    |

(1) Represents unit count as of June 30, 2006, which may differ from June 30, 2005 unit count due to unit conversions or expansions.

(2) Represents net rentable square feet as of June 30, 2006, which may differ from June 30, 2005 net rentable square feet due to unit conversions or expansions.

Our property portfolio is a made up of different construction types and unit configurations depending on the site and the municipality where it is located. Our sites are most often hybrid facilities, or a mix of both drive-up buildings and multi-floor buildings. We have several multi-floor buildings with elevator access only, and a number of facilities featuring ground-floor access only.

Our properties are generally situated in accessible, visible locations clustered within large population bases. In addition, we have a handful of locations outside the top Metropolitan Statistical Areas that were developed or acquired based on the market, familiarity with the properties, or as part of a larger portfolio.

In addition to the 208 wholly-owned properties and the 348 properties in which we have an ownership interest, we also managed 82 properties for third parties and franchisees as of June 30, 2006. We receive a management fee equal to approximately 6% of gross revenues to manage these sites.

## **RESULTS OF OPERATIONS**

### **Comparison of the three and six months ended June 30, 2006 and 2005**

#### **Overview**

Results for the three and six months ended June 30, 2006 include the operations of 556 properties (208 of which were consolidated and 348 of which were in joint ventures accounted for using the equity method) compared to the results for the three and six months ended June 30, 2005, which included the operations of 148 properties (130 of which were consolidated and 18 of which were in joint ventures accounted for using the equity method).

**Revenues**

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

|                               | Three months ended |               | Six months ended |               |
|-------------------------------|--------------------|---------------|------------------|---------------|
|                               | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| Property rental               | \$ 42,020          | \$ 23,819     | \$ 81,195        | \$ 46,041     |
| Management and franchise fees | 5,181              | 400           | 10,340           | 768           |
| Tenant insurance              | 971                |               | 1,892            |               |
| Development fees              | 175                | 262           | 225              | 529           |
| Other income                  | 184                | 70            | 249              | 121           |
| Total revenues                | \$ 48,531          | \$ 24,551     | \$ 93,901        | \$ 47,459     |

**Property Rental** The increase in property rental revenue for the three and six months ended June 30, 2006 consists of \$13,744 and \$27,091, respectively, associated with the acquisition of 61 wholly-owned properties in conjunction with the Storage USA acquisition in July 2005, \$2,504 and \$4,265, respectively, associated with other acquisitions, \$1,482 and \$2,887, respectively, from rate increases at stabilized properties, and \$471 and \$911, respectively, from increases in occupancy at lease-up properties.

**Management and Franchise Fees** Our taxable real estate investment trust ( REIT ) subsidiary, Extra Space Management, Inc., manages properties owned by our joint ventures, franchises and third parties. Management fees generally represent 6.0% of cash collected from properties owned by third parties and unconsolidated joint ventures. The increase in management fees is due mainly to new fees associated with the Storage USA acquisition. Through this acquisition we obtained equity interests in joint ventures which own a total of 336 properties. We obtained management contracts for these new joint venture properties, and also obtained over 50 new third party and franchise management contracts in conjunction with the Storage USA acquisition.

**Tenant Insurance** Tenant insurance revenue relates to a new tenant insurance program adopted in 2005. This program was started in conjunction with the Storage USA acquisition to replace Storage USA s tenant insurance program.

**Expenses**

The following table sets forth information on expenses for the periods indicated:

|                     | Three months ended |               | Six months ended |               |
|---------------------|--------------------|---------------|------------------|---------------|
|                     | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| Property operations | \$ 15,248          | \$ 9,041      | \$ 29,990        | \$ 17,919     |

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

|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Tenant insurance                          | 589       |           | 1,222     |           |
| Unrecovered development/acquisition costs | 24        | 168       | 342       | 275       |
| General and administrative                | 8,747     | 3,320     | 17,992    | 6,297     |
| Depreciation and amortization             | 9,057     | 6,213     | 18,333    | 11,943    |
| Total expenses                            | \$ 33,665 | \$ 18,742 | \$ 67,879 | \$ 36,434 |

**Property Operations** The increase in property operations expense for the three and six months ended June 30, 2006 was primarily due to increases of \$4,712 and \$9,617, respectively, associated with the Storage USA acquisition, \$1,058 and \$1,618, respectively, associated with other acquisitions, and \$394 and \$800, respectively, primarily from utilities and property taxes.

