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EXR - Q1 2013 Extra Space Storage Inc. Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the first-quarter 2013 Extra Space Storage Inc. earnings conference call. My name is Chantillay and I will be your facilitator for today's call. At this time all participants are in listen-only mode. We will be facilitating a question-and-answer session towards the end of this conference. (Operator Instructions) As a reminder, this conference is being recorded for replay purposes.

I would now like to turn the call over to your host for today, Mr. Clint Halverson, Director of Investor Relations. Please proceed, sir.

Clint Halverson *- Extra Space Storage Inc. - VP Corporate Communication & IR*

Thank you, Chantillay. Good afternoon, everyone. Welcome to Extra Space Storage's first-quarter 2013 conference call. In addition to our press release we have also furnished unaudited supplemental financial information on our website.

Please remember that management's remarks and answers to your questions may contain forward-looking statements as defined in the Private Securities Litigation Reform Act. Actual results could differ materially from those stated or implied by our forward-looking statements due to risks and uncertainties associated with the Company's business. These forward-looking statements are qualified by the cautionary statements contained in the Company's latest filings with the SEC, which we encourage our listeners to review.

Forward-looking statements represent management's estimates as of today, Monday, April 29, 2013. The Company assumes no obligation to revise or update any forward-looking statements because of changing market conditions or other circumstances after the date of this conference call. I would now like to turn the call over to Spencer Kirk, Chief Executive Officer.

Spencer Kirk - *Extra Space Storage Inc. - CEO*

Good afternoon, everyone. As a participant on a panel earlier this year in New York, I was asked to describe in a single sentence how I viewed the self-storage industry for 2013. Being a man of many words I described my expectations for the year simply as -- solid.

The first quarter definitely produced very solid results as FFO was up 39% and we experienced excellent same-store growth. Demand for storage remains strong. New supply is de minimis, and our occupancies are at record levels.

Organic growth remains a primary focus for Extra Space. During the quarter, we reaped the benefits of previous accretive acquisitions. In addition, we benefited from greater economies of scale resulting from our growing third-party management platform. Our footprint is over 9% larger than one year ago.

I would now like to turn the time over to Karl, our Chief Operating Officer.

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Thanks, Spence. During the first quarter, we had great same-store revenue growth of 7.5%, and that is on top of 6.3% realized in the first quarter last year. We added 62 properties to our same-store pool in 2013, consisting primarily of the 55 stabilized assets that were acquired in 2011. The addition of these 62 assets to our same-store pool contributed roughly about 100 basis points to the same-store revenue growth for the quarter.

Rental rates -- rental trends remained strong and our square-foot occupancy continued at record high levels. Our same-store occupancy ended the quarter at 88.6%, up 2.9% over last year.

We still don't see significant volume of new development in the industry. With good demand for the product and lack of new supply, we are able to increase street rates 3% to 4% on average for the quarter.

We had strong expense control in the first quarter. Increases in payroll and property taxes were partially offset by lower utility and advertising expenses. Utilities were lower primarily due to solar panels added in 2011 and 2012. Advertising was lower in Q1 as we finished our elimination of the Yellow Pages.

Net operating income for the quarter was 10.8%. This is especially impressive when you consider that net operating income was up 10.8% in the first quarter of last year. This is even more impressive when you contrast the performance with long-term industry averages that are less than half of the recent levels.

Our results continue to be the best I have seen in my 25 years in the business. And now I would like turn it over to Scott Stubbs.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

Thanks, Karl. Earlier today we reported first-quarter FFO of $0.46 per share, $0.02 above the high end of our guidance. This beat can be attributed to better than expected same-store property results, lower G&A, and lower interest expense.

During the quarter, we added 55 properties to our management program, growing the managed property count by over 30%. We also purchased a partner's interest in two flagship assets located in Baltimore and Chicago. As of today, we have five additional assets under contract for $53.6 million located in Hawaii, Maryland, North Carolina, and Texas.

As of the end of the quarter, we had 450 wholly-owned assets, 279 joint venture properties, and 236 sites under management for a total of 965 properties.

During the quarter, we actively managed the balance sheet and we reduced our weighted average interest rates by another 10 basis points. We remain committed to exploring all financing options that have a long-term benefit to our shareholders and that increase the financial flexibility of Extra Space.

This morning we updated our full-year 2013 FFO guidance to be between $1.94 and $2.01 per share. We expect FFO for the second quarter to be between $0.47 and $0.49.

I will now turn the time back to Spencer for some closing remarks.

Spencer Kirk - *Extra Space Storage Inc. - CEO*

Thanks, Scott. Our team produced a solid quarter and we look forward to producing solid results for the rest of the year. Now I would like to open this up with the Q&A session, and we will have Clint start that for us.

