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EXR - Q3 2014 Extra Space Storage Inc Earnings Call

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Todd Thomas *KeyBanc Capital Markets - Analyst*

Michael Salinsky *RBC Capital Markets - Analyst*

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q3 2014 Extra Space Storage, Inc., earnings conference call. My name is Sean, and I'll be your operator for today. (Operator Instructions.) As a reminder, this call is being recorded for replay purposes.

I would now like to turn the call over to Mr. Jeff Norman, Senior Director, Investor Relations. Please proceed.

Jeff Norman - *Extra Space Storage, Inc. - Senior Director IR*

Thank you, Sean. Welcome to Extra Space Storage's third-quarter 2014 conference call. In addition to our press release, we have furnished unaudited supplemental financial information on our website.

Please remember that management's prepared 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, Thursday, October 30, 2014. 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*

Hello, everyone. In the third quarter, we saw steady demand and muted supply. These factors contributed to year-over-year increases in achieved rates and occupancy. As a result, revenue increased 7.2%, NOI grew 9.3% and occupancy increased 100 basis points. FFO, as adjusted, increased 26.3%. This is on top of growing 24.0% the year before.

This quarter marks four years of consecutive quarterly double-digit FFO growth. The climate for self-storage remains favorable, and I believe that we will experience double-digit FFO growth for many quarters to come.

Despite heightened competition for properties on the open market, we continue to grow our portfolio through accretive acquisitions and expansion of our third party management platform. The relationships with our partners enable us to negotiate mutually beneficial off-market transactions.

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

Thanks, Spence. Last night we reported FFO of $0.72 per share for the third quarter. Excluding costs associated with acquisitions and non-cash interest, FFO as adjusted was also $0.72 per share. One penny of our beat was due to better-than-expected property performance, including tenant insurance. The rest of our beat was due to lower income taxes in our taxable REIT subsidiary.

Over the last few years, we have researched the tax structure of our TRS, specifically the concept of paying a royalty to the OPREIT for access to its intellectual property. Charging this type of fee is not uncommon in the insurance industry and can be paid to affiliated companies or third parties. Recent IRS rulings and expert opinions have given us the necessary comfort to adopt this practice. This change provides a tax benefit for the current year and will provide an ongoing benefit in the years to come.

During the quarter, we acquired three properties for $26.7 million in Florida, Georgia, and Texas. Subsequent to the end of the quarter, we acquired two additional properties for $17.5 million located in Colorado and Georgia. We currently have 11 properties under contract for $108.2 million, which should close by the end of the first quarter of 2015. As of today, we have closed or have under contract $493.2 million.

In addition to the $493 million, we have seven other properties that we will acquire upon completion of construction, totaling $69.5 million. These properties are under contract and will open in 2015 and 2016. The sites are located in Arizona, California, Massachusetts, North Carolina, and Texas. Two of these properties, totaling $21.9 million, will be purchased by a joint venture, of which Extra Space will have a 10% equity interest.

We have revised our full-year 2014 FFO guidance to be from $2.54 to $2.57 per share. The increase is primarily due to lower income taxes. These estimates include non-cash interest and acquisition-related costs. Adjusting for these items, FFO is estimated to be from $2.58 to $2.61 for the full year.

I'll now turn the time back to Spencer.

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

Thank you, Scott.

As a management team, our job is to maximize shareholder value. On August 12, we celebrated our 10-year anniversary as a public company. We are now included in the 10-year total return benchmarks with 106 publicly traded REITs. Since that time, our total return to shareholders has been the highest or second highest of any REIT on the NYSE.

It is noteworthy that the total returns of all three storage REITs with a 10-year track record rank in the top 15. It has been a great decade for self-storage, and I am very pleased with the result we have created for our shareholders.

Let's turn the time over to Jeff to start the Q&A.

Jeff Norman - *Extra Space Storage, Inc. - Senior Director IR*

Thank you, Spencer. In order to ensure we have adequate time to address everyone's questions, I would ask that everyone keep your initial questions brief and, if possible, limited to two. If time allows, we will address follow-on questions once everyone has had the opportunity to ask their initial questions.

With that, we will turn the time over to Sean to start our Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions.) Christy McElroy, CitiGroup.

Christy McElroy - *CitiGroup - Analyst*

When you're buying in these CofO deals, can you talk a little bit about how you think about pricing? And is there a limit to how many you would buy in a given year to limit the dilutive impact? You've been pretty vocal in recent years about not going full on into the development game anymore.

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

Yes, Christy, this is Scott. As far as the total dilution we're targeting right now, it's 2% to 3% of our annual FFO. So we'd like to keep it fairly minimal but also participate. As far as how we underwrite them and what kind of returns we're looking for, it really depends a little bit on the market and the property, but it's usually anywhere between 150 and 250 basis points over what a stabilized property would go for today.

