

LOCATION, LOCATION, LOCATION IN THE 21ST CENTURY: WHY WALKABILITY HAS BECOME THE KEY DRIVER OF REAL ESTATE PERFORMANCE

1. INTRODUCTION

The speed, volume and flow of information in the 21st century have revolutionized our work, our lifestyles and our relationships to one another. The generation that grew up during the technology explosion in the 1990s and early 2000s, often called Millennials or Generation Y (born roughly between 1981 and 2000), have reached adulthood and are building their careers. The facility and assuredness with which they instinctively approach not just technology, but change and diversity, is generating shockwaves in all industries, and is in particular beginning to have a disruptive impact on our built environment.

Whether real estate investment strategies implemented today can remain successful over the medium and long-term will hinge on the accuracy of our tenant demand forecasts. As Millennials, the oldest of which are today in their mid-thirties, begin not just provoking, but leading change in the economy and in their workplaces, it is imperative that we look more closely at the deeper underlying motivations of this cohort. Real estate outperformers will be those early embracers of the requirements Millennials have on the buildings and neighborhoods they will live, play and work in.

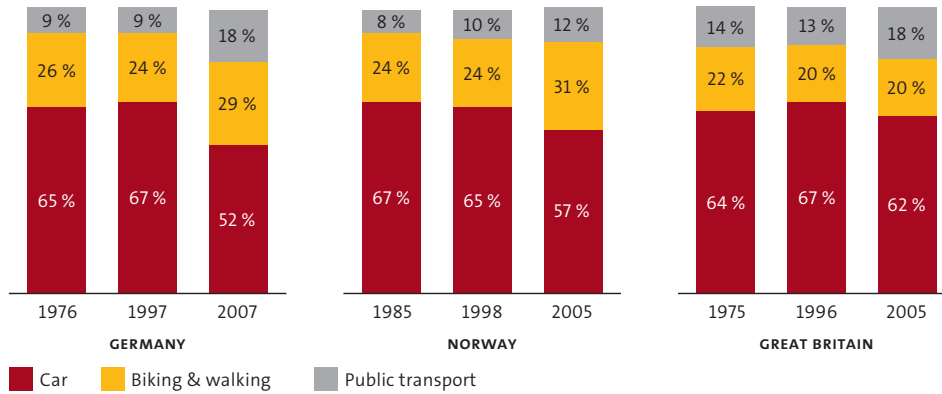
In particular, we look here at the effects of Millennial preferences and the growth of the knowledge society on office markets. Although the phenomena described touch all developed countries, as we will see, we focus here particularly on Europe, a well-established property market where the appreciation of the trends appears to be only just beginning and offers an opportunity to be an early industry mover. The realignment of priorities seen most distinctly in the Millennial generation will cause unavoidable disruption to our industry, including to that element of the built environment that welcomes nearly half of today's employees for the majority of their waking hours and their adult lives. Understanding people's needs today will help us meet and support our tenants' needs and will be crucial to outperformance in the long game.

2. THE MILLENNIAL GENERATION: CHANGING PRIORITIES

Millennials often appear to be a much-maligned generation: the general consensus defines them as self-centered and fun-loving, but commitment-shy technology-natives. Millennials have grown up overwhelmingly in an age of familial economic comfort but personal job uncertainty, political stability yet increasing terrorist attacks, more direct parental involvement but high divorce rates and weaker ties to community and institutions, increasing life expectancy but spiking obesity rates and rising cancer diagnoses. It is a generation that grew up in comfort, but the majority is unlikely to attain their parents' standard of living. The focus on diversity and sustainability launched by their parents following large scale

immigration, social unrest, and high oil prices in the 1960s and 1970s has become second nature to this generation, who tend to prefer variety, internationalism, and a healthy lifestyle including walking and biking.