Clint Halverson - *Extra Space Storage Inc. - VP Corporate Communication & IR*

Thanks, Spence. As in the past, in order to ensure we have adequate time to address everyone's questions, I would like to ask that everyone keep your initial question brief and, if possible, limited to two. If time allows we will address follow-on questions once everyone has had an opportunity to ask their initial questions. With that we will turn the time over to Chantillay to start our Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) RJ Milligan, Raymond James.

RJ Milligan - *Raymond James & Associates - Analyst*

Hey, thanks, guys. Good morning. Good afternoon. Question on your same-store revenue expectations for the rest of the year. You guys increased your guidance, and I am just curious what you think that mix is going to look like in terms of -- where is that revenue growth coming from? Is it an increase in expectations for street rates, lower discounting, increases to existing customers? Maybe you could just talk about that mix.

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

This is Karl. Yes; it is going to be all those things. We anticipate rate is -- we are seeing good ability to hold street rates up. Our occupancy is holding nicely.

The delta will continue to slightly decrease because we don't expect to get -- the delta is not going to be above 3% and chances are it will continue to decline, so that by the end of the year probably less than 2%.

But we will continue to have existing customer rate increases, discounts. We will see some decrease; probably the decrease will get less and less because, like with occupancy, we have squeezed that pretty hard.

RJ Milligan - *Raymond James & Associates - Analyst*

So versus two months ago when you gave 2013 guidance, which one of those levers do you think has more upside versus two months ago?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Probably the occupancy. But rate also is -- we are pleased with the ability to be able to hold our street rates up a little higher than we expected.

RJ Milligan - *Raymond James & Associates - Analyst*

Okay, great. Thanks, guys. I will get back in the queue.

Operator

Nicholas Joseph, Citi.

Nicholas Joseph - *Citigroup - Analyst*

Thanks. Spencer, you mentioned that the new supply is de minimis right now. But can you put some numbers around that, and compare it to what you have seen historically?

Spencer Kirk - *Extra Space Storage Inc. - CEO*

At the expense of repeating statistics that we've talked about many times -- from 2003 through 2007, a five-year period, 13,011 self-storage facilities were built in the United States. That is an average of 2,600 a year. The last numbers that we saw reported by FW Dodge showed 196 total assets either under development or permits being pulled for significant redevelopment.

So if you look at 200 versus an average of 2,600 a year, it is de minimis.

Nicholas Joseph - *Citigroup - Analyst*

Do you expect that to tick up in the future? When do you think supply could begin to return?

Spencer Kirk - *Extra Space Storage Inc. - CEO*

I do expect it to tick up. I think supply is starting to already show in levels of interest. We just came back from the self-storage show in Philadelphia, and there was quite a bit of talk of development and new supply coming.

But this is a property type that typically takes one to two years to get an entitlement; about nine to 12 months to build; and then two to four years to lease up. And even if you opened up the spigot fully today, before you had meaningful supply that would be challenging this statement that supply is de minimis today, I think we are one, two, three years out before we see anything that is pronounced.

Nicholas Joseph - *Citigroup - Analyst*

All right, great. Thanks.

Operator

David Toti, Cantor Fitzgerald.

David Toti - *Cantor Fitzgerald - Analyst*

Good morning, guys. Hey, Karl, a question for you. The move-in/move-out rate or the growth rate seems to have flipped in this quarter versus the fourth quarter. Is that indicative, in your mind, of increasing strength versus maybe tapering demand? Or is it just a seasonal pattern from fourth quarter to first quarter?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

I'm not really sure. I mean, I haven't really looked at it that way. But we just continue to focus on the delta to last year.

The reality is we push rates, so that is going to drive rentals down a little bit. But we are looking at the combination of rate and occupancy to get to the right balance. So I really -- I try not to stay too focused on the rentals. I am looking at more -- where is my occupancy? And how does that compare to prior year? And how does that -- and in revenue?

Now, management is driving the rates to try to get the maximum out of the properties. So it is a little bit more complicated than simply looking at the rentals for the current quarter. I mean, you could panic if you're not careful as far as rentals could go down because we could drive rates up because we feel like we're at or getting closer to the occupancy that we are striving for.

David Toti - *Cantor Fitzgerald - Analyst*

Okay. That's helpful. My second question is also to do with the gap in pricing between the Internet reservations and the Internet quotes versus what you are giving to the walk-ins and to the callers. I know historically that has been wider.

It is that gap changing at all, given the renewed strength and the higher occupancy levels? Are you still pricing well above those other rates?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Our gap is still around 15%. We continue to test it. There might be some -- we definitely feel that there is some property, some markets where that gap could even be larger, and some where it could be smaller. But in general, our gap is still 15%.