**Tenant Insurance** Tenant insurance expense relates to a new tenant insurance program adopted in 2005. This program was started in conjunction with the Storage USA acquisition to replace Storage USA's tenant insurance program.

**General and Administrative** The increase in general and administrative expenses during the three and six months ended June 30, 2006 was due mainly to the increased costs associated with the management of the additional properties that have been added through acquisitions and new joint venture arrangements entered into during 2005. Included in general and administrative expense for the three and six months ended June 30, 2006 is compensation expense of \$630 and \$1,016, respectively, related to stock grants and stock options upon adoption of SFAS 123R.

**Depreciation and Amortization** The increase in depreciation and amortization expense results from more properties being open during the three and six months ended June 30, 2006 than were open during the quarter ended June 30, 2005 due mainly to acquisitions of new properties.

**Other Revenues and Expenses**

The following table sets forth information on other revenues and expenses for the periods indicated:

|  | Three months ended |               | Six months ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| Interest expense                           | \$ (12,784)        | \$ (7,493)    | \$ (24,769)      | \$ (13,732)   |
| Interest income                            | 148                | 66            | 630              | 76            |
| Minority interest - Operating Partnership  | (225)              | 110           | (279)            | 166           |
| Equity in earnings of real estate ventures | 1,087              | 288           | 2,226            | 605           |
| Total other income (expense)               | \$ (11,774)        | \$ (7,029)    | \$ (22,192)      | \$ (12,885)   |

**Interest Expense** The increase in interest expense for the three and six months ended June 30, 2006 was due primarily to \$1,372 and \$3,318 of interest incurred on the new trust preferred debt and \$4,328 and \$8,457 of interest expense on the mortgage loans on the 61 properties acquired in connection with the Storage USA acquisition, respectively. This amount was partially offset due to repayment of borrowings from funds raised through our equity offerings during 2005. The remainder of the increase was due mainly to other new loans or advances on the line of credit related to other acquisitions. Capitalized interest for the three and six months ended June 30, 2006 was \$546 and \$929, respectively. There was no capitalized interest for the three and six months ended June 30, 2005.

**Interest Income** The increase in interest income for the three and six months ended June 30, 2006 when compared to June 30, 2005 was primarily the result of the interest earned on approximately \$12 million of notes receivable that we acquired in connection with the Storage USA acquisition.

**Minority Interest Operating Partnership** Income/loss allocated to the Operating Partnership represents 6.88% and 7.96% of the net income/loss for the six months ended June 30, 2006 and 2005, respectively.

**Equity in Earnings of Real Estate Ventures** The increase in equity in earnings of real estate ventures is due primarily to our purchase of new equity interests in joint ventures. As a result of the Storage USA acquisition we own joint venture interests in an additional 336 new properties.

**FUNDS FROM OPERATIONS**

Funds from operations ( FFO ) provides relevant and meaningful information about our operating performance that is necessary, along with net loss and cash flows, for an understanding of our operating results. FFO is defined by the National Association of Real Estate Investment Trusts, Inc. ( NAREIT ) as net income (loss) computed in accordance with accounting principles generally accepted in the United States ( GAAP ),

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

excluding gains or losses on sales of operating properties, plus depreciation and amortization and after adjustments to record unconsolidated partnerships and joint ventures on the same basis. We believe that to further understand our performance, FFO should be considered along with the reported net income (loss) and cash flows in accordance with GAAP, as presented in the consolidated financial statements.