MODAL SPLIT OF TRIPS TAKEN BY YOUNG ADULTS (20-29 YRS)
SOURCE: INSTITUTE FOR MOBILITY RESEARCH [31]

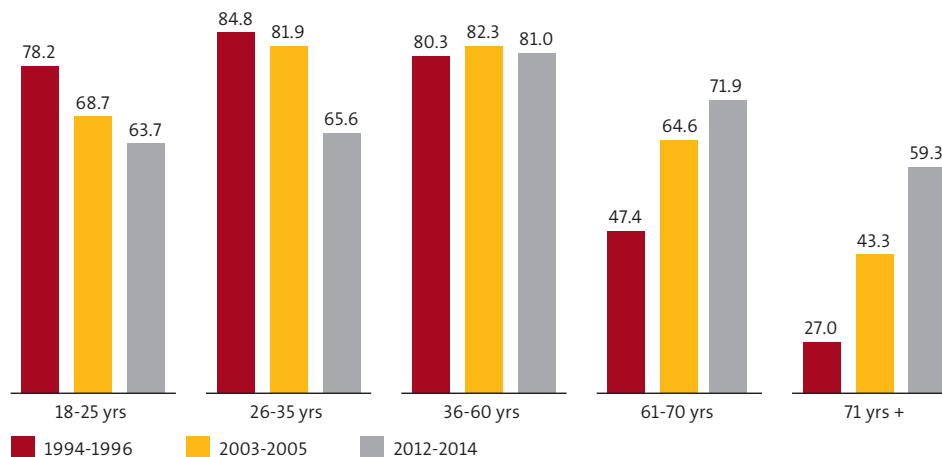


The trend among young adults towards less automobile reliance has been documented across the globe. Between 1976 and 2007, the percentage of trips taken by 20-29 year olds in Germany on foot, bike, or by public transport increased by nearly 40%, reversing a global trend in the late 1990s towards more automobile usage. By the late 2000s, alternative forms of transportation had grown nearly as popular as the car for this age group (48% to 52%). Since the mid-nineties, Germans 18-35 years old have dramatically reduced their regular car usage, with just over one-third not using the car at all in a given week.

**CAR USAGE DROPPING
STEADILY ACROSS
EUROPE AMONG
MILLENNIAL GENERATION**

These preferences for a sustainable lifestyle, diversity and flexibility have led Millennials to re-embrace central, urban locations that offer easy access on foot, bike or by public transport to a myriad of shops, services, restaurants, entertainment venues and workplaces.¹¹² Although often accused of being addicted to their smartphones, they are just as likely to get their social and communicative needs met by being “in the thick of things”, and are re-appropriating their spending to prioritize experiences and relationships, including travel and eating out. In contrast to the suburbanization trends of the 1980s, Millennials, less attached to the car, are finding that walkable urban landscapes can often best satisfy their demands. They are also more likely to view work as an extension of their out-of-work lifestyle, dropping by the gym between meetings or networking over coffee. As this cohort develops into one of our larger consumer and employee pools, those firms that recognize and cater to their preferences will come out stronger

PERCENTAGE OF RESPONDENTS USING AUTOMOBILE DURING WEEK REPORTED BY AGE
SOURCE: GERMAN MOBILITY PANEL, KARLSRUHE INSTITUTE FOR TECHNOLOGY [32]



3. THE DRAW OF WALKABLE LOCATIONS

Well-educated younger employees are being increasingly drawn to metropolitan areas for the job opportunities and quality of life, and are settling down. Jeff Speck, author of *Walkable City*, summarizes, “Surveys show how creative-class citizens, especially Millennials, vastly favor communities with street life, the pedestrian culture that can only come from walkability.”³ Having put off marriage and children longer than previous generations, the older Millennial generation is often reluctant to part with the excitement and variety of the walkable urban lifestyle they grew to love as young singles and have become strong supporters of good quality childcare, schools and family-friendly infrastructure in their urban environments. In a reversal of previous trends out of the city, demographic forecasts from the German Economics Institute in Cologne (IW Köln) forecast that by 2035, one-fifth of the population of large German metropolitan areas such as Munich, Frankfurt and Berlin will be made up of children under the age of 15. In contrast, children under 15 will make up only one-eighth of the population nationwide. This represents an increase in cities of up to 360 percentage points from today.⁴

