How to finance your ADU

When a homeowner plans to finance the construction of an accessory dwelling unit (ADU), their options are typically based on their home equity, income, savings and creditworthiness. Wealthier homeowners have frequently used personal savings for ADU construction, but most homeowners cannot pay for a $125,000-$200,000 project on their own. While low and moderate income homeowners can qualify for traditional mortgage products, there is often a gap between ADU construction costs and their borrowing capacity. Other sources of financing, including some emerging, innovative approaches, could help to bridge this gap in the near future.

Traditional mortgage products

Home Equity Line of Credit (HELOC) is a revolving line of credit based on the equity an owner has in the home. The borrower is approved by the lender up to a limit and can then borrow money from the line of credit to pay for expenses as needed. HELOCs are sometimes offered without fees for closing costs, making them an attractive option. The interest rate will likely be higher and variable, compared to a traditional first mortgage. The terms are often 10 years. The HELOC can be refinanced after construction is complete to combine with the primary mortgage. Lenders will typically lend up to a maximum of 80% of the current value but some may go to 85%.

Second Mortgage or Fixed Home Equity Loan is a loan for a fixed amount of money that the borrower receives to pay for a project, when an owner has enough equity in the house to borrow against. Second mortgages are likely to have a shorter term than a typical 30-year first mortgage, but could be longer than 10 years. A second mortgage or home equity loan will have a higher interest rate than the interest rate on a first mortgage. This kind of loan would incur typical closing costs and fees such as appraisal, lender fees, credit report, title, etc.

Cash-out Refinance replaces the first mortgage with a new first mortgage, but also extracts some of the equity the owner has in the home as cash that can be used to pay for construction. The terms can be 30 years or shorter, and the interest rate can be fixed or variable. This transaction will incur all the fees and costs associated with refinancing a mortgage. This approach has the benefit of receiving the best interest rates and the option of a 30-year term.

Construction or Renovation Loans offer a loan based on the assessed value of the home once improvements (like an ADU) are completed. This is a good option for homeowners who have less than 20% equity in their home, and have a financing gap to cover construction expenses. By using the future appraised value of the property once the ADU is completed, the owner might have enough anticipated equity to qualify for the loan. Some construction loan rates are only marginally higher than traditional refinance rates (e.g. only by 0.125%). Banks often offer a construction/renovation loan with conversion to a permanent 30-year fixed rate mortgage loan after the ADU project is completed, all for one set of closing costs. Construction is defined as a ground-up project while renovation is considered renovation of an existing structure like creating a basement or garage apartment.

In construction and renovation loans, the bank plays a larger role. The bank approves the General Contractor selected by the homeowner. It also releases funds in a series of draws as construction progresses, which might involve an inspector verifying the progress. While these inspections involve fees, this approach not only protects the bank, it also protects a homeowner who might be less familiar with how to provide oversight to a major home construction project like this.

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Other sources of financing

Friends and family loans are also frequently used to help finance an ADU, but depend on having family or friends with substantial wealth that they can loan for a period.

Unsecured credit like a credit card or a personal loan will offer lower amounts of money for much higher rates. Using this kind of credit may be a way to pay for initial funds for soft costs like architectural drawings. Soft costs can be added to a line item in a budget and reimbursed with a draw from a construction loan during the building process. Given the high interest rates associated with these loans, they should either be avoided or only be considered as short-term measures when other financing is unavailable.

Retirement account loan: Retirement accounts may allow an owner to borrow funds for home improvements. Borrowing from a retirement account should be considered a last resort. However, an investment in an ADU that increases your income might be justified. The most you can borrow from certain accounts is 50% of the total value.

Housing Choice Voucher Program rental income: A Housing Choice Voucher Program (HCVP) guarantees a market-rate rent that can provide a reliable income stream for the owner. The program pays the difference between what a low income renter can afford and the cost of market rent. Financing programs in other parts of the country are using the reliability of HCVP payments to reduce the risk for a loan to build an ADU. Depending on the neighborhood, the HCVP rent might be on the high end of the local market rate. To assess what rent your potential ADU would qualify for, see D.C. rents by neighborhood here.

Eligibility for conventional bank loans and lines of credit

Here are some of the criteria banks consider to assess the ability of the borrower to pay back a loan.

Credit history: often a good credit score (middle of three) is considered “good” at 680, and “very good” at 740 and above. Some loan programs allow borrowers to have a score from 660 to 620.

Debt to income ratio: typically 43-45%. This is the total amount of monthly debt payments divided by the borrower’s monthly income.

Maximum loan to value (LTV): Typically, a 75-80% loan to the existing or future appraised value of the property is the threshold for a construction or renovation loan. In other words, the owner has 20% equity in the property.

Appraisals are required to borrow against the equity of the property to pay for the mortgage and/or construction costs of the ADU. These appraisals are based on the property’s current value. For construction or renovation loans, the appraiser will also assess the future value of the property after the improvement based on architectural plans. Such valuations can be a challenge if sales data for comparable homes with accessory units are uncommon in a given neighborhood or submarket.

Rental income is currently not considered part of the borrower’s income in the case of proposing to build a new accessory rental unit. However, if a borrower can prove that they have a history of rental income from the property or a signed lease, then this income can count towards the owner’s income. The rare circumstance for this occurring is probably with the legalization of an existing rental apartment.

Further reading

Santa Cruz County Accessory Dwelling Unit Cost and Financing Guide, September 2018
Lay Explanation of Conventional ADU Financing Options, By Kol Peterson, June 27, 2015, Accessorydwellings.org
ADU Financing by HR&A at DC ADU Conference, October 2017