The computation of FFO may not be comparable to FFO reported by other REITs or real estate companies that do not define the term in accordance with the current NAREIT definition or that interpret the current NAREIT definition differently. FFO does not represent cash generated from operating activities determined in accordance with GAAP, and should not be considered as an alternative to net income (loss) as an indication of our performance, as an alternative to net cash flow from operating activities as a measure of our liquidity, or as an indicator of our ability to make cash distributions. The following table sets forth the calculation of FFO per share (dollars are in thousands, except for per share data):

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

|   | Three months ended |               | Six months ended |               |
|---|--------------------|---------------|------------------|---------------|
|   | June 30, 2006      | June 30, 2005 | June 30, 2006    | June 30, 2005 |
| <b>Net income (loss)</b>                                    | \$ 3,092           | \$ (1,220)    | \$ 3,830         | \$ (1,860)    |
| <b>Plus:</b>  |                    |               |                  |               |
| Real estate depreciation                                    | 6,648              | 3,902         | 13,121           | 7,666         |
| Amortization of intangibles                                 | 1,951              | 2,109         | 4,504            | 4,036         |
| Joint venture real estate depreciation                      | 1,247              | 100           | 2,447            | 201           |
| Income allocated to Operating Partnership minority interest | 225                |               | 279              |               |
| <b>Less:</b>  |                    |               |                  |               |
| Loss allocated to Operating Partnership minority interest   |                    | (110)         |                  | (166)         |
| <b>Funds from operations</b>                                | \$ 13,163          | \$ 4,781      | \$ 24,181        | \$ 9,877      |
| <b>Diluted funds from operations per share</b>              | \$ 0.24            | \$ 0.14       | \$ 0.43          | \$ 0.29       |

**SAME-STORE STABILIZED PROPERTY RESULTS**

We consider our same-store stabilized portfolio to consist of only those properties which were wholly-owned at the beginning and at the end of the applicable periods presented that have achieved stabilization as of the first day of such period. The following table sets forth operating data for our same-store portfolio. We consider the following same-store presentation to be meaningful in regards to the 103 properties shown below. These results provide information relating to property-level operating changes without the effects of acquisitions or completed developments.

|  | Three Months Ended |               | Percent Change | Six Months Ended |               | Percent Change |
|--|--------------------|---------------|----------------|------------------|---------------|----------------|
|  | June 30, 2006      | June 30, 2005 |                | June 30, 2006    | June 30, 2005 |                |
| Same-store rental revenues                         | \$ 20,774          | \$ 19,486     | 6.6%           | \$ 40,910        | \$ 38,405     | 6.5%           |
| Same-store operating expenses                      | 7,117              | 6,790         | 4.8%           | 14,369           | 13,699        | 4.9%           |
| Same-store net operating income                    | 13,657             | 12,696        | 7.6%           | 26,541           | 24,706        | 7.4%           |
| Non same-store rental revenues                     | 21,246             | 4,333         | 390.3%         | 40,285           | 7,636         | 427.6%         |
| Non same-store operating expenses                  | 8,131              | 2,251         | 261.2%         | 15,621           | 4,220         | 270.2%         |
| Total rental revenues                              | 42,020             | 23,819        | 76.4%          | 81,195           | 46,041        | 76.4%          |
| Total operating expenses                           | 15,248             | 9,041         | 68.7%          | 29,990           | 17,919        | 67.4%          |
| Same-store square foot occupancy as of quarter end | 88.9%              | 87.7%         |                | 88.9%            | 87.7%         |                |
| Properties included in same-store                  | 103                | 103           |                | 103              | 103           |                |

The increase in same-store rental revenues for the three and six months ended June 30, 2006 was due to increased rental rates and our ability to increase occupancy. The increase in same-store operating expenses was primarily due to an increase in utilities and property taxes.