Talented workers aren’t just looking to live in interesting walkable areas; in fact, surveys show they are even more interested in spending their working days there as well. The highly-educated who have the luxury of choosing their workplaces find themselves gravitating towards firms located in urban submarkets with walkable characteristics. Sub-markets with frequent, reliable and fast public transport links to various parts of the city and vibrant mixed-use neighborhoods offer staff the ability to multi-task busy workdays: drop off dry cleaning on the way to the office, fill a prescription at lunchtime or enjoy a sandwich in the park, attend a fitness class, pick up groceries on the way home, or join colleagues at a bar after work.

Describing the reasons for being located in central Paris, founder of online carpooling portal, BlaBlaCar, Francis Nappéz, explains the benefits for companies when looking to recruit: “We have a heck of time recruiting those who will help us grow, the developers, the young, innovative engineers... this work environment is undoubtedly an advantage. After all, we spend the better part of our days in the office. Why should it be strange that they should like to pick their workplace?”⁵

What makes walkable areas so attractive to people of all ages are the emotions they elicit in us. Architect Jan Gehl reasons that desirable urban locations with high levels of pedestrian footfall give the pedestrian the feeling of security and comfort, and offer interesting scenes for humans: approximately 1.75m tall beings moving at around 5 km/h.⁶ Their building height, facades (both in width and complexity), signage, distance from the street, etc. are designed with the human body and senses in mind.

Examples of the ideal physical structures for a walkable location:

- Facades of 5-6 m in length that are interesting, differentiated, and inviting to passers-by
- Large windows and open restaurants/cafes permitting eye contact between interior and exterior
- Wide sidewalks with places to sit, stand, shop and meet
- Few interruptions in between active facades, such as car parks or office buildings with no ground floor footfall
- If not a pedestrianized zone, protected via physical barriers such as trees or bike lanes from adjacent traffic, which is ideally slow-moving
- Well-timed street level crossings that allow pedestrians to follow the most direct route between major destinations
- Good lighting and minimal dark, non-active areas (tunnels, passageways, deep overhangs)

TALENTED EMPLOYEES
INCREASINGLY PREFER
WALKABLE OFFICE
LOCATIONS

The involuntary reaction of a pedestrian when faced with large towers set across from each other over lonely expanses (a feeling of being small and insignificant) or in locations where drivers are prioritized through overwhelming parking lots, thin sidewalks adjacent to fast-moving traffic, and/or signage designed to be read and processed at 50 km/h (a feeling of boredom or even physical danger) is to avoid the area in question. The feeling of comfort and level of interest offered by animated, human-sized landscapes subconsciously draws more pedestrians.



People attract more people, in the same way that a packed restaurant attracts more diners (and an empty restaurant scares them away). A large flux of pedestrians also has a positive impact on one's safety (both perceived and actual) ⁷⁸ by increasing, as early urbanist, Jane Jacobs, calls them "eyes on the street". To test this, one need only compare how one feels walking through a lively restaurant scene in the evening or a dark and empty street.

GOOD DESIGN CAN
MAKE OR BREAK A
WALKABLE AREA

Above all, cities that offer a good quality of life, including a lively city center, an abundance of parks and inviting open spaces, and a broad cultural offer (ranging anywhere from opera houses to breweries), are preferred by professionals and empty nesters alike. Richard Florida and Andrew Small note, "Now we know that amenities—not just restaurants and bars but the whole package of great museums and libraries—play a key role in drawing the highly-skilled knowledge economy workers back to the city[...]" ⁹ The Bertelsmann Foundation, which provides data and support for German municipal officials and planning teams, adds, "Cultural institutions such as theaters, orchestras, museums, libraries, art societies and cultural centers, but also entertainment and leisure opportunities, function as pulling factors for younger, but also increasingly older, inhabitants when deciding where to reside. They represent a soft locational factor that impacts whether the firm will be successful in recruiting sufficient talent." ¹⁰

4. URBANIZATION AND GROWTH OF THE KNOWLEDGE ECONOMY

Reinforcing the current urbanization boom is a radical split in economic structure that many developed countries are currently undergoing. Where previously the reduction in manufacturing output and growth of the service sector preoccupied economists, a new trend is becoming clear: the growth of the "knowledge society". In all industry sectors,

we are witnessing a growth in the importance of economic added value resulting primarily from human innovation. Bernd Streich, in his book, *City Planning in the Knowledge Society*¹¹, describes it as “a sea change in human occupation towards intellectual, idea-producing activities.”