David Toti - *Cantor Fitzgerald - Analyst*

Okay, so it is really asset, inventory specific; it sounds like.

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Yes.

David Toti - *Cantor Fitzgerald - Analyst*

Okay, great. I will get back in the queue. Thanks.

Operator

Todd Thomas, KeyBanc Capital.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Hi, thanks. I am on with Jordan Sadler as well. Just a follow-up question on pricing.

I know there are a lot of different ways that you price all of the units. But, Karl, I think you mentioned that asking rents were up 3% to 4% year-over-year on average. But I was just wondering, what is the spread between the rent for tenants that moved out in the quarter versus tenants moving in, in the quarter? Are you replacing vacates with higher or lower rent paying customers at this point?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Well, if you are looking specifically at the tenants that are leaving and the tenants that are coming in, there is always going to be a gap. Because people that have stayed with us -- a lot of times, especially if they been here with us a long time, they will have gotten multiple increases and so -- but we don't focus on that. What we focus on is what our overall in-place rental rates are versus what our street rates are.

That gap, that was a big problem back in 2008/2009. That hasn't been a problem since 2009, and we are keeping that -- that gap is pretty close.

Spencer Kirk - *Extra Space Storage Inc. - CEO*

This is Spencer. One additional comment, Todd. As you look at the rates and what we have achieved in the first quarter, you also need to factor in that our discounts are down more than 10% in the same period. It's rate plus the discount, or the elimination of the discount, that provides the juice.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Okay. So what is the spread today then, between the street rates and the in-line rent for the portfolio?

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

They are almost right on top of each other, within 0% to 2%, depending on when it is measured.

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

But you've got to keep in mind that we can change that real quickly by just pushing the street rates. So you have to look at it over a longer period of time.

Because I am looking at a schedule right now that has for 2013, and in a couple months it was a percent over, and a couple months it was a percent down. So it goes up and down because we are constantly adjusting street rates. But there is no deep issue there, like there was three years ago.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Okay, understood. Then the second question, I was just wondering if you could give us a little color on the 55 properties added to the third-party management business in the quarter. I was just wondering if you could give us a sense for what is in the pipeline, what you are seeing for new contracts right now.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

The 55 assets, if you look at them, it is really primarily made up of three additionals. We did a portfolio of 29 assets that are located throughout the US, and another 10 assets located in Texas, and then five assets in the Chicago area.

Those assets all fit our footprint very well. They are all assets that we want in the portfolio for some economies of scale.

We also get management fees, tenant insurance on those. They are not necessarily all assets that we would buy.

So I think it fits our footprint. We are making money on those, and we saw some significant growth in the quarter.

As far as the pipeline, it is more onesie-twosies from here on. We don't have any significant growth we are projecting right now.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Okay, thank you.

Operator

Christy McElroy, UBS.

Christy McElroy - *UBS - Analyst*

Hey, good morning, guys. Just on page 15, just with the same-store realized rent per occupied square foot up about 3.3% year-over-year in Q1, your broader overall stabilized portfolio had a similar occupancy gain. But looking at rent growth it was more flattish year-over-year.

Can you talk about that in the context about how you are moving rents throughout your whole portfolio? And if your same-store properties saw rent growth does that mean that the rents declined at the rest of your properties? Was it necessarily to go a little easier on rents to maintain or grow occupancy at those properties?

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

Our revenue management system, Christie, doesn't look at who owns the properties. It is going to treat every property the same.

So with a sophisticated revenue management system it is focusing more on what -- how to maximize the revenue rather than the rate and the occupancy. So it is a combination of rate and occupancy, and it obviously does not look at all of the portfolio. So I would tell you that it is basically -- you will get some of that depending on the portfolio and the number of properties within the portfolio, you will get some discrepancies or differences.

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Christy, this is Karl. I also think we probably have more occupancy opportunity on some of the third-party stuff than on owned. And as a result then you're going to see a little bit less rate growth because we are going to be getting probably a little bit more -- I haven't looked at it in depth, but my guess would be that it is more a result -- revenue management is going to be able to push rates more on more highly occupied -- or will be pushing rates more on more highly occupied properties.

And the owned properties we probably have more occupancy, a little bit more occupancy there. So that is probably what is occurring.

Christy McElroy - *UBS - Analyst*

Okay, I guess I am just looking at -- if I just look at the same-store pool versus, say, just split out the 2005 Prudential JVs, occupancy is higher on the Pru JVs, but the next rents per occupied square foot were down year-over-year. I am just trying to get a sense for what that -- what story is that telling me.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

Part of that is a little bit of the makeup of the same-store pool. Karl addressed it a little bit in his comments. But we had a change in the same-store pool this year where we added 62 assets, and 55 of those assets were acquisitions that took place in 2011. And those assets have really, we would say, outperformed the normal historical -- the legacy properties.