**COMMON CONTINGENT SHARES AND COMMON CONTINGENT UNIT PROPERTY PERFORMANCE**



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

As described in the notes to our unaudited Condensed Consolidated Financial Statements, upon the achievement of certain levels of net operating income with respect to 14 of our pre-stabilized properties, our contingent conversion shares ( CCS ) and our Operating Partnership's contingent conversion units ( CCU ) will convert into additional shares of common stock and Operating Partnership units, respectively. As of June 30, 2006, there have been no conversion of CCS/CCUs as these properties have not achieved the requisite level of net operating income. The table below outlines the performance of the properties for the three and six months ended June 30, 2006 and 2005:

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

|   | Three Months Ended |               | Percent<br>Change | Six Months Ended |               | Percent<br>Change |
|---|--------------------|---------------|-------------------|------------------|---------------|-------------------|
|   | June 30, 2006      | June 30, 2005 |                   | June 30, 2006    | June 30, 2005 |                   |
| CCS/CCU rental revenues                         | \$ 2,545           | \$ 1,973      | 29.0%             | \$ 4,969         | \$ 3,825      | 29.9%             |
| CCS/CCU operating expenses                      | 1,330              | 1,312         | 1.4%              | 2,659            | 2,620         | 1.5%              |
| CCS/CCU net operating income                    | 1,215              | 661           | 83.8%             | 2,310            | 1,205         | 91.7%             |
| Non CCS/CCU rental revenues                     | 39,475             | 21,846        | 80.7%             | 76,226           | 42,216        | 80.6%             |
| Non CCS/CCU operating expenses                  | 13,918             | 7,729         | 80.1%             | 27,331           | 15,299        | 78.6%             |
| Total rental revenues                           | 42,020             | 23,819        | 76.4%             | 81,195           | 46,041        | 76.4%             |
| Total operating expenses                        | 15,248             | 9,041         | 68.7%             | 29,990           | 17,919        | 67.4%             |
| CCS/CCU square foot occupancy as of quarter end | 74.7%              | 66.7%         |                   | 74.7%            | 66.7%         |                   |
| Properties included in CCS/CCU                  | 14                 | 14            |                   | 14               | 14            |                   |

The increase in CCS/CCU rental revenues was primarily due to increased rental rates and increased occupancy. The increase in CCS/CCU operating expenses was primarily due to an increase in property taxes and repairs and maintenance.

### CASH FLOWS

Cash flows provided by operating activities were \$36,264 and \$4,445, respectively, for the six months ended June 30, 2006 and 2005. The increase in cash provided by operating activities was due to the addition of new properties through the Storage USA acquisition and other acquisitions. There have also been lower cash funding requirements relating to our lease-up properties as occupancy has increased.

Cash used in investing activities was (\$107,850) and (\$76,605), respectively, for the six months ended June 30, 2006 and 2005. The increase is primarily the result of higher acquisitions costs of real estate assets in the six months ended June 30, 2006 than the same period in 2005.

Cash provided by financing activities was \$47,183 and \$142,873 for the six months ended June 30, 2006 and 2005, respectively. The 2006 financing activities consisted primarily of additional net borrowings of \$72,357 offset by \$23,561 paid in dividends. The 2005 financing activities consisted primarily of additional net borrowings of \$76,714 offset by \$14,182 paid in dividends. During 2005, the Company issued 6.2 million shares of its common stock for net proceeds of \$81.3 million.

### OPERATIONAL SUMMARY

For the three and six months ended June 30, 2006, we continued our same-store, year-on-year revenue growth with revenue increases of 6.6% and 6.5%, respectively, compared to the same periods in 2005. Occupancy at our stabilized properties was up on a year-on-year basis, averaging

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

87.0% as of June 30, 2006 compared to 85.7% as of June 30, 2005.