Back in 2002, Richard Florida identified the main driver of this new economy, cited in his 2011 book, *The Rise of the Creative Class Revisited*, “Beneath the surface, unnoticed by many, an even deeper force was at work – the rise of creativity as a fundamental economic driver, and the rise of a new social class, the Creative Class.”¹² Building economic value in the knowledge society involves harnessing creativity, a unique capacity of the human mind. Creativity occurs when associations between potentially unrelated information, things, or people are drawn, resulting in new ideas. It therefore thrives on information, communication and variety, as the more connections between unrelated elements, the greater the potential for innovation. Streich adds, “The knowledge society can be seen as a sort of ‘knowledge network’, a complex system of individuals, groups and technical ‘intelligence’ in cooperation.”

“BENEATH THE SURFACE, UNNOTICED BY MANY, AN EVEN DEEPER FORCE WAS AT WORK – THE RISE OF CREATIVITY AS A FUNDAMENTAL ECONOMIC DRIVER, AND THE RISE OF A NEW SOCIAL CLASS, THE CREATIVE CLASS.”

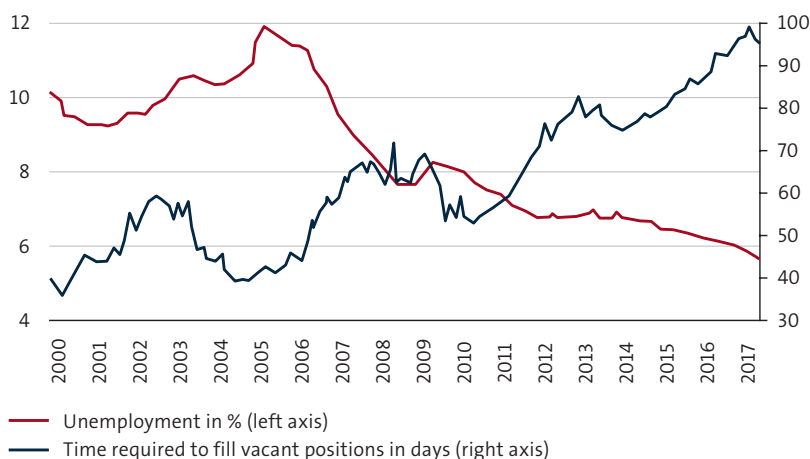
5. THE WAR FOR YOUNG TALENT

To build on this, a firm also needs to be able to attract the workforce capable of sustaining and growing that innovation. Norbert Arnold, from the Konrad Adenauer Foundation, summed up the problem as follows, “The knowledge society thrives on creative and innovative people, who incorporate their expertise and skills into a variety of functions.”¹³

Upon deciding to move their headquarters from a suburban campus to a walkable urban location renamed “Innovation Point”, General Electric’s chairman Jeff Immelt described his motivation, “We want to be at the center of an ecosystem that shares our aspirations.” The architect, Doug Gensler, added, “The migration into a city like Boston is an acknowledgment that you want to be at the epicenter of the innovation economy where talent is coming out of schools, combined with the mature talent that exists in the economy here, and recognition that there’s a global platform that you want to build off of. Being at the center of that energy is really key.”¹⁴

Exacerbating the problem for employers across the globe is the talent shortage appearing as the older generations retire and new skills become critical in an increasingly complex world. Since 2000, unemployment in Germany has dropped by nearly half to 5.7%, with the amount of time companies require in filling a vacancy having tripled since 2000. In certain key regions, unemployment rates have fallen to 2.0% or lower, challenging employers to come up with new ways to attract and keep talented workers.¹⁵