Christy McElroy - *CitiGroup - Analyst*

Okay, and -- go ahead.

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

And on a prior call, Christy, we talked about that as a management team, we have targeted 2% to 3% of our FFO as the target for dilution that we would be willing to accept. Now, that target may move, but with these CofO opportunities that are presented in the sales, we've set a target to make sure that we deliver the earnings that the street is expecting without massive dilution. We've been down that road before.

Christy McElroy - *CitiGroup - Analyst*

Right. As you continue to gain scale, how do you think about your property management platform today from a profitability perspective? Is it still just a future source for acquisitions and a source of incremental tenant insurance revenues? Or is it a profitable business?

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

It is a profitable business, Christy. You hit the key point on the head, and that is it becomes a proprietary off-market acquisition pipeline. That's why we're doing this.

Secondarily, obviously, we collect management fees. To that point, depending on where you put a property into the system, if you put a single property into Los Angeles, for instance, that's a very profitable proposition for us. When you go to places where we don't have the same kind of density, it's still profitable, but maybe not to the same degree.

Tenant insurance, obviously, works very well. And not to be missed, with 270-something properties, that has provided us a much bigger footprint in the world of digital real estate, with Internet searches and dollars that we can allocate to pay-per-click advertising on the Internet. So the scale is of great benefit, and I think oftentimes that's overlooked.

Christy McElroy - *CitiGroup - Analyst*

Thank you.

Operator

Ryan Burke, Green Street Advisors.

Ryan Burke - *Green Street Advisors - Analyst*

Thanks for the color on development versus acquisition yields. Are you able to generalize that dynamic on a dollar-per-square-foot basis? So where are you acquiring these CofO deals on a dollar-per-square-foot basis relative where you could acquire stabilized acquisitions in a given market?

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

We haven't been heavily focused on that, Ryan, for the reason that we feel like when we're buying certificate of occupancy deals, you're effectively eliminating two of the three risks associated with a property. You're eliminating the construction risk, you're eliminating the entitlement risk, and we're taking on the lease-up risk, which we feel like is acceptable and is something we're good at, something that we can minimize. But we haven't necessarily looked at it in terms of cost per square foot.

Ryan Burke - *Green Street Advisors - Analyst*

Okay, thank you. Separate question, Scott, on the tax benefit. I just want to clarify one point that I believe you made in your prepared remarks, and that is that if you offered tenant insurance through a third-party provider instead of doing it in-house, would you have been able to put this tax structure in place?

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

It's a little different. We're viewing it more from the taxable REIT subsidiary and the tenant insurance company that we do own as a fee that the Company has to pay in order to have access to the intellectual property, the customer base, similar to what is being offered to other self-storage companies, where those tenant insurance companies are paying a similar fee. So I'm not sure if that clarifies it or not, Ryan.

Ryan Burke - *Green Street Advisors - Analyst*

I'm trying to -- so -- I'll circle back with you on that. And third question, and we'll jump back in line. There's been some news on a fire at your Venice Beach property, and I don't want to shine a light on an unfortunate event, but if you could just talk to us generally about how the tenant insurance process goes into play in a scenario like this.

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

Yes, so the tenant insurance process -- obviously, we have to go through the process of them coming in, seeing if there's a total loss. We then work with the adjusters. They make the claim through Beecher Carlson, our management, and they handle the claims. Typically, if it's a total loss, it would just be paid out immediately. Those losses, we accept some of the risk upfront, so we will have a loss associated with this fire.

Ryan Burke - *Green Street Advisors - Analyst*

Okay, thank you.

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

And it's one of the reasons why we feel like it's a good thing for our customers to have insurance, either through us or through their homeowner's.

Ryan Burke - *Green Street Advisors - Analyst*

Got it. Thank you.

Operator

Vikram Malitouhortia, Morgan Stanley.

Vikram Malitouhortia - *Morgan Stanley - Analyst*

Occupancy as today, are you thinking about seasonal trends going into 4Q? And just associated with that, you had a very nice bump in rent growth. Can you maybe give us a sense of was there any specific area that gave you that bump up in rents this quarter?

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

So from a rent perspective, if you look at where our growth is coming from, year to date you've had 1.7% come from occupancy. The rest is really coming from rates. Those rates then break down into increases in street rates, increases to existing customers, and increases due to discount savings. So 1.7% comes from occupancy growth, 4.5% comes from increases in street rates, and then the rest is coming through increases to existing customers and decreases in discounts.

