

The green transition takes hold of Germany's property market

More than 60% of the current German housing stock will need to be renovated over the next ten years to meet climate targets set by the European Commission. The transition will come with soaring costs and increasing house price divergence, with energy efficiency expected to rise rapidly to the top of the list of priorities for buyers



Renovation of an old home with energy efficient insulation and windows

In search of a new equilibrium

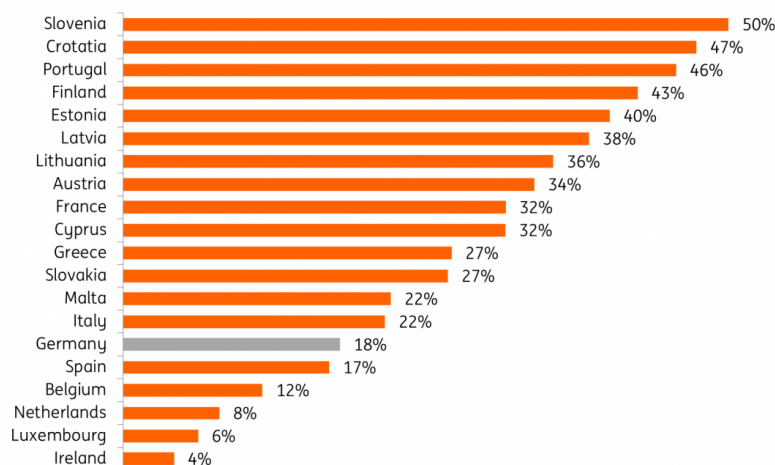
The German real estate market has entered the expected phase of correction on the back of higher interest rates and weakening real disposable income. In the first quarter, real estate prices were down by some 7% year-on-year. This is not a crash but a correction. At the same time, it will take while before the market is able to reach a new equilibrium. We currently see it reaching a bottom in the second half of the year, followed by a muted recovery in 2024. Financing costs and household income remain the most important drivers of the German real estate market, but factors like location and greenification will add to increased divergence.

The real estate sector plays an important role in the country's efforts to reach climate targets. In

2019, space heating in the private household sector accounted for 17.5% of total energy consumption and is also the source of around two-thirds of final energy consumption in households. Energy is also used for space cooling, heating water, lighting, electrical appliances and cooking.

Less than 20% of household energy consumption in Germany is currently covered by renewable energy.

Share of renewable energy sources and heat pumps in total household energy consumption (2021)



Source: Eurostat; ING

It doesn't come as a surprise that the government is now trying to step up to the plate. The highly debated German Building Energy Act (GEG) has determined that from 1 January 2024, all new buildings must be heated by at least 65% with renewable energy. For existing buildings, a 'decision period' is granted until 2028. From 2045 onwards, no more fossil fuels are to be used for heating.

However, even the greenest heating system is of little use if energy consumption is still high and energy efficiency remains low thanks to poor insulation. As a result, the EU Commission is aiming for all residential properties in the EU to at least carry an energy label of D by 2033.

12.5 million chances to go green

Looking at the age of the German housing stock shows that there is a serious need for substantial renovation. The older a residential property is, the more likely it is that fossil fuels are still being used for heating. In buildings completed before 1979, just one in 100 homes are heated with geothermal and other environmental or exhaust air heat systems. By contrast, in homes built after 2011, these are seen in almost every fourth building. In addition, older homes are generally poorly insulated or glazed so energy consumption remains high, and the energy efficiency class is often poor. Unfortunately, only 3% of the current housing stock was completed after 2011.

A survey by the estate agent McMakler in 2021 showed that just 10% of properties built before 1979 are classified in energy classes A, A+ or B. In residential properties built from 2010 onwards, the share is more than 70%. It therefore doesn't come as a surprise that the majority of German

residential properties have an energy label of E or worse.