GERMAN EMPLOYMENT CREATING WAR FOR TALENT
SOURCE: GERMAN DEPARTMENT OF LABOR, JUNE 2017



Whilst technology firms have led the charge, in part out of their mission-critical need to attract the best tech-savvy Millennial employees, many knowledge industries are discovering the quantifiable benefits of being part of an industry hub, including decreased travel times to meetings, ease in hiring specialists, and the innovativeness that comes with being “at the heart of things”. Urbanist Leo Hollis concurs, “Cities are the ideal laboratories of innovation: there are more people here, so the likelihood is that more ideas will bubble to the surface. It is not just the size of the population, however, but the density of the connections that matter. [...] Good ideas often do not come from solitary moments of contemplations but from sharing, of rubbing two notions together to produce something new...moments of serendipity that cause a surprise symbiosis [...]”¹⁶

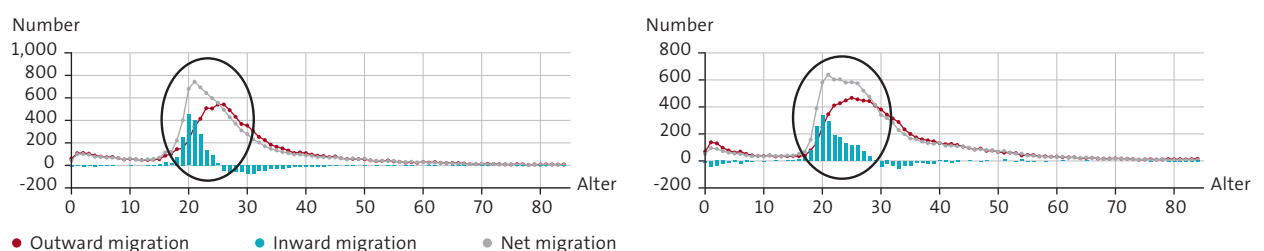
As managers understand more about how human creativity can be supported, industries that recognize the importance of innovation to stay competitive are putting a greater value on the exchange of ideas both inside and outside the firm. For example, Microsoft in Germany has begun successively moving their regional offices to better connected locations, including opening an office on central Berlin axis, Unter den Linden. In addition to workspaces for the firm’s employees, the building includes “The Digital Eatery” on the ground floor: a restaurant and cafe open to the public, a conference and seminar center, and a start-up accelerator. Microsoft’s website emphasizes the role of communication in their decision: “The historic building Unter den Linden 17 offers four stories of networking and dialogue.”¹⁷

Whilst the largest metropolitan areas may appear to have the strongest cultural draw and therefore the easiest path to establishing that virtuous circle of attracting young graduates and therefore firms; the strongest pull for knowledge workers is clearly not just the size, but the quality of life. Next to Frankfurt and Munich, one of the fastest growing cities in Germany today is Leipzig, with forecasted population growth of 13.9% to 2030, as the Eastern German city benefits particularly from having invested heavily since 2000 in improvements to the walkability of the city, leading to continued strong employment growth.¹⁸

Some examples of other regional German centers that have successfully counteracted the strong forces of increased job opportunity in large urban conglomerations include Münster, Regensburg, and Darmstadt. A well-known university can be an excellent catalyst for population and job growth, but as cities such as Giessen have discovered, are not enough on their own to convince graduates to stay put. (See net migration comparison below.) Giessen attracts a large number of residents of university age, but is unfortunately unable to retain them. By age 25, net migration to Giessen turns negative. Regensburg, on the other hand, continues to see net inward migration even among 25-30 year olds who are starting a key career-building phase.

Researcher Harald Simons at the Empirica Institute sums up their appeal: “As long as the city you’re living in is a lively, vibrant, urban city, it’s an acceptable city.”¹⁹ Young graduates are looking for walkable cities with a high quality of life, and are weighing up the attractiveness of job opportunities, cost of living, and expected salaries to determine their next step. Focusing on cities and locations that offer walkability can provide a key USP for both employers and office owners.