Vikram Malitouhortia - *Morgan Stanley - Analyst*

And as you think about going into 4Q, just the interplay between occupancy and rents, can you give us a sense of how you expect the seasonal trends to move?

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

Yes, we expect to keep our prices lower in the fourth quarter. So we were quite aggressive in the summer months, when we peaked out in occupancy. We expect to be less aggressive in the fall and winter in order to maintain occupancy so that we can push rates again in the summer.

Vikram Malitouhortia - *Morgan Stanley - Analyst*

Okay, thanks, guys.

Operator

Todd Thomas, KeyBanc Capital Markets.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

A question for Spencer. I was just wondering if you could just talk about the landscape for new supply today, maybe just give us an update on what you're seeing for the year ahead from a broader industry perspective and whether your view has changed at all since the last update.

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

Great question, Todd. I would say on the periphery, my view has changed from the last call. I'm still of the opinion that the new supply coming into the market may be keeping pace with the population increase in the country.

One of the revelations that has come -- I hear a lot of noise about new developments coming out of the ground. But one of the revelations for me has been we have multiple parties oftentimes claiming they've got a parcel under contract, and it happens to be the same parcel. So trying to weed through the noise on this has been problematic. I talked (technical difficulty)

-- some or all of the tenant insurance. So my outlook for 2015? There will be some supply. I don't think it's going to be massive, and I don't think it's going to affect our ability to deliver a decent result in 2015 as well.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Okay, and then as you think about your investments going forward here, your deal flow for 2015 and maybe even 2016, we've seen more CofO deals and less operating properties. Do you think that that composition skews even further towards development and CofO deals?

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

Not necessarily. I can tell you over the last 4.5 years, we've done $2.06 billion worth of acquisitions. Acquisitions tend to be lumpy. And I wouldn't draw or extrapolate the lumpiness of acquisitions and the opportunity of CofO deals into any meaningful trend just yet. I think it's premature.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Okay. And if I could just sneak one more in for Scott on the tax expense savings. So you mentioned that it will be an ongoing expense savings here. Guidance implies about $1.5 million of incremental tax expense in the fourth quarter. Is that the right run rate to think about, going forward? So about $6 million per year, or will it be more chunkier or volatile in nature on a quarterly basis?

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

That is the guidance for this year. It could potentially get slightly better in the future. We'll just update guidance with our annual guidance this year. I'd tell you just to look to our guidance for that number.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Okay.

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

But it could be slightly better next year.

Todd Thomas - *KeyBanc Capital Markets - Analyst*

Okay, great. Thank you.

Operator

Michael Salinsky, RBC Capital Markets.

Michael Salinsky - *RBC Capital Markets - Analyst*

Just going back to that last question, just thinking about the solar tax credits, you're several years into the program. And why would -- what could potentially bring that down next year from the run rate of the fourth quarter? Is there a potential to get more solar tax credits, or what would be the driver that would actually pull that down, just in your last comment there?

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

The solar taxes are coming down. So solar taxes will actually go away by the end of 2016, the benefit from solar tax. This benefit is actually a royalty fee charged between the OPREIT and the TRS. So this is something completely different than solar.

Michael Salinsky - *RBC Capital Markets - Analyst*

So as you grow the third-party management business, you would be able to charge more royalties and it would actually take your tax expense down? I'm just trying to understand the dynamics of that.

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

So effectively, you're charging a royalty between the insurance company and the OPREIT, thus reducing income in the insurance company and reducing your tax expense.

Michael Salinsky - *RBC Capital Markets - Analyst*

Okay. Then just my follow-up. Spencer, you talked about supply and people owning multiple parcels. Are there any markets right now that you've put on hold, you're just looking at supply coming online? Anything that concerns you, just from a market standpoint?

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

By the way, my comment, Mike, was people claiming to have under contract the same parcel, which obviously is not possible. So just a small semantic detail there.

With regards to markets, I will tell you there seems to be a huge amount of interest in the greater metro New York area. I could also say the same for the core markets in Texas. And it comes back to the statement that we've made many, many times. You have to look at the micro-market, generally a 3-mile ring around the property that is being proposed, to ascertain whether you've got a parcel that is going to make sense or perhaps might not make as much sense. A lot of markets claim to be overbuilt, and you might find a pocket within that market that is underserved, so that would make a great deal of sense.

So this is on a case-by-case basis, but I will tell you, Texas and New York are the two that we are a bit more cautious in our analysis because of the level of interest that has been generated to put new product into those markets.

Michael Salinsky - *RBC Capital Markets - Analyst*

Thanks, guys. Appreciate the color.

Operator

Ki Bin Kim, SunTrust Robinson Humphrey.

