PROLOGIS
Form 10-Q
May 07, 2004

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2004

[ ] **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 01-12846

PROLOGIS

(Exact name of registrant as specified in its charter)

Maryland **(State or other jurisdiction of incorporation or organization)**	**74-2604728** **(I.R.S. Employer Identification No.)**
14100 East 35th Place, Aurora, Colorado **(Address or principal executive offices)**	**80011** **(Zip Code)**

(303) 375-9292
(Registrant s telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 for the past 90 days.

Yes [X] No [ ]

Indicate by check mark whether the registrant is accelerated file (as defined in Rule 12b-2 of the Securities Act of 1934).

Yes [X] No [ ]

The number of shares outstanding of the Registrant s common shares as of May 5, 2004 was 181,359,530.

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CONSOLIDATED CONDENSED BALANCE SHEETS

(In thousands, except share data)

	March 31, 2004 (Unaudited)	December 31, 2003 (Audited)
ASSETS		
Real estate	$6,100,639	$5,854,047
Less accumulated depreciation	883,119	847,221
	5,217,520	5,006,826
Investments in and advances to unconsolidated investees	577,611	677,293
Cash and cash equivalents	172,850	331,503
Accounts and notes receivable	36,259	44,906
Other assets	326,578	306,938
Discontinued operations assets held for sale	159,605	
Total assets	$6,490,423	$6,367,466
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Lines of credit	$ 862,073	$ 699,468
Senior unsecured debt	1,758,147	1,776,789
Secured debt and assessment bonds	508,852	514,412
Accounts payable and accrued expenses	139,629	155,874
Construction costs payable	28,045	26,825
Other liabilities	119,547	97,389
Discontinued operations assets held for sale	55,530	
Total liabilities	3,471,823	3,270,757
Minority interest	36,775	37,777
Shareholders equity:		
Series C Preferred Shares at stated liquidation preference of $50.00 per share; $0.01 par value; 2,000,000 shares issued and outstanding at March 31, 2004 and December 31, 2003	100,000	100,000
Series D Preferred Shares at stated liquidation preference of $25.00 per share; $0.01 par value; 5,000,000 shares issued and outstanding at		125,000

December 31, 2003		
Series F Preferred Shares at stated liquidation preference of $25.00 per share; $0.01 par value; 5,000,000 shares issued and outstanding at March 31, 2004 and December 31, 2003	125,000	125,000
Series G Preferred Shares at stated liquidation preference of $25.00 per share; $0.01 par value; 5,000,000 shares issued and outstanding at March 31, 2004 and December 31, 2003	125,000	125,000
Common Shares; $0.01 par value; 181,222,238 shares issued and outstanding at March 31, 2004 and 180,182,615 shares issued and outstanding at December 31, 2003	1,813	1,802
Additional paid-in capital	3,101,973	3,073,959
Accumulated other comprehensive income	180,599	138,235
Distributions in excess of net earnings	(652,560)	(630,064)
Total shareholders equity	2,981,825	3,058,932
Total liabilities and shareholders equity	$6,490,423	$6,367,466

The accompanying notes are an integral part of these consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF EARNINGS AND COMPREHENSIVE INCOME

(Unaudited)
(In thousands, except per share data)

	Three Months Ended March 31,	
	2004	**2003**
Revenues:		
Rental income, including expense recoveries from customers of $27,011 in 2004 and $26,466 in 2003	$138,161	$142,012
Property management and other property fund fees	11,267	9,739
Development management fees and other CDFS income	1,522	310
Total revenues	150,950	152,061
Expenses:		
Rental expenses	36,644	36,557
General and administrative	19,566	15,876
Depreciation and amortization	42,758	41,485
Other	996	778
Total expenses	99,964	94,696
Gains on certain dispositions of CDFS business assets, net:		
Net proceeds from dispositions	155,880	248,173
Costs of assets disposed of	128,722	217,431
Total gains, net	27,158	30,742
Operating income	78,144	88,107
Income from unconsolidated property funds	9,537	457
Income from other unconsolidated investees	300	2,670
Interest expense	(39,623)	(37,254)
Interest and other income	738	369

Earnings before minority interest	49,096	54,349
Minority interest share in earnings	(1,226)	(1,283)
Earnings before certain net gains and net foreign currency exchange gains (expenses/losses)	47,870	53,066
Gains recognized on dispositions of certain non-CDFS business assets, net		383
Foreign currency exchange gains (expenses/losses), net	3,313	(5,102)
Earnings before income taxes	51,183	48,347
Income tax expense:		
Current	2,213	509
Deferred	2,739	998
Total income tax expense	4,952	1,507
Net earnings from continuing operations	46,231	46,840