DEMOGRAPHIC CHANGE BY AGE GROUP, GIESSEN (LEFT) AND REGENSBURG (RIGHT)
SOURCE: BERTELSMANN STIFTUNG, 2015

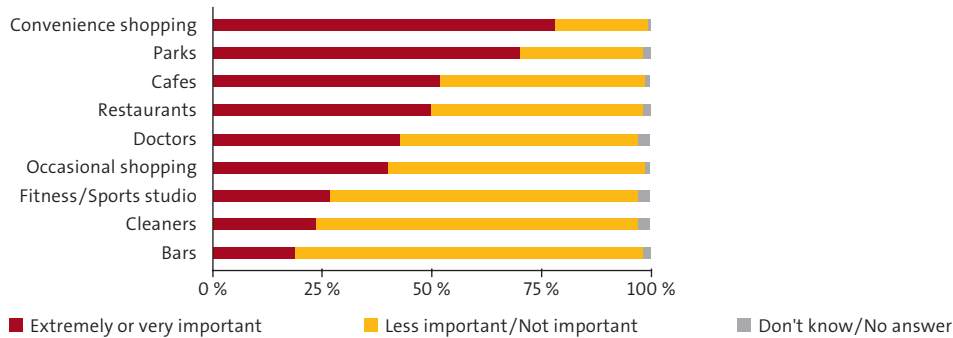


6. THE BENEFITS FOR EMPLOYERS LOCATED IN WALKABLE SUBMARKETS

However, it goes without saying that not every location, even in burgeoning metropolitan areas, will be equally enchanting to firms and their workforces. In a recent German study, over three-quarters of respondents confirmed that when choosing a workplace, they considered it extremely or very important that there be convenience shopping (ie. supermarkets, pharmacies, etc.) within walking distance. Parks came in second with 70% labelling them as extremely or very important.²⁰

GERMAN EMPLOYEES OVERWHELMINGLY FAVOR OFFICES WITH CONVENIENCE SHOPPING WITHIN WALKING DISTANCE

HOW IMPORTANT ARE THE FOLLOWING AMENITIES WITHIN WALKING DISTANCE TO THE OFFICE?
SOURCE: CONSULTING CUM LAUDE/SAVILLS POLL, AUG. 2016 [20]



Companies not well-located can therefore find themselves at a notable disadvantage compared to their competitors. Suburban HR teams we spoke to anonymously as part of this research mentioned not infrequent situations in which potential employees turned down attractive conditions for a comparable position in the city center, citing in particular the loss of time in commuting to and from the office as a weighty factor in their decision.

More highly educated than earlier generations, Millennials are also highly appealing to potential employers. With the continued move towards more focus on the long-term impacts of our lifestyles, more and more professionals are viewing car ownership as no longer a necessary accoutrement, and public transport as an increasingly practical commute (not to mention one in which the all-present smart phone can still be comfortably attended to). As a result, workplaces without good public transport can find it increasingly difficult to recruit and retain staff.

Just as any potential tenant, office tenants searching for new space are faced with numerous opposing constraints. While needing to minimize cost, managers will be looking to find office premises that represent their company values and success and allow for anticipated future growth. Crucial to their search will be the micro-location and ease of access for both current and future employees. Increasingly, we see office occupiers, particularly in high-value-add service sectors, recognizing the importance of proximity to other market players in order to remain competitive in their industries. An earlier trend towards green suburban locations that prioritized intra-firm communication has begun to reverse in most established markets, with suburban office parks frequently demonstrating higher vacancy rates and early functional obsolescence.²¹²²

In an effort to provide a high-end office environment at a reasonable cost, tenants have often looked to out-of-town locations. Long-term, however, many are discovering that the opportunity costs of being further from clients and suppliers, as well as missing out on attracting young talent, are not worth the savings. More recent trends have shown companies moving all or part of their workforces, particularly those market-facing, back into central locations, despite sky-rocketing rents.