In addition, there are -- we added eight properties that were coming from our development pipeline. We have never changed our same-store definition; but we do have a bit of a benefit from those properties in the current year.

Christy McElroy - *UBS - Analyst*

If I look at just those 62 properties, what was the year-over-year occupancy change? Do you have that?

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

The easier way to look at -- well, I don't know if it's easier. If you look at the 2012 pool of 282 properties, the occupancy change there went up about 200 basis points. In the new pool, the 344 assets, your occupancy change went up by about 300 basis points, just under 300 basis points. And the majority of that, obviously, is coming from these assets. I don't have it specifically related to those assets.

Christy McElroy - *UBS - Analyst*

Okay.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

Yes, we could look at this and - I am sure Clint could probably get back to you or get out with more information related to those kind of -- that kind of in-depth analysis.

Christy McElroy - *UBS - Analyst*

Thank you so much.

Operator

Michael Knott, Green Street Advisors.

Michael Knott - *Green Street Advisors - Analyst*

Hey, guys. Spencer, boy, you guys sure crushed your prior guidance for the full year, just within a couple short months. So I'm just curious how you guys thought about -- when you set your initial guidance and then how you thought about where you go from here.

Obviously, you upped it quite a bit. But just curious your thoughts looking forward on the 6.5% to 8.25% for the year.

Spencer Kirk - *Extra Space Storage Inc. - CEO*

Good morning for you, Michael. Great question. As we are looking at guidance for 2013, at the latter part of last year, we did not have perfect clarity, obviously. It is easy to look back now that a third of the year, come Wednesday morning, is behind us. And with having gone through the low point of the season -- the third week of February, Michael, is the slowest time of the year historically in self-storage in seasonality.

And having gotten through that and seen what we been able to do with the asking rates, having seen what we could do with eliminating discounts, having taken a look at where we think this business is going to go, Q3 and Q4 in 2013 we were taking a much more conservative approach. And as we have looked at the year is transpiring and unfolding we have become more confident that the strong, solid trends that we have been seeing (technical difficulty) continue to play out the rest of the year.

So once again our guidance -- it is our best educated estimate as to what we think we can produce, and produce with a high degree of confidence. And with May just being around the corner and our busy season coming upon us, we have firmed up our guidance and said -- yes, we are confident that we can produce these kind of results. So it is really a recognition that we have gone through the toughest part of the year and that we have better clarity as to what the rest of the year will hold for us.

Michael Knott - *Green Street Advisors - Analyst*

Okay. Thanks for that. And then second question would be just on the acquisition pace and your thoughts about your $150 million target for the year. How you feel about what you are seeing out there; what you are able to acquire; how pricing looks; how you feel about your cost of capital today; and how that may be changes or doesn't change your appetite for doing acquisitions.

Spencer Kirk - *Extra Space Storage Inc. - CEO*

Acquisitions environment, our estimate is still $150 million for the year. I think with the two properties that we acquired and the five under contract, we're at $66.5 million. Once again, a third of the year is behind us, so I would say we are reasonably on track for what is or could be expected.

What we don't know is the numerous conversations we are having, how they are going to play out. We are like every other self-storage operator that is publicly traded. We have got a nice cost of capital advantage versus the private guys, both with debt and equity. The challenge for us is to be disciplined and focus on accretive acquisitions.

As we talked about the results of the 55 assets that were purchased in 2011 and 2012, part of our success, Michael, is because we were disciplined and we went after acquisitions that intellectually and financially made sense in the short term, mid term, and the long term.

And for us, we want to remain disciplined even though we recognize with an implied cap rate with a 5 handle on it, that it is not the time to get crazy or become irrational, because things can and will change. And furthermore, we recognize that a blend between debt and equity is the strategy this Company tends to employ in going out after acquisitions.

So I can say there is an incredible amount of money chasing too few opportunities. Cap rates have a lot of pressure on them. And Extra Space wants to be selective and bring in those that fit our footprint operationally and also that meet the short-term, intermediate, and long-term objectives.

Michael Knott - *Green Street Advisors - Analyst*

Okay. So with that, you are not thinking about going into development the way Public Storage has, since you'd shut that down and that was a permanent decision, even though the acquisition environment is pretty aggressive or heated, it sounds like.

Spencer Kirk - *Extra Space Storage Inc. - CEO*

Yes, it is heated, but still there are opportunities out there. Last year we did $700 million of acquisitions, Michael, and $500 million were off-market. I don't know what the number will be this year, but I think that there are relationships that we enjoy that say we will participate in the open market acquisition and we will participate in some off-market acquisition. But we are not developing, to underscore that one more time, if I could.

Michael Knott - *Green Street Advisors - Analyst*

Thank you.