Ki Bin Kim - *SunTrust Robinson Humphrey - Analyst*

Just wanted to ask a couple of questions regarding your pricing strategy and some trends I've been noticing. Could you just provide the street rates that you experienced in the third quarter and maybe the promotions, the delta year over year?

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

So without getting into specifics for exact times, Ki Bin, I would tell you that during the summer months, we saw our street rates 7% to 8% up, and then also towards the end of the quarter, they were probably more like 2% to 3% up. It's obviously at a point in time, but I wouldn't necessarily focus just on street rates. I think that you need to also take into account your discounts being down, which they were. We saw them go down into high single-digit decreases. And then in addition to that, you also have to look at the discount being offered on the Internet and what percentage is closing at that lower rate, too.

Ki Bin Kim - *SunTrust Robinson Humphrey - Analyst*

Okay, and my follow-up is that I think last year, heading into the winter, you guys proactively decreased street rates year over year. And the reasoning was that that winter customer was of higher value longer term. Just curious as to how that's turning out. Is that turning out to be -- I know it's a small data set, but turning out true? And what is the decision to maybe decrease street rates a little bit a couple of months in advance of what you did last year? Because it seems like in last year, you did it in the winter, and now you're doing it a little bit in the fall. Just curious what was the thinking behind that?

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

It's actually been a pretty similar philosophy. I think that -- give or take a month or so here. But I think that we've been pretty consistent in decreasing them in the fall and then keeping them flat in the winter, effectively. We do see the benefit from these customers, and we have seen our average length of stay increase.

Ki Bin Kim - *SunTrust Robinson Humphrey - Analyst*

Okay, thank you.

Operator

Tayo Okusanya, Jefferies.

George Hoglund - *Jefferies & Co. - Analyst*

This is actually George. One question on the tenant insurance. Just wondering on the new leases or new tenants that are coming in, what is the overall participation rate?

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

George, it's Spencer. New customers coming in were over 90%. And for existing customers, we're north of 70%.

George Hoglund - *Jefferies & Co. - Analyst*

Okay, and do you have an update on how high, do you think for the overall portfolio, that can get to?

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

I think we're starting to top out. There might be some incremental gains, George, on this. But when you consider that you have people storing automobiles, or you have the small contractor with their own property and casualty policy, this is one of those things that I think we have done a really good job. And I wouldn't bake in a lot more at this point.

George Hoglund - *Jefferies & Co. - Analyst*

And on the occupancy front, since you guys are focusing on keeping higher occupancy in the winter, what can we expect on a year-over-year basis, do you think, for maybe like 1Q 2015?

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

I think year over year, we could potentially see them go another 50 to 100 basis points higher than they did this year.

George Hoglund - *Jefferies & Co. - Analyst*

Okay, all right, thanks, guys.

Operator

(Operator Instructions.) Ross Nussbaum, UBS.

Jeremy Metz - *UBS - Analyst*

Jeremy Metz here with Ross. I just want to quickly go back on the CofO deals. You've been pretty adamant in the past that you're out of the development business. So while you're not necessarily taking on the entitlement and development risk here, I'm just wondering what gives you the confidence in taking on the multiyear leasing risk again.

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

Okay, Jeremy, it's Spencer. There are three risks that you take when you try to pull a property out of the ground. One is entitlement risk, the second is construction risk, and the third is lease-up risk. So by effectively doing a CofO deal, we have hived off what I would consider two of the more risky elements of bringing a new property into the market.

What I think Extra Space has become really good at is driving traffic to a property. I have confidence in our Internet marketing prowess. I have confidence in our operational team to capture those rentals when they walk through the door, And with that and our national platform, I think it's a reasonable risk to take, and it's something, quite frankly, that the small guy can't compete in that arena, and we have a symbiotic relationship where the small developer does what they do best, and we do what we do best, and we replicate it again and again.

Jeremy Metz - *UBS - Analyst*

Okay, so no real change in thinking, though, towards more ground-up development, then, at this point?

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

No, we're out of development.

Jeremy Metz - *UBS - Analyst*

And so I guess, then, if you have that confidence in the leasing, why the decision to be just a 10% minority partner with no real control on these?

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

On an earlier call, I talked about keeping dilution of our FFO to 2% to 3%. And a JV partner allows us to operate the asset, have a nice takeout when they decide to liquidate their position, and keep us within the bounds of what we have wanted to do, and that is maximize shareholder value by driving the highest and best result on FFO growth quarter in, quarter out.

Operator

Sir, we have no further questions at this time. (Operator Instructions.)

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

All right, ladies and gentlemen, we appreciate your interest in Extra Space. We'll look forward to next quarter's call. Have a good day.

Operator

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