A study carried out by Jones Lang LaSalle measured the additional costs to moving from a central to a suburban location, including employee productivity, attraction and retention of talent, company image, and management styles, such as encouraging cooperation. These they compared to rental levels, breaking down the additional, generally unrecognized costs of a particular location to ease comparison. They reach the conclusion that for knowledge workers, particularly those in front office positions whose responsibilities included a large proportion of external meetings, the net value creation from being located in a central location compared to a suburban one amounted to approx. EUR 200 per sqm per year.²³

ADDED VALUE OF A
CENTRAL LOCATION UP TO
EUR 200 PER M² PER YEAR

In 2010, Zurich Insurance moved their head offices from suburban Paris to a much more central location in the 17th district. When asked about the effects of their move on their performance, the Head of HR stated, "Our move to the CBD translated rapidly into increased performance on the part of our employees. The increased accessibility by public transport reduced their commute time. The teams are less tired, more available. [...] Our salespeople's ability to acquire new clients has equally noticeably improved, because they can now meet on average twice as many clients than before."²³

Supported by recent studies regarding the true company costs of suburban locations, decision-makers are beginning to focus their office searches on vibrant, well-connected urban submarkets. As a result, walkable offices boast statistically stronger occupancy rates, higher rental levels, and greater capital growth, a reflection of their lower risk level and long-term stability compared to similar properties. Furthermore, longer-term analysis across the globe shows that these premiums are solidifying and continuing to grow.

7. REAL ESTATE INVESTMENTS IN WALKABLE LOCATIONS OUTPERFORM

A study of the thirty largest metropolitan areas across the United States showed an average rental rate premium for walkable urban offices of 90 % over drivable suburban offices. Between 2010 and 2015, this premium increased on average 28 % in the top 10 metros. The same study found that 81 % of all office absorption between 2010 and 2015 was in walkable urban locations. In all of the thirty cities studied, walkable urban locations were gaining market share compared to the suburbs, with the top 10 most walkable cities achieving a rate of 3.25:1, despite already having dominant walkable office submarkets.²⁴

Ground-floor retail and amenities show similar boosts from walkability. A French study across six cities recorded an 87 % higher weekly retail spend brought by pedestrian customers compared to car drivers.²⁵ Other studies in Australia or the Netherlands have demonstrated comparable results for customers on two wheels or on foot.²⁶

PER WEEK, PEDESTRIANS
AND CYCLISTS SPEND
MORE THAN CUSTOMERS
ARRIVING BY CAR

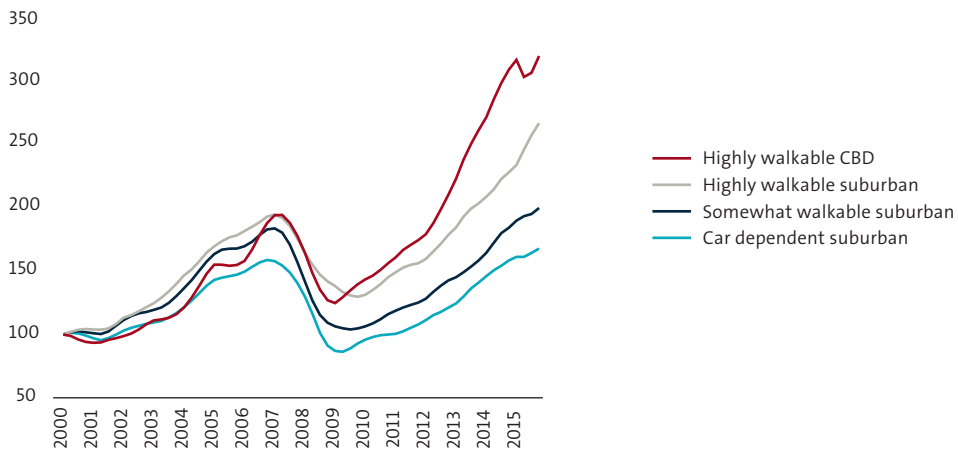
An evaluation of street-level improvements to pedestrian safety, including pedestrian lights, traffic calming, expanded bike lanes and widened sidewalks by the New York City Department of Transportation found that commercial vacancies in the areas studied drop-

ped by just under 50 % (compared to 2-5 % overall) and local retail sales increased by between 14 and 172 % (or between 3 and 16 times higher than the borough as a whole over the same time period).²⁷

Assets that cater to tenant demand by offering vibrant, walkable locations with multiple transportation modes are destined to best the competition going forward and therefore demand higher rental levels and see lower vacancy rates. As investors recognize the long-term potential and lower risk stability of walkable assets, owners can also look forward to higher capital growth.