Operator

Steve Sakwa, ISI Group.

Steve Sakwa - *ISI Group - Analyst*

Thanks, good morning. I guess my first question, maybe it is for Karl, is just talk a little bit about the expense growth or lack thereof. How much of -- I know the business has become more and more technology driven and more driven by all the algorithms that you do on the Internet. I am just wondering; how sustainable is a 1% to maybe 2% expense growth figure?

And what are you seeing on the property tax side that maybe hasn't come through yet, like we are seeing in other real estate sectors right now?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Well, I don't think we are seeing the 1% to 2% growth. We are seeing that the growth will be higher than that. We continue -- what we are looking at is year-over-year. So whatever we put in the bank last year, as far as that year-over-year, and not having the increase -- well, then this year we start over again. We are continuing -- there are certain things that we are continuing to get benefit of that is going away.

Yellow Pages, that is a big part of the savings that we had this quarter. And as we are almost totally out of it, it is not going to -- we can't go to negative growth on it, because we're going to have zero growth and zero expenditure. So we will continue to spend more on the Internet, so that is going to increase.

Our payroll expense, as you can see, we are seeing -- the growth this quarter is a little bit exaggerated because we had a special bonus in there. But payroll expense is going to run 3.5% to 4% growth.

The utilities, as we continue to invest in the solar panels, we might be able to hold that down and actually have some -- our actual electricity expense I think was down by 10%, but actually natural gas was up by 9%. So luckily we use less natural gas than electricity so that was a bigger savings.

We continue to find things on office and expense that gives us a benefit. But once again it is harder and harder.

So I think our guidance for the rest of the year is more -- not that far from -- we lowered a little bit because we got some benefit in the first quarter. We are still saying we are going to end the year at 2.5% to 3.25% growth.

And that is pretty realistic. There is only so much we can cut.

So we have done a great job the last three or four years. And maybe we will find something we haven't discovered, but I don't know what that is going to be.

As far as property tax, I will let Scott talk about that.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

We have estimated kind of 3% to 4% is what we have estimated. We have done that for the past several years, and it hasn't necessarily jumped at that rate. But we are expecting the municipalities to reassess our properties on an annual basis.

Steve Sakwa - *ISI Group - Analyst*

Okay. Then just a small question, in terms of like maintenance CapEx across the portfolio. What are you guys budgeting for this year?

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

I think it is -- you mean cents per square foot?

Steve Sakwa - *ISI Group - Analyst*

Yes, if you want to give it that way, that's fine.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

Yes, I think it is in the range of $0.35. It really varies by property and type and -- yes. That is CapEx.

Repairs and maintenance runs about the same and it's been running the same. Our maintenance -- I mean, that's one thing we haven't done is we are trying to be careful to spend the money we need to keep our properties at the level that our customers expect. We increase the rents a lot, and we need to give that back to them.

Steve Sakwa - *ISI Group - Analyst*

Right, okay. Thanks.

Operator

Michael Salinsky, RBC Capital Markets.

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Michael Salinsky - *RBC Capital Markets - Analyst*

Good morning, guys. Karl, first question for you. Can you talk a little bit about street rates, how that progressed throughout the quarter, and where you guys ended the quarter up, on a year-over-year basis? And also what you would need to see in the industry to give you more confidence in pushing street rates a bit more aggressively, kind of back to the 2006, 2007 levels?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Yes, Mike. It is up and down constantly. Actually in April we went up a little bit more, but it is -- we are constantly -- I guess the short answer is, I don't control rates. Our revenue management group does, and they are constantly tweaking it.

So it is going up and down. I think Scott probably has something in front of him that he could tell you month by month if that is what you are looking for.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

Yes, our rates as far as a dollar amount per unit have been pretty flat. But if you look year-over-year, as Karl mentioned, they were 3% to 4% on average for the quarter, depending on when you looked at that, what day, what time, because those rates are dynamic and they are moving. They have been probably as low as 2% and as high as just over 5%.

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

The good thing, Mike, is what we are seeing is we are at a much higher square foot delta than we thought we were going to be, and yet being able to hold our rates at the 3% to 4%. It is a good combination.

And certainly it is reflective of no new supply, and I don't think we are unique. I think you are going to see our competitors probably will report things probably similar.

Michael Salinsky - *RBC Capital Markets - Analyst*

Is it your expectation that as occupancy gains in the second half of the year moderate that you're going to be able to push a bit more on street rates?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

We hope.

Michael Salinsky - *RBC Capital Markets - Analyst*

Okay. Then my second question. Scott, just to go back to your comments, sounded a little bit more open than you have typically been just on the secured debt front. Should we -- does that suggest you guys are open to doing term loans and moving to more of a balanced financing strategy going forward? As opposed to --?