Property revenue growth remained strong with increases in every market in which we operate. The increase in property revenue is the result of gains in occupancy and increases in rental rates to both new and existing customers. Discounting continued to be higher on a year on year basis, but has had a net positive effect on both occupancy and overall revenue growth.

Property expenses increased primarily as a result of increases in property taxes and utilities. Property tax increases are the result of re-assessments on properties that we have acquired and other annual tax re-assessments of properties.

### **OUTLOOK**

The continued increases in same-store revenue is positive, though there can be no assurance that this trend will continue. We expect a continued positive operating climate for self-storage operators, particularly for those with well-located, visible, and efficiently managed self-storage properties. We are continually seeking to drive revenue growth by actively managing both pricing and promotional strategies through our revenue management team and utilizing the yield management features of our technology system. In-house training and operational initiatives and marketing promotions continue to be implemented which also provide support for increased revenue at the store level.

We anticipate continued competition from all operators, both public and private, in all of the markets in which we operate. We expect competitors in the industry to continue aggressive promotional campaigns that may inhibit our ability to control discounts at certain properties in certain markets, especially at our properties in the lease-up phase.

## REVENUE OUTLOOK

We believe that positive demand for self storage will continue and that our pricing and discount strategies position us well to increase revenues for the remainder of 2006 as compared to 2005. Insurance revenues are lower than forecasted as a result of lower penetration rates and will have a slightly negative effect on overall revenues for 2006. We aim to achieve the highest level of occupancy with the highest sustainable level of rental rates to increase revenues. We will continue to selectively discount certain markets, sites and units based on occupancy, availability, and competitive parameters that are controlled by the revenue management team through our technology solutions. We believe that the disciplined, systematic and proactive approach we use will have a continued positive effect on the maximization of revenue at our facilities.

With our enhanced size and scale, promotional opportunities such as radio and television advertising become more cost effective. We will continue to seek to more efficiently utilize our marketing expenditures by testing new approaches that drive traffic to the store level at the lowest possible cost and highest effectiveness. We believe that traditional self-storage marketing approaches such as yellow pages and newspaper advertisements are high cost and low return communication tools and we are redistributing dollars to marketing channels that we believe will provide a higher return at a lower cost.

## EXPENSE OUTLOOK

Property taxes and utilities were the main components of our increased operating expenses in the three and six months ended June 30, 2006 compared to the same period in the prior year. Certain of our properties will continue to receive re-assessment and our utility expenses will likely continue to exceed prior years; however, we believe that the overall property expenses for the remainder of the year will be in-line with budgeted levels. In addition, the acquisition of Storage USA provides us with additional buying power for yellow pages and other advertising that we believe could lead to expense efficiencies in the future.

Included in our general and administrative expenses for the three and six months ended June 30, 2006 is \$630 and \$1,016, respectively, of compensation expense relating to stock options and stock grants upon adoption of SFAS 123R. We estimate that we will continue to recognize expenses relating to options and grants at a rate similar to the amount incurred during the six months ended June 30, 2006.

We believe that we currently have the personnel in place required to operate and grow our existing business. We do not foresee significant increases to our general and administrative expenses in future periods unless we experience significant growth or other unforeseen events that necessitate the need to increase our current levels of staffing.

## LIQUIDITY AND CAPITAL RESOURCES

As of June 30, 2006, we had \$4,250 available in cash and cash equivalents. We will be required to distribute at least 90% of our net taxable income, excluding net capital gains, to our stockholders on an annual basis to maintain our qualification as a REIT. We intend to use this cash to purchase additional self-storage properties and fund other working capital needs during the third quarter of 2006. Therefore, it is unlikely that we will have any substantial cash balances that could be used to meet our liquidity needs. Instead, these needs must be met from cash generated from operations and external sources of capital.