(Continued)

The accompanying notes are an integral part of these consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF EARNINGS AND COMPREHENSIVE INCOME (CONTINUED)

(Unaudited)
(In thousands, except per share data)

	Three Months Ended March 31, 2004	Three Months Ended March 31, 2003
Discontinued operations:		
Income attributable to assets held for sale	3,395	
Assets sold in 2004:		
Operating income (loss) attributable to assets disposed of	(79)	44
Gain (loss) recognized on dispositions, net:		
Non-CDFS business assets	(545)	
CDFS business assets	5,415	
Total discontinued operations	8,186	44
Net earnings	54,417	46,884
Less preferred share dividends	6,684	8,179
Less excess of redemption value over carrying value of Preferred Shares redeemed	4,236	
Net earnings attributable to Common Shares	43,497	38,705
Other comprehensive income:		
Foreign currency translation adjustments	42,774	3,322
Unrealized losses on derivative contracts, net	(410)	
Comprehensive income	$ 85,861	$ 42,027
Weighted average Common Shares outstanding Basic	180,732	178,600
Weighted average Common Shares outstanding Diluted	185,255	181,003
Net earnings attributable to Common Shares per share Basic:		

Continuing operations		$	0.20	$	0.22
Discontinued operations			0.04		
Net earnings attributable to Common Shares per share	Basic	$	0.24	$	0.22
Net earnings attributable to Common Shares per share	Diluted:				
Continuing operations		$	0.19	$	0.21
Discontinued operations			0.04		
Net earnings attributable to Common Shares per share	Diluted	$	0.23	$	0.21
Distributions per Common Share		$	0.365	$	0.360

The accompanying notes are an integral part of these consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)
(In thousands)

	Three Months Ended March 31,	
	2004	**2003**
Operating activities:		
Net earnings	$ 54,417	$ 46,884
Minority interest share in earnings	1,226	1,283
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	42,878	41,518
Gains (losses) on dispositions of non-CDFS business assets, net	545	(383)
Straight-lined rents	(2,224)	(2,054)
Amortization of deferred loan costs	1,492	1,627
Cost of share-based compensation awards	4,365	3,111
Adjustments to income and fees recognized from all unconsolidated investees	(9,104)	(3,376)
Adjustments to foreign currency exchange amounts recognized	(3,547)	4,041
Deferred income tax expense	2,739	998
Increase in accounts and notes receivable and other assets	(5,759)	(4,711)
Increase (decrease) in accounts payable and accrued expenses and other liabilities	9,178	(23,767)
Net cash provided by operating activities	96,206	65,171
Investing activities:		
Real estate investments	(417,571)	(298,730)
Tenant improvements and lease commissions on previously leased space	(10,505)	(9,293)
Recurring capital expenditures	(5,009)	(2,300)
Proceeds from dispositions of real estate	217,500	210,359
Net cash received from unconsolidated investees	15,131	15,591
Adjustments to cash balances resulting from reporting changes	3,284	
Net cash used in investing activities	(197,170)	(84,373)
Financing activities:		
Net proceeds from sales of Common Shares and issuances of Common Shares under plans	18,669	13,301

Repurchases of Common Shares, net of costs		(9,771)
Redemption of Preferred Shares	(125,000)	
Distributions paid on Common Shares	(65,993)	(64,332)
Distributions paid to minority interest holders	(1,776)	(4,023)
Dividends paid on Preferred Shares	(6,684)	(8,179)
Issuance costs incurred	(473)	(2,856)
Proceeds from issuance of senior unsecured debt		300,000
Proceeds from issuance of secured debt		31,000
Principal payments on senior unsecured debt	(18,750)	(18,750)
Net proceeds from (payments on) lines of credit	162,605	(151,571)
Regularly scheduled principal payments on secured debt and assessment bonds	(1,263)	(1,586)
Principal payments on secured debt and assessment bonds at maturity and prepayments	(18,612)	(62,094)
Purchases of derivative contracts	(412)	(750)
Net cash provided by (used in) financing activities	(57,689)	20,389
Net increase (decrease) in cash and cash equivalents	(158,653)	1,187
Cash and cash equivalents, beginning of period	331,503	110,809
Cash and cash equivalents, end of period	$ 172,850	$ 111,996

See Note 11 for information on non-cash investing and financing activities and other information.