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

We would tell you, Mike, that we would like to have some optionality. We would like to have -- in a perfect world, we would like to have a tranche of secured. We are primarily going to be a secured borrower; but if we had an unsecured tranche or even a preferred tranche, we feel like that would be good for the Company. Obviously, it depends on terms of those types of loans and rates.

Michael Salinsky - *RBC Capital Markets - Analyst*

So you're okay with corporate covenants at this point?

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

We are not looking to do corporate covenants to this point. But dependent on the covenant some things you might consider.

Michael Salinsky - *RBC Capital Markets - Analyst*

Thank you.

Operator

Tayo Okusanya, Jefferies.

Tayo Okusanya - *Jefferies & Company - Analyst*

Yes, good afternoon. Just going back to Steve's questions in regards to acquisitions, could you talk a little bit about cap rates and what you are seeing in the markets right now for Class A and B assets?

Spencer Kirk - *Extra Space Storage Inc. - CEO*

Tayo, it's Spencer. Class A, and Class B, once again we have got to be a little more specific on this. Let me go back to the quality scoring that we use internally, which by the way has a great deal of subjectivity, even internally, personality by personality here in Extra Space.

But there is the quality of the physical asset itself. There is the quality of the market in which that asset is located. And then there is the quality of the location of that asset within the market.

So if you want to talk a Class A asset in a Class A market with a Main & Main location, we see cap rates that are in the 5 range, maybe even some drifting down a little lower. If you want to talk midmarket, an A asset in a secondary market, Tayo, you might be high 6s, low 7s.

For us, Extra Space has said that we want to try and do our acquisitions with those assets that are in the 6 and 7 range. We need to have a spread; we need to be intelligent; we need to be taking the long view on this.

Because interest rates can and will change. Where you are buying today, property performance and other things to be affected. To go in there and acquire just to get large is not part of our strategy. We want to be disciplined.

I don't know if that gives you the color, but we have seen stuff starting with a 5 and going up and above that. But A assets, B markets are kind of in the 6 to 7 range.

Tayo Okusanya - *Jefferies & Company - Analyst*

Okay. That's helpful. Then second of all, it doesn't seem like you got any real pushback in first quarter from pushing rents despite consumers generally paying higher taxes. Were you surprised at that? What does that suggest to you in regards to how much you can continue to raise rents on existing tenants going forward?

Spencer Kirk - *Extra Space Storage Inc. - CEO*

What it suggests, Tayo, is that our existing customer rate increase program, which we test and retest, continues to produce exactly the result that we have come to expect. That the tax increase at the personal level has not, to our understanding or analysis, had any material impact whatsoever.

And we are going to continue to send out rate increases and that 8% to 9% range, running about 50,000 customers a month. We have learned and learned it well long ago that once the product is in storage it is very sticky. There is a great deal of adhesion.

People aren't going to rent a U-Haul truck and take a Saturday morning and move out for the sake of $8, $9, $10. It just doesn't happen. Good economies, bad economies, higher taxes, lower taxes, people don't move out. It is too much hassle.

Tayo Okusanya - *Jefferies & Company - Analyst*

Well said. Congratulations on crushing it again this quarter.

Operator

Paula Poskon, Robert W. Baird.

Paula Poskon - *Robert W. Baird & Company - Analyst*

Thank you. So speaking of crushing it, just looking at the market-by-market numbers on page 18, the Cincinnati/Northern Kentucky region has had stellar performance. And as we reflect back on when you first bought those assets, I remember there was a fair amount of skepticism about going into such markets.

Can you just talk a little bit about how your acquired assets over the last, say, two years are performing relative to how you underwrote them? And then secondarily, do you think it is these kinds of markets where you are going to see the most accretive opportunities going forward?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Paula, this is Karl. I will start and I will let Scott finish.

But there are certain acquisitions where going in we feel like we can have a lot of impact, and Cincinnati was one of those. The prior operator did things like didn't take credit cards and had a little bit restricted access hours and things like that, that we feel going in can have an impact. And then, obviously, both our revenue management and our Internet applications have also had a significant impact.

We were a little worried on that portfolio because there are some rural properties in there that we were worried that the Internet may not have quite the impact that it does elsewhere. But it has turned out well.

And we have had that in a number of other acquisitions where clearly we have an advantage. There is an advantage to being bigger, having better resources. And our revenue management group is pretty sophisticated, and I will put them up against anybody in the industry, but especially a local operator.

I have been in this business 25 years, and my gut was telling me we couldn't do some of the things we do. But because of the data and the really smart guy -- a lot smarter than me -- that are making those decisions, they are doing things that -- we look at it and go, I don't know about that; and it holds. I will let Scott maybe add some more color.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

As far as the underwriting goes, Paula, we are very consistent in how we underwrite things. So our acquisition group brings things to our real estate committee, and I would tell you that we don't miss badly as far as our underwriting goes. I would tell you if anything it may be slightly conservative. I mean in Cincinnati, we didn't pro forma this kind of growth, and you would rather be surprised on the upside.

