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Research Update:

Prologis European Properties Fund II Upgraded To 'A-' On Acquisition Of Assets From PTELF

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Overview

- Luxembourg-registered logistics property fund Prologis European Properties Fund II FCP-FIS (PEPF II) has announced that it has agreed to acquire the portfolio of assets owned by Prologis Targeted Europe Logistic Fund FCP-FIS (PTELF) and change its name to Prologis European Logistics Fund FCP-FIS (PELF).
- The transaction will strengthen PEPF II's leadership position in the logistics real estate sector in Europe--the combined entity will reach a gross asset value of €8.2 billion.
- We anticipate that the combined entity's credit quality will improve as a result of a more robust asset base and stronger credit ratios. Consequently, we are raising our long-term ratings on PEPF II to 'A-' from 'BBB+'.
- The stable outlook reflects our view that the combined pan-European portfolio of logistics assets should continue to generate stable recurring income under supportive market conditions and allow the company to maintain EBITDA interest coverage well above 4.5x and a debt-to-debt-plus-equity ratio around 30%.

Rating Action

On Oct. 17, 2017, S&P Global Ratings raised its long-term corporate credit rating on Luxembourg-registered logistics property fund Prologis European Properties Fund II FCP-FIS (PEPF II) to 'A-' from 'BBB+'. The outlook is stable.

At the same time, we raised our issue rating on PEPF II's senior unsecured debt to 'A-' from 'BBB+'.

Rationale

The upgrade reflects our view that the announced transfer of Prologis Targeted Europe Logistic Fund's (PTELF's) logistics assets to PEPF II's portfolio will improve our assessment of the combined entity's overall credit quality. The combined group will benefit from increased scale and scope, as well as a stronger balance sheet.

The transaction will combine two of Prologis Inc.'s (A-/Stable/--) core pan-European logistics funds. We understand that the combined entity will change its name to Prologis European Logistics Fund FCP-FIS (PELF), in which Prologis, as the largest unit holder, will have a pro forma stake of 24.1%.

Following the transfer of assets, the combined entity would become the largest logistics fund in Europe, about three times the size of its closest competitor, Goodman European Partnership (GEP; BBB+/Stable).

We take a positive view of the over €8.2 billion combined portfolio--as of June 2017, PEPF II's portfolio was €5.1 billion and PTELF's €3.1 billion. The combined portfolio will comprise prime, recently built logistics properties with an average building age of 10.5 years that are well-located across robust markets such as Germany, the U.K., and France. Both existing portfolios include core, complementary, and well-performing assets with an average occupancy rate of 96.2%.

We expect the transaction to enhance the combined entity's presence in the markets where the two funds currently operate. The level of demand in these markets remains good, supported by the rise of e-commerce, consumer demand for rapid delivery of goods, and the ongoing reconfiguration of global supply chains (see "Large Logistics REITs In Europe Are Comfortably Investment Grade," published on Feb. 16, 2017). The fund will be present in 12 countries (44 markets). Although it will be exposed to some Eastern European countries, these would represent a small proportion of the company's total net operating income of the company (Poland 10.6%, Czech Republic 5.1%). The transaction will therefore enhance the company's competitive position and increase its market diversification.

The transfer will also further improve risk diversification across assets (462 assets and 9.8 million square meters) and tenants. Before the transaction, the top 20 tenants represent 37.3% of PEPF II's revenue; after the transaction, we estimate that this will fall to 32.8% of the pro forma revenue. We also consider that the good average lease duration (weighted-average lease term of 4.4 years) and high tenant retention (79% for PEPF II for 2016) highlights the fund's solid competitive advantage in a market where the supply of new, modern warehouses remains low.

Although the portfolio mainly comprises prime quality logistics properties, whose rents and valuations are generally more resilient than older or less-specialized properties in the industrial and logistics segments, the combined entity will only have exposure to the logistics property segment, which suffered from a sharp fall in values in 2009-2010. The sector has benefited from material yield compression in the last few years, but we still consider it more volatile than other real estate sectors, such as residential.

We also take a positive view on the lack of exposure to speculative development risk. Like PEPF II, the combined entity will have access to Prologis' development pipeline in Europe. We understand that it has no legal obligation to buy the mentioned assets and we gain comfort from the robust governance that the company has put in place to ensure that the interests of every unitholder are well represented. It has an advisory council comprising eight investors (the four largest, three rotating members, and Prologis) to support this aim. In addition, Prologis will not be able to vote in any related-party transaction. We see limited integration risk, as both management

teams will remain in place and there is no cannibalization anticipated between the two portfolios.