The accompanying notes are an integral part of these consolidated condensed financial statements.

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

March 31, 2004 and 2003
(Unaudited)

1. General:

Business

ProLogis (collectively with its consolidated subsidiaries and partnerships ProLogis) is a publicly held real estate investment trust (REIT) that owns (directly or through unconsolidated investees), operates and develops industrial distribution properties in North America (the United States and Mexico), Europe (11 countries) and Asia (Japan). ProLogis has initiated operations in China, but ProLogis owned no real estate assets in China at March 31, 2004. ProLogis has elected to be taxed as a REIT under the Internal Revenue code of 1986, as amended (the Code).

ProLogis business consists of two reportable business segments: property operations and the corporate distribution facilities services business (CDFS business). The property operations segment represents the long-term ownership, management and leasing of distribution properties. The CDFS business segment primarily encompasses the development of distribution properties that are either contributed to an unconsolidated property fund in which ProLogis has an ownership interest and acts as manager, or sold to third parties. Additionally, ProLogis will acquire distribution properties in the CDFS business segment that are generally rehabilitated and/or repositioned prior to being contributed to a property fund. See Note 10.

Principles of Financial Presentation

ProLogis Consolidated Condensed Financial Statements are prepared in accordance with generally accepted accounting principles in the United States of America (GAAP). The accounts of ProLogis, its wholly owned subsidiaries and its majority owned and controlled subsidiaries and partnerships are consolidated in the accompanying financial statements and are presented in ProLogis functional currency, the U.S. dollar. ProLogis consolidates all entities in which it owns a majority voting interest and those variable interest entities, as defined, in which it is the primary beneficiary. All material intercompany transactions, including transactions with unconsolidated investees, have been eliminated.

The Consolidated Condensed Financial Statements of ProLogis as of March 31, 2004 and for the three months ended March 31, 2004 and 2003 are unaudited and, pursuant to the rules of the United States Securities and Exchange Commission (the SEC), certain information and footnote disclosures normally included in financial statements have been omitted. Management of ProLogis believes that the disclosures presented are adequate; however, these interim Consolidated Condensed Financial Statements should be read in conjunction with ProLogis December 31, 2003 audited Consolidated Financial Statements contained in ProLogis 2003 Annual Report on Form 10-K.

Interpretation No. 46, Consolidation of Variable Interest Entities , was issued in January 2003 and revised in December 2003. The revised Interpretation No. 46 (FIN 46R) was adopted by ProLogis as of January 1, 2004. FIN 46R clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements , and requires that variable interest entities in which ProLogis is the primary beneficiary be presented on a consolidated basis in its financial statements. As a result of adopting FIN 46R, ProLogis began consolidating its investments in TCL Holding S.A. (TCL Holding), formerly Frigoscandia Holding S.A., and CSI/Frigo LLC, a company that holds the voting ownership interest in TCL Holding, as of January 1, 2004. Through December 31, 2003, ProLogis presented its investments in TCL Holding and CSI/Frigo LLC under the equity method. ProLogis combined effective ownership in these entities was 99.75% at December 31, 2003. None of ProLogis other unconsolidated investees are variable interest entities as defined in FIN 46R. Therefore, ProLogis will continue to present its investments in these entities under the equity method. See Note 3.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and

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liabilities as of the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

Certain amounts included in ProLogis Consolidated Condensed Financial Statements for the prior period have been reclassified to conform to the 2004 financial statement presentation.

Proposed Acquisition Transaction

On May 3, 2004, ProLogis and certain private REIT subsidiaries of established investment funds (the Fund Partners) established five property funds (the Acquiring Property Funds). Also on that date, ProLogis and the Acquiring Property Funds entered into an agreement to acquire the outstanding equity and operating units of Keystone Property Trust (Keystone) (the Keystone Transaction). ProLogis has a 20% ownership interest in the Acquiring Property Funds with the remainder owned by the Fund Partners. As part of the Keystone Transaction, ProLogis, through a wholly owned subsidiary, will directly acquire certain assets of Keystone. Consideration for the common equity of Keystone will be paid in cash at $23.80 per share. ProLogis anticipates that a portion of the consideration that it pays will be in the form of limited partnership units that are convertible into ProLogis common shares of beneficial interest, par value $0.01 per share (Common Shares). Keystone, a publicly traded REIT, owns and leases industrial distribution properties located in New Jersey, Pennsylvania, Indiana, Florida, South Carolina and Ohio. The Keystone Acquisition is subject to the approval of Keystone s shareholders.