During September 2004, we, as guarantor, and our Operating Partnership entered into a \$100 million revolving line of credit ( Credit Facility ), which includes a \$10 million swingline sub facility. The Credit Facility is collateralized by self-storage properties. The Operating Partnership intends to use the proceeds of the Credit Facility for general corporate purposes and acquisitions. As of June 30, 2006, the Credit Facility had approximately \$75.7 million of available borrowings based on the assets collateralizing the Credit Facility. As of June 30, 2006, we had \$25,000 outstanding under the Credit Facility.

On October 4, 2004, we entered into a reverse interest rate swap with U.S. Bank National Association, relating to our existing \$61,770 fixed rate mortgage with Wachovia Bank, which is due in 2009. Pursuant to the swap agreement, we will receive fixed interest payments of 4.30% and pay variable interest payments based on the one-month LIBOR plus 0.66% on a notional amount of \$61,770. There were no origination fees or other up front costs incurred by us in connection with the swap agreement.

As of June 30, 2006, we had approximately \$950.3 million of debt, resulting in a debt to total capitalization ratio of 51.3%. As of June 30, 2006, the ratio of total fixed rate debt and other instruments to total debt was 89.1%. The weighted average interest rate of the total of fixed and variable rate debt at June 30, 2006 was 5.5%.

We expect to fund our short-term liquidity requirements, including operating expenses, recurring capital expenditures, dividends to stockholders, distributions to holders of Operating Partnership units and interest on our outstanding indebtedness out of our operating cash flow, cash on hand and borrowings under our Credit Facility.

### **Long-Term Liquidity Needs**

Our long-term liquidity needs consist primarily of distributions to stockholders, new facility development, property acquisitions, principal payments under our borrowings and non-recurring capital expenditures. We do not expect that our operating cash flow will be sufficient to fund our long term liquidity needs and instead expect to fund such needs out of additional borrowings, joint ventures with third parties, and from the proceeds of public and private offerings of equity and debt. We may also use Operating Partnership units as currency to fund acquisitions from self-storage owners who desire tax-deferral in their exiting transactions.

### **FINANCING STRATEGY**

We will continue to employ leverage in our capital structure in amounts determined from time to time by our board of directors. Although our board of directors has not adopted a policy which limits the total amount of indebtedness that we may incur, we will consider a number of factors in evaluating our level of indebtedness from time to time, as well as the amount of such indebtedness that will be either fixed or variable rate. In making financing decisions, our board of directors will consider factors including but not limited to:

the interest rate of the proposed financing;

the extent to which the financing impacts flexibility in managing our properties;

prepayment penalties and restrictions on refinancing;

the purchase price of properties acquired with debt financing;

long-term objectives with respect to the financing;

target investment returns;

the ability of particular properties, and the Company as a whole, to generate cash flow sufficient to cover expected debt service payments;

overall level of consolidated indebtedness;

timing of debt and lease maturities;

provisions that require recourse and cross-collateralization;

corporate credit ratios including debt service coverage, debt to total capitalization and debt to undepreciated assets;  
and

the overall ratio of fixed- and variable-rate debt.

Our indebtedness may be recourse, non-recourse or cross-collateralized. If the indebtedness is non-recourse, the collateral will be limited to the particular properties to which the indebtedness relates. In addition, we may invest in properties subject to existing loans collateralized by mortgages or similar liens on our properties, or may refinance properties acquired on a leveraged basis. We may use the proceeds from any borrowings to refinance existing indebtedness, to refinance investments, including the redevelopment of existing properties, for general working capital or to purchase additional interests in partnerships or joint ventures or for other purposes when we believe it is advisable.

#### **OFF-BALANCE SHEET ARRANGEMENTS**

Except as disclosed in the notes to our unaudited Condensed Consolidated Financial Statements, we do not currently have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purposes entities, which typically are established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, except as disclosed in the notes to our unaudited Condensed Consolidated Financial Statements, we have not guaranteed any obligations of unconsolidated entities nor do we have any commitments or intent to provide funding to any such entities. Accordingly, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in these relationships.