Percentage distribution of efficiency classes by energy demand of the German residential property stock (%)



Source: BMWK; dena; ING

Plans laid out by the European Commission call for homes to achieve at least an energy efficiency class D by 2033 on a scale that will be standardised at the EU level, ranging from A to G. Based on the current German scale (which ranges from A+ to H), this means that 11 million single and two-family houses as well as 1.5 million multi-family houses – i.e., 64% of the entire German housing stock – will have to be renovated within the next 10 years.

Green comes at a cost

Renovation activity has been limited so far. Renovations that resulted in energy savings of more than 60% were only conducted on an average of 0.1% of the German housing stock each year between 2012 and 2016. In the EU, the rate was 0.2%. For Germany to reach the EU's energy label target by 2033, the pace of green renovation would have to increase 65-fold.

The cost of realising the European Commission's targets by 2033 could range from anywhere between 740 billion and 1 trillion euro

It is not only about pace but also about funding. Referring to a rule of thumb among experts, housing refurbishments could cost between 400 and 600 euro per square metre. Full modernisation of a flat would roughly cost 505 euro per square metre. Consequently, the cost of realising the European Commission's target of renovating the German housing stock to energy efficiency class D by 2033 could range from anywhere between 740 billion and 1 trillion euro.

Renovation can be quite economical and usually amortises after 11 to 17 years for house owners, or after about 14 years for flat owners. For most homeowners, however, it will initially mean that new financing will have to be taken out in order to be able to afford the financial challenges of the green transition. In Germany, more than half of all homeowners still have an outstanding loan,

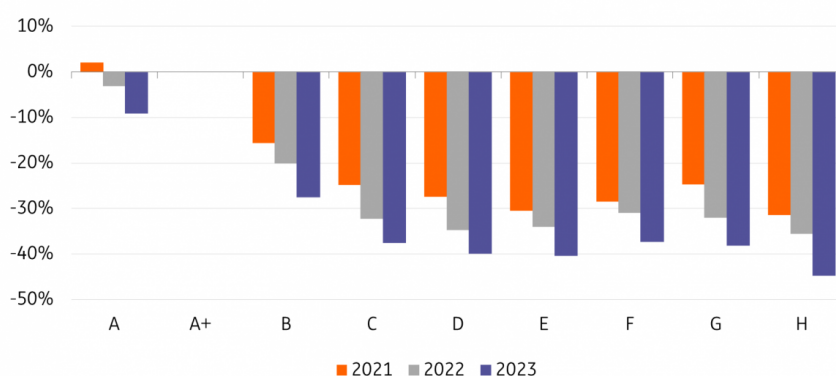
which may make it difficult to borrow more – especially in view of the current high financing costs and strict lending conditions.

Green is the new location

The impact of climate change combined with policy uncertainty is already very much visible in the German real estate market. An analysis of anonymised ING data confirms that the green transition in the housing market has already been a decisive factor for price development in recent years. There is a strong price differential between energy efficient residential properties and their non-renovated counterparts, which has increased significantly between 2021 and 2023.

Enormous efficiency premiums are already being paid and renovation discounts are being demanded. This year, the price of a home with an energy label H was on average 45% lower than that of a residential property with an A+ energy label. Last year, the difference was 36%. Even those with an energy label B are worth 28% less this year, after a 20% discount in 2022.

Renovation discount from energy efficiency class A+ per energy efficiency class



Source: ING

Sellers will now have to accept renovation discounts to compensate for the costs occurring after purchases

As regulation progresses, the demand for new buildings is likely to see a continued increase, which will lead to elevated prices given the scarce supply and simultaneously high construction costs. Prices for energy efficient new buildings are therefore likely to continue rising over the coming years, while we expect more significant price drops for non-renovated existing buildings. Sellers will now have to accept renovation discounts to compensate for the costs occurring after purchases. As a result, the negative price development for existing properties could be even stronger than the current market environment around high financing costs and real wage losses alone would suggest.

In the past, the rule of thumb when buying a property was based on three criteria: location,

location, location. With the green transition, it seems three more are quickly rising to the top of the list: energy efficiency, energy efficiency, energy efficiency.

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