Collectively, the Acquiring Property Funds would acquire $1.37 billion of assets from Keystone, including 22.9 million square feet of operating properties. ProLogis direct acquisition includes operating properties aggregating 2.4 million square feet, Keystone s 20% ownership interests in two unconsolidated entities that own 7.7 million square feet of operating properties, Keystone s 50% ownership interest in an unconsolidated entity that is developing a 0.8 million square foot property and land positions aggregating 126 acres. The assets to be acquired directly by ProLogis are valued at $290.0 million. The Acquiring Property Funds anticipate that Keystone s existing direct fixed-rate obligations will be retired after the closing date. The combined value of the Keystone Transaction is estimated to be $1.66 billion, including the assumption of liabilities and transaction expenses.

In anticipation of the proposed transaction, the Acquiring Property Funds have entered into interest rate swap agreements to hedge a portion of the future interest payments associated with the secured debt that the Acquiring Property Funds anticipate will be obtained as part of the financing of the Keystone Transaction. ProLogis believes that the interest rate swap agreements qualify for hedge accounting treatment. Certain of the interest rate swap agreements are subject to an indemnification agreement between the Acquiring Property Funds and ProLogis. Under the indemnification agreement, ProLogis is obligated to make any settlement payments that may become due and, alternatively, ProLogis is entitled to receive any settlement proceeds that may be paid. This indemnification agreement relates to interest swap agreements with an aggregate notional amount of $185.2 million, the approximate amount of the secured debt to be obtained by the Acquiring Property Funds attributable to ProLogis 20% ownership interest.

Keystone will file a proxy statement with the SEC related to the Keystone Transaction. ProLogis anticipates that the Keystone Transaction will close during the third quarter of 2004.

2. Real Estate:

Real Estate Assets

Real estate assets directly owned by ProLogis consist of income producing industrial distribution properties, industrial distribution properties under development and land held for future development of industrial distribution properties. ProLogis real estate assets, presented at cost, include the following as of the dates indicated (in thousands of U.S. dollars):

	March 31, 2004	December 31, 2003
Operating properties(1):		
Improved land	$ 866,979	$ 815,606
Buildings and improvements	4,198,579	4,053,189
	5,065,558	4,868,795
Properties under development (including cost of land)(2)(3)	422,694	404,581
Land held for development(4)	521,710	511,163
Other investments(5)	90,677	69,508
Total real estate assets	6,100,639	5,854,047
Less accumulated depreciation	883,119	847,221
Net real estate assets	$5,217,520	$5,006,826

(1) At both March 31, 2004 and December 31, 2003, ProLogis had 1,252 operating properties. These properties consisted of 134,072,000 square feet at March 31, 2004 and 133,141,000 square feet at December 31, 2003.

(2) Properties under development consisted of 37 buildings aggregating 12,800,000 square feet at March 31, 2004 and 27 buildings aggregating 9,823,000 square feet at December 31, 2003.

(3) In addition to the construction costs payable balance of $28.0 million, ProLogis had aggregate unfunded commitments on its contracts for properties under development of $439.4 million at March 31, 2004.

(4) Land held for future development consisted of 2,625 acres at March 31, 2004 and 2,706 acres at December 31, 2003.

(5) Other investments include: (i) earnest money deposits associated with potential acquisitions; (ii) costs incurred during the pre-acquisition due diligence process; and (iii) costs incurred during the pre-construction phase related to future development projects.

ProLogis directly owned real estate assets are located in North America (the United States and Mexico), 11 countries in Europe and in Japan. No individual market in any country, as defined by ProLogis and presented in Item 2 of its 2003 Annual Report on Form 10-K, represents more than 10% of ProLogis total real estate assets, before depreciation.

Operating Lease Agreements

ProLogis leases its operating properties to customers under agreements that are generally classified as operating leases. At March 31, 2004, minimum lease payments on leases with lease periods greater than one year for space in ProLogis directly owned properties for the remainder of 2004 and the other years in the five-year period ending December 31, 2008 and thereafter are as follows (in thousands of U.S. dollars):

Remainder of 2004	$ 309,280
2005	339,897
2006	251,147
2007	180,996
2008	129,199
2009 and thereafter	225,145
	$1,435,664

For ProLogis directly owned properties, the largest customer and the 25 largest customers accounted for 1.27% and 15.75%, respectively, of ProLogis annualized collected base rents at March 31, 2004.