As far as markets go, we continue to look at all markets. I think, obviously, you prefer to buy in New York City and Los Angeles and Washington, DC; but pricing might not make sense. So if there is a market such as a Cincinnati that is still a major metropolitan area and the pricing is very accretive to us, it is something we will look at if it makes sense with our footprint.

Paula Poskon - *Robert W. Baird & Company - Analyst*

Thanks, Scott and Karl. Spence, just a bigger-picture question for you, just in terms of valuation. I know, obviously, a lot of folks are talking about the implied cap rates of the sector and relative to historical norms. Given the technology component that is driving performance in this sector, do you think this sector has just permanently repriced at a lower implied cap rate level?

Spencer Kirk - *Extra Space Storage Inc. - CEO*

I would hope that it is permanently repriced because we have proven -- and when I say we, I try to include the other public operators -- but we have proven that the Internet is not the great equalizer. It is the great divider.

And the chasm has not only widened, the rate at which it is widening is accelerating. I just think that we as the public operators with the national footprint and the sophisticated systems that Karl alluded to can and should get credit.

Because it is a highly fragmented business. Most of our competitors do not have the wherewithal to begin to do what we do. And I think that when you put up, in the case of Extra Space, a 39% FFO growth year-over-year, I would hope that we would be treated more as a growth company and less as a just a me-too storage operator with a Yellow Page ad and some local marketing flyers going out to the local apartment complexes.

The world changed, and it has changed permanently.

Paula Poskon - *Robert W. Baird & Company - Analyst*

Thank you very much. That's all I have.

Operator

Jeremy Metz, Deutsche Bank.

Jeremy Metz - *Deutsche Bank - Analyst*

Hi, just going back -- you just made a comment about DC as a market and New York and LA where you'd prefer to buy. But just looking at the market, it looks like it has underperformed some of your other major markets a little bit. Can you just give us a little color on what is going on in that market?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Yes, this is Karl. I actually happened to be traveling in the DC market last week. It is still a great market, but we pushed it very hard. It was one of the earlier high-growth markets, and I think in some cases we might have gotten -- our revenue management system is very, very good, but it is not perfect. And sometimes I think -- and we can have a tendency to maybe push it a little bit too hard.

And that, I think, is a case where we pushed it a little bit too hard. And also in general -- while the rest of the country is feeling really, really good, there is a lot of concerns in the DC market about sequestration, and I heard a lot of ad hoc comments about governmental agencies that have units that were going to move in that didn't move in, or were moving out. So there is a little bit of that going on as well.

But if I had to bet on a market long-term, we love the DC market. The great part about it is, whereas the suburbs of Cincinnati could have a lot of new properties built someday and may, and we probably will be faced with that, the DC market, it takes -- we just opened a property -- a third-party owner just opened a property. They have been working on it for 10 years, in McLean, Virginia, and it's -- you go into markets like that, there's not going to be a lot of new competition there. And there are a ton of people with a lot of money, and that is a good formula for us.

Jeremy Metz - *Deutsche Bank - Analyst*

Okay, great. Appreciate the color. And along that same line, I know you are not looking to sell any assets, but just looking at a market like Houston where occupancy is below 80% and the strong bid for storage assets you mentioned earlier. Are you changing that thinking at all? Would you look at maybe looking to cull some of your assets that are either underperforming or older?

Spencer Kirk - *Extra Space Storage Inc. - CEO*

Jeremy, it's Spencer. We are trying to build a Company. There might be an asset or two that we cull. But realistically, to Karl's point, we're trying to invest in our assets to keep them relevant in the market, and we will yet be more aggressive in terms of recognizing that as the portfolio ages we have got to invest additional dollars to make sure that they stand competitive in each of these markets in which we are doing business.

But, no, we're not trying to balance the portfolio. We are trying to grow one.

Jeremy Metz - *Deutsche Bank - Analyst*

Okay, great. Thanks, guys. Appreciate it.

Operator

Todd Thomas, KeyBanc Capital.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Yes, hi. Thanks. Just a follow-up on the Cincinnati/Northern Kentucky properties. The performance does look strong, but effective rents stick out at just under $7 a foot. I was just wondering; is that a function of concessions? Or can those properties get to $9 or $10 rents over time? Or is that really just a lower-priced market?

Then secondly, I was just wondering. You have owned these assets now for a little over 18 months. I was just curious where the yield on that portfolio of properties is today. Maybe you can remind us where the in-place yield was at the time you acquired them in mid 2011.