In an in-depth evaluation of all commercial property transactions that took place in the United States between 2000 and 2016, Real Capital Analytics identified a capital value increase in highly walkable locations double that of car-dependent assets. During the crisis in 2008-2012, walkable locations fell less far and recovered their peak values 2½ years sooner than car-dependent properties. In Germany, we see these trends just beginning to take off, in parallel with the increased appreciation of decision-makers of the importance of prioritizing the impact of a walkable headquarters location on talent draw and innovativeness.

CAPITAL GROWTH IN U.S. COMMERCIAL PROPERTY BY WALKABILITY (2000=100)
 SOURCE: RCA & WALK SCORE® CPPI, TO Q3 2016, RETRIEVED FEB. 2017. ALL RIGHTS RESERVED.



8. HOW TO IDENTIFY AND INVEST IN GOOD WALKABLE LOCATIONS

Walkable locations can, but need not be, in traditional CBD areas or existing office clusters. What the research is showing us is that an office cluster or public transportation connections are simply not enough in and of themselves to provide above-average returns in today's market. Here are some examples for forward-thinking investors of walkable locations with future potential:

- Cities with growing populations in the 25-35 year age bracket. The ability to attract young graduates and professionals is a strong sign of a vibrant, well-rounded city. Regional cities can pull above their weight and offer excellent distribution yields, but investors should remain cautious of potential liquidity issues and anything outside of the center. (Example: Leipzig)
- Submarkets in international cities located centrally with excellent public transport but not considered traditional office markets. (Examples: London Victoria, Munich Ostbahnhof/Werksviertel)
- Central, high-end or trendy residential locations of major cities with sufficient retail and restaurant provision (Example: Munich Glockenbachviertel)
- Selected opportunities in well-established office submarkets that suffer from weak walkability in which improvements to the ground floor, landscaping, or programming to increase footfall are feasible (Example: Frankfurt Taunusanlage)

An introductory way of measuring walkability is the internet algorithm developed by Seattle-based WalkScore™ to determine the depth and diversity of amenities, parks, services and public transport connections at a given address. WalkScore™ allows for a quick desktop analysis of walkability on a 0-100 basis, with 0 representing a location that is car-dependent and 100 an ideally walkable location with an appealing, animated fusion of shops, services and amenities.

At the end of the day, however, nothing can replace in-depth knowledge of the markets and industry. When looking at a new development, how do you determine whether tenants will prefer this location to another going forward, or whether you will be engaging in expensive re-letting and refitting on a perpetual basis?

In today's low interest environment, meeting long-term return targets can be increasingly challenging. Accurately identifying and managing locations that fit the current and future needs of the user is crucial to achieving strong performance. This requires foresight grounded in a deep cultural understanding and on-the-ground presence. Walkable offices embrace deep-seated societal trends and have been shown to result in higher rental levels, higher occupancy rates, and greater long-term risk-adjusted capital performance. As the knowledge economy develops and the Millennial generation matures, the most sought after locations will increasingly be walkable neighborhoods that are overwhelmingly dense, vibrant, and well-connected, offering tenants easy access and a diversity of services. Buying, renovating, or developing in walkable submarkets can provide professional real estate investors with significant above-average returns that are capable of withstanding economic crises and market downturns.

For more information, or to learn more about KGAL's dedicated separate accounts and commingled funds for institutional investors grounded in 50 years of industry experience in the German and European markets, we invite you to visit our site at www.kgal-group.com

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