Our assessment of the combined entity's financial risk profile is underpinned by its new financial policy and commitment to maintain a loan-to-value (LTV) ratio of 30%-35%. In our view, this represents a step change from the current commitment of less than 40% and is key to our raising the rating. PTELF currently has lower leverage than PEPF II--its LTV ratio is 19.8%--and the combined entity will benefit from this. Pro forma for the transaction, we anticipate an S&P Global Ratings ratio of debt-to-debt-plus-equity of about 30%, versus 35.3% for PEPF II on a stand-alone basis, as of December 2016. This leverage ratio is relatively low, compared with our rated universe of commercial real properties in Europe.

The combined fund will also benefit from low weighted-average interest rates at 2.8% and a staggered debt maturity profile. In addition, the fund will be open for new equity quarterly, enhancing liquidity (there is already a committed equity queue of approximately €550 million at the end of the third quarter of 2017). As a result, we have improved our overall assessment of the financial risk profile to modest from intermediate.

We also see limited subordination risk on PEPF II's unsecured debt with regard to the secured debt issued by the combined entity. Pro forma for the transfer, the total pool of unencumbered assets will be around €6.5 billion and these unencumbered assets will generate around 80% of the total pro forma net operating income. We therefore continue to align our issue rating on the unsecured bonds with the corporate credit rating on PEPF II.

Our base case assumes:

- Eurozone GDP growth around 2.2% for 2017 and 1.8% for 2018.
- Rental income like-for-like growth around 1%-2% in 2017 and 2018, underpinned by our projection of a broadly stable occupancy rate around 96% and modest rent increases. This is supported by the growth of the European economy and the expanding e-commerce industry, which also supports an increase in demand for modern logistics real estate.
- An EBITDA margin of about 86%-87% over the next two years.
- A positive like-for-like portfolio growth of 2.0%-2.5% in 2017 and again in 2018, as we believe there is still some room for additional cap rate declines, particularly in central eastern and southern Europe.

Based on these assumptions, we arrive at the following credit measures on a pro forma basis:

- S&P Global Ratings-adjusted EBITDA interest coverage well above 4.5x in 2017 and 2018
- A debt-to-debt-plus-equity ratio around 30% over the next two years.

Liquidity

We do not expect any liquidity issues as a result of the transaction and we note that the liquidity of the combined entity will benefit from backup facilities of about €520 million plus a €180 million accordion option, which

will increase current credit lines by €200 million as part of the transaction.

Outlook

The stable outlook reflects our view that after the transfer of assets, PELF will generate stable cash flows and maintain its pro forma credit metrics, with an adjusted debt-to-debt-plus-equity ratio around 30%. The outlook also reflects our assumption that the governance and financial policy of PELF's largest shareholder--U.S.-based global owner, developer, and manager of industrial properties Prologis--will remain constant. We assume that PELF will maintain high occupancy rates and long-term leases to generate steady operating cash flows over the medium term. We also anticipate that the company will maintain an average debt duration over three years and an EBITDA interest coverage well above 4.5x over the next 24 months.

Upside scenario

Rating upside is unlikely at this stage, but an upgrade would hinge on PELF's ability to reduce its debt-to-debt-plus equity ratio below 25% while maintaining EBITDA interest coverage well above 4.5x. PELF's commitment to ensure a disciplined financial policy consistent with these levels would also be needed for a positive rating action, which we do not foresee at present.

Downside scenario

We might lower the rating if we saw evidence of deterioration in PELF's rental activities, which in turn, would result in EBITDA interest coverage below 4.5x. We would also view negatively debt-to-debt-plus-equity exceeding 35% because of a deterioration in the portfolio value, similar to the one experienced in 2009 and 2010.

Other Credit Considerations

We consider PELF to be favorably positioned compared with logistical peers in Europe and certain regions. Peers include GEP and Goodman Australian Industrial Fund. The company's credit ratios are also stronger than most of its peers, particularly given its commitment to maintain an LTV ratio of 30%-35%.

Therefore, we modify the anchor upward by one notch to reflect our positive comparable ratings assessment.

Pro forma for the transaction, PELF will be rated at the same level than its parent company Prologis. Although the combined fund will still be considerably smaller than Prologis, we consider that it will benefit from stronger credit ratios and also be exempt from any development risk.

Ratings Score Snapshot

Corporate Credit Rating: A-/Stable/A-2

Business risk: Satisfactory

- Country risk: Low
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: bbb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Real Estate Industry, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded; Ratings Affirmed

	To	From
Prologis European Properties Fund II FCP-FIS Corporate Credit Rating	A-/Stable/A-2	BBB+/Stable/A-2

Research Update: Prologis European Properties Fund II Upgraded To 'A-' On Acquisition Of Assets From PTELF

Upgraded

	To	From
Prologis International Funding II S.A. Senior Unsecured	A-	BBB+

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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