3. Unconsolidated Investees:

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Summary of Investments and Income

Since 1997, ProLogis has invested in various entities in which its ownership interest is less than 100% and in which it does not have control as defined under GAAP. Accordingly, these investments are presented under the equity method in ProLogis Consolidated Condensed Financial Statements. Generally, these entities are not variable interest entities as defined in FIN 46R (see Note 1). Certain of these investments were originally structured such that ProLogis ownership interest would allow ProLogis to continue to comply with the requirements of the Code to qualify as a REIT. However, with respect to ProLogis investments in property funds, having an ownership interest of 50% or less is part of ProLogis business strategy. This business strategy allows ProLogis to realize, for financial reporting purposes, a portion of the profits from its development activities, raise private equity capital or issue private debt instruments, generate fee income, provide liquidity to fund its future development activities, while still allowing ProLogis to maintain a long-term ownership interest in its developed properties.

ProLogis investments in entities that were accounted for under the equity method are summarized by type of investee as follows as of the dates indicated (in thousands of U.S. dollars):

	March 31, 2004	**December 31, 2003**
Property funds	$560,409	$548,243
CDFS business investees	11,881	12,734
Other investees(1)	5,321	116,316
Totals	$577,611	$677,293

(1) As of January 1, 2004, ProLogis began presenting its investments in TCL Holding and CSI/Frigo LLC on a consolidated basis due to the adoption of FIN 46R. See Note 1.

ProLogis recognizes income or losses from its investments in its unconsolidated investees consisting of its proportionate shares of the net earnings or losses of these investees recognized under the equity method and interest income on advances made to these investees, if any. Further, ProLogis earns fees for providing services to the property funds. The amounts recognized by ProLogis from its investments in unconsolidated investees are summarized as follows for the periods indicated (in thousands of U.S. dollars):

	Three Months Ended March 31,	
	2004	**2003**
Equity in earnings (including interest income):		
Property funds	$ 9,537	$ 457
CDFS business investees		300
Other investees	300	2,370

Totals	$ 9,837	$3,127
Fees earned:		
Property funds	$11,267	$9,739

Property Funds

Since 1999, ProLogis has formed eight property funds. ProLogis ownership interests in these property funds range from 14% to 50%. The property funds own operating properties that have generally been contributed to the property funds by ProLogis. In most cases, ProLogis receives ownership interests in the property funds as part of the proceeds received from these contributions. ProLogis recognizes its proportionate share of the net earnings or losses of each property fund under the equity method. ProLogis earns fees for acting as the manager of each of the property funds and may earn additional fees by providing other services to certain of the property funds including, but not limited to, development and leasing activities performed on their behalf.

ProLogis investments in the eight property funds, presented under the equity method, were as follows as of the dates indicated (in thousands of U.S. dollars):

	March 31, 2004	December 31, 2003
ProLogis California(1)	$120,069	$117,529
ProLogis North American Properties Fund I(2)	38,125	38,342
ProLogis North American Properties Fund II(3)	5,796	5,853
ProLogis North American Properties Fund III(4)	5,211	5,506
ProLogis North American Properties Fund IV(5)	3,400	3,425
ProLogis North American Properties Fund V(6)	62,030	56,965
ProLogis European Properties Fund(7)	277,769	267,757
ProLogis Japan Properties Fund(8)	48,009	52,866
Totals	$560,409	$548,243

ProLogis investments in the property funds at March 31, 2004 consisted of the following components (in millions of U.S. dollars):

	ProLogis California(1)	ProLogis North American Properties Fund I(2)	ProLogis North American Properties Fund II(3)	ProLogis North American Properties Fund III(4)	ProLogis North American Properties Fund IV(5)	ProLogis North American Properties Fund V(6)	ProLogis European Properties Fund(7)	ProLogis Japan Properties Fund(8)
Equity interest	$ 194.7	$ 54.3	$ 14.4	$ 12.1	$ 8.4	$62.3	$303.3	$ 23.5
Distributions	(93.9)	(19.8)	(5.3)	(3.6)	(2.9)	(9.3)	(56.0)	(0.2)
ProLogis share of the net earnings of the property fund, excluding fees earned by ProLogis	45.6	9.3	2.2	1.3	1.5	6.9	20.7	2.3