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

This is Karl. I will answer part of your question. Scott can talk about the yield.

But $6 and $7 is better than $5 and $6, and that is what we have grown it. That is a blended rate. Some of these properties are very rural, and $6 is a great rate in some of those rural markets. Some of them are making -- are in the $9 range, so it is kind of all over the place.

But I don't think we are going to get that total portfolio to $9 anytime soon. What we have been able to do, though, is there was a lot of occupancy opportunity. You can only go -- you are not going to be able to drive the rate tremendously above what the market is. But if you buy a group of properties that are 75% occupied, 80% occupied, you can drive them to 90% or 92%, and that is a lot of what we have been able to do on those properties. Scott?

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

As far as the yield, we haven't necessarily broken it out. We can tell you that -- north of an 8 cap, well north of that.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

That is what it is yielding today?

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

If you look at the cap rate and where we bought it, that is correct.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Okay. Then just one last question on guidance. Interest expense, it looks like the first quarter annualized would be a little bit below $70 million. You're forecasting $72 million to $73 million.

I was just wondering what assumptions that you are making for the balance of the year that would cause interest expense to increase toward the midpoint of that range.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

Timing of some of those loans. And as we refinance or put loans on for acquisitions, your debt will go up slightly, primarily through acquisition.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Okay, great. Thank you.

Operator

Christy McElroy, UBS.

Christy McElroy - *UBS - Analyst*

Hi, thanks. Just with regard to the 100 basis points added to the revenue growth rate from the 62 properties added to the same-store pull, does that include the impact of tenant insurance revenues on the newly added properties? Presumably for the acquisitions it was probably pretty low when you bought them.

Scott Stubbs - *Extra Space Storage Inc. - EVP, CFO*

Yes, but the majority of that increase is actually from rental revenue than from tenant insurance.

Christy McElroy - *UBS - Analyst*

Okay. You talked about discounts and asking rents. How much are you pushing existing customer rents currently?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

In the range of 8% to 9%.

Christy McElroy - *UBS - Analyst*

8% to 9%? Are all those numbers representative of your overall portfolio, or just your same-store properties?

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Overall portfolio. We don't differentiate.

Christy McElroy - *UBS - Analyst*

Got you. Okay. Thank you.

Operator

(Operator Instructions) Michael Knott, Green Street Advisors.

Michael Knott - *Green Street Advisors - Analyst*

Hey, guys, just a follow-up on Spencer, your comment earlier about the discounts coming down. I think you said they were 10% less. Just wondering if you can put a little more color around that.

How much juice is there left to squeeze out of the discount lemon compared to, say, the top of the last cycle? Then also, is it possible to think about your rent gain for the quarter year-over-year in terms of the three different buckets? How much came from discounts receding, how much came from street rates, and how much came from your existing customers?

Spencer Kirk - *Extra Space Storage Inc. - CEO*

I will that Karl take the second half of the question. The first question, Michael, is -- so our discounts were down more than 10% for the quarter, which we were pleased about. And as we push our occupancies and go through this busy season and everything else, I think you will see that percentage shrinking.

Just don't know that it is sustainable. Obviously, we could be pleasantly surprised, but I think realistically the asking rates will be pushed first and foremost; we will couple that with the discount; and we will see what the effective price is that we get on each of the units. But I see that coming down.

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

Michael, as far as where the 7-plus-% rental rate growth came from this quarter, I think that almost half of it came from occupancy. You had almost 300 basis points from occupancy. Rates were 3% of 4% on average up for the quarter.

So another half of what is left came from the street rate growth as well as the decreased discounts. So your effective rate that you are charging incoming tenant. And the rest came from existing customer rate increases.

Michael Knott - *Green Street Advisors - Analyst*

Okay. Then just a question on Los Angeles. It looks like that is now the biggest component, at least of the wholly owned stabilized Group. It looks like it had above the portfolio average performance this quarter, which I don't think it had; I think it was below average in 2012. Just curious if you are seeing a decided turnaround in that region.

Karl Haas - *Extra Space Storage Inc. - EVP, COO*

This is Karl. Yes. it had suffered for two or three years, and now it has come around.

It is a great market for us. We have very good product there and a good location, good quality. But the market has been a struggling market. There is a lot of self-storage there. And it is coming back nicely, though.

Michael Knott - *Green Street Advisors - Analyst*

Okay, thanks.

Operator

At this time there are no additional questions in the queue. I would like to turn the call back over to Clint Halverson for closing remarks. Please proceed.

Spencer Kirk - *Extra Space Storage Inc. - CEO*

Actually a name change. It's Spencer. We appreciate your interest in Extra Space today and we will look forward to the Q2 earnings call in 90 days. Thanks very much. Have a good day.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a wonderful day.

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