**CONTRACTUAL OBLIGATIONS**

The following table summarizes our contractual obligations as of June 30, 2006:

|  | Total        | Payments due by Period: |            |            |                  |
|--|--------------|-------------------------|------------|------------|------------------|
|  |              | Less Than<br>1 Year     | 1-3 Years  | 4-5 Years  | After<br>5 Years |
| Operating leases   | \$ 45,200    | \$ 4,484                | \$ 8,684   | \$ 8,160   | \$ 23,872        |
| Notes payable, notes payable to trusts<br>and line of credit |              |                         |            |            |                  |
| Interest   | 271,873      | 50,897                  | 95,399     | 56,255     | 69,322           |
| Principal  | 950,269      | 2,981                   | 216,715    | 292,800    | 437,773          |
| Total contractual obligations                                | \$ 1,267,342 | \$ 58,362               | \$ 320,798 | \$ 357,215 | \$ 530,967       |

**SEASONALITY**

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

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK****Market Risk**

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

**Interest Rate Risk**

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

As of June 30, 2006, we had \$950.3 million in total debt of which \$103.4 million was subject to variable interest rates (including the \$61.8 million on which we have the reverse interest rate swap). If LIBOR were to increase or decrease by 100 basis points, the increase or decrease in interest expense on the variable rate debt would increase or decrease future earnings and cash flows by approximately \$1 million annually.



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

The fair value of fixed rate notes payable and notes payable to trusts at June 30, 2006 was \$800,202. The carrying value of these fixed rate notes payable at June 30, 2006 was \$846,876.

#### **ITEM 4. CONTROLS AND PROCEDURES**

##### **(i) Disclosure Controls and Procedures**

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

We have formed a disclosure committee that is responsible for considering the materiality of information and determining the disclosure obligations of the Company on a timely basis. The disclosure committee reports directly to our Chief

Executive Officer and Chief Financial Officer.

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

**(ii) Changes in internal control over financial reporting**

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

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

We are involved in various litigation and proceedings in the ordinary course of business. We are not a party to any material litigation or legal proceedings, or to the best of our knowledge, any threatened litigation or legal proceedings, which, in the opinion of management individually, or in the aggregate, will have a material adverse effect on our financial condition or results of operations.

**ITEM 1A. RISK FACTORS**

There have been no material changes in our risk factors from those disclosed in our 2005 Annual Report on Form 10-K.

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

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

We held our annual meeting of stockholders on May 24, 2006. The first item of business was the election of seven members of the board of directors. The votes were tabulated as follows: 41,414,568 votes were cast for Kenneth M. Woolley and 530,683 votes were withheld; 41,839,474 votes were cast for Anthony Fanticola and 101,810 votes were withheld; 41,385,517 votes were cast for Hugh W. Horne and 555,767 votes were withheld; 39,011,314 votes were cast for Spencer F. Kirk and 2,933,937 votes were withheld; 39,263,642 votes were cast for Joseph D. Margolis and 2,677,642 votes were withheld; 39,092,116 votes were cast for Roger B. Porter and 2,842,695 votes were withheld; and 39,243,948 votes were cast for K. Fred Skousen and 2,690,863 votes were withheld. The second item of business was a proposal to ratify the selection of Ernst & Young LLP as our independent registered public accounting firm for the year ending December 31, 2006. The votes were tabulated as follows: 41,905,807 were cast for, 30,938 were cast against, and 8,506 abstained.

**ITEM 5. OTHER INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

None.

**ITEM 6. EXHIBITS**

Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

EXTRA SPACE STORAGE INC.  
*Registrant*

Date: August 9, 2006

/s/ Kenneth M. Woolley  
Kenneth M. Woolley  
*Chairman and Chief Executive Officer*  
*(Principal Executive Officer)*

Date: August 9, 2006

/s/ Kent W. Christensen  
Kent W. Christensen  
*Senior Vice President and Chief Financial Officer*  
*(Principal Financial Officer)*