Portland had lead the way in the Accessory Dwelling Unit (ADU) movement. A potent combination of ADU-friendly regulations and financial incentives have a lot of Portland homeowners (and aspiring homeowners) considering building an ADU.

ADU owners see benefits for themselves—an ADU can generally pay for itself in rents received (short term, long term or a combination). ADU owners see benefits for their families— an ADU can provide multi-generational housing or offer a space to downsize into upon retirement. ADU owners even provide benefits to the community—each ADU adds one more housing unit to our tight housing supply.

So what's the catch?

As is so often the case in life, the catch is money.

The good news is there are a lot of ways to find the funding needed to build an ADU. They fall into three broad categories (and many ADU projects are funded with a combination):

1. Outside funds
2. Equity you already have
3. Equity you create

Outside funds

By outside funds, I mean any money you have that is not coming from equity in real estate you own. Sometimes these sources are the long-term answer. Other times, you may want to use them temporarily and replace them with financing later. Here are some examples.

Cash on hand

If you've got adequate savings to fund your ADU, lucky you! (And nice job saving!) Although most of us aren't so lucky, a lot of ADU projects get started by paying cash for the design and permits and maybe even some initial site work. Anything you can pay for from savings reduces what you'll need to finance later.

Retirement account loans or withdrawals

Check and see if your retirement account has a loan provision. Most plans allow you to borrow 50% of your vested balance, up to $50,000.. Loans from retirement plans are cheap, quick to set up and not taxable. You'll pay yourself back through payroll deductions, but generally have the option to pay the full remaining balance in a lump-sum too. But beware, if you change employers and can't pay the loan back, it may be treated as a taxable distribution.

And of course another option is to take a distribution. This might be a better idea if you are old enough to take distributions without penalty (and can be a great way to set yourself up with affordable housing for retirement, literally in your own backyard) (or maybe your kids' backyard). Just don't forget to budget for any taxes you'll owe.

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Private financing or gifts

If family or friends are willing and able, you may be able to finance your ADU with gifted or borrowed funds. If the help you can get from family is a short-term loan, make sure you do have a solid game plan for repaying their generosity. Read on, do your homework and get prequalified for one of the options below.

Credit cards and personal loans

Many an ADU is finished up and/or furnished with credit cards or personal lines of credit. But I've seen more than one ADU financed entirely on credit cards. If your plan is to use credit cards as a stop gap that you'll refinance, beware. Rapidly running up credit card balances can have a significant negative impact on your credit scores. As your credit scores fall, credit card companies often raise the rates on the amount you owe them and your lower credit scores can make refinancing the debt more expensive or impossible.

Equity you already have

If you have owned your home a long time or you made a large down payment when you bought it, you may have enough equity to build your ADU sitting there already. You just need to figure out the best way to liberate it.

Home equity line or loan

A home equity line of credit (HELOC) or home equity loan (HELoan) may be just the ticket. HELOCs and HELoans are "second" mortgage programs. This means you keep whatever loan you already have and borrow additional funds in a separate loan, with its own terms and payment. If you've got a really low rate on your existing mortgage, you get to keep it.

In general, a HELOC is quick and cheap to set up. Closing costs may run no more than $1000 (and are often zero). You can typically borrow up to 90% of your current property value. To estimate what you can borrow, multiply your current property value by 0.9 and subtract the balance of your current loan. Note that the banks and credit unions that offer these loans tend to be a little conservative with their estimates of property value, so don't be surprised if you find you can't borrow quite as much as you'd hoped.

One cool feature of a HELOC is that it is, well, a line of credit. You pay no interest on a HELOC until you draw funds from it. As you build your ADU, you only pay interest on the amount you've actually spent.

Often (but not always) the minimum monthly payment required for an initial period of time (typically 10 years) is interest-only, making the monthly payment fairly low… for starters.

There are a few drawbacks to keep in mind. HELOCs are always a variable interest rate based on the Prime rate, commonly Prime + 1%. The Prime rate is 4.75% (as of March 22, 2018). Most credit lines have an interest rate cap, but it's usually quite high (18% is common). Borrowing a six-figure sum at 5.75%, knowing the rate is likely to climb…and could wind up in the teens…might sound less appealing. And when that interest-only period runs out, you are required to pay the loan back, either all at once in a "balloon" payment, or over a specified period of time.

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A HELoan, is a fixed rate second mortgage. So, no variable rate, change to your payment or balloon payment to worry about. HELoan rates tend to be higher than first mortgage rates and loan terms are often fairly short 5, 10 and 15 year terms are most common. The combination of a higher interest rate and shorter loan term, can make for a pretty high monthly payment.

Worth noting, a lot of HELOCs are somewhat of a hybrid. They start out as a HELOC and offer you the option to switch some or all of what you owe to a fixed rate and payment, like a HELoan.

Refinance

The other way to liberate the existing equity from your property is to refinance. Refinancing replaces your existing mortgage with a new first mortgage. If you already have a HELOC or HELoan, it can be consolidated into the new loan.

Refinance rates for first mortgages tend to be lower (sometimes by quite a lot) than HELOC/HELoan options and you can pick any loan you'd like, with a fixed or adjustable rate. You can also pick any loan term you'd like.

Refinancing to a new 30 year mortgage is often the path to the lowest overall monthly payment. However, if you are building your ADU to rent, consider a shorter term mortgage — the rates on 15 and 20 year loans are lower than those on 30 year loans and may be affordable with the income from your ADU in the mix.

You can generally borrow up to 80% of the current value of your property. Multiply your current market value by 0.8 and subtract what you owe already for an estimate of how much equity you could free up.

Worth noting, closing costs usually are higher than HELOC/HELoan costs. Typical refinance closing costs are $4000-5000, but, of course, vary based on your situation. When you apply for a refinance, your lender will provide a Loan Estimate detailing all loan costs.

And, if you were lucky enough score a really low rate on your current loan, refinancing means letting go of that low rate and going to current market rates.

Equity you create

So what if you don't have enough equity in your home or a pile of savings or a rich uncle willing to fund your ADU project? It's time to look into renovation and construction loans. These loan options allow you to borrow from the future value of your property, including the value you create by building your ADU (and any other remodeling you do).

Construction loan

Although generally used to build a new home from scratch, construction loans can also be used to fund major remodeling projects and to build an ADU. The construction loans I work with most often and recommend are called "construction-permanent" loans, sometimes called a "one-time-close" loan. They have a construction term (typically 9-12 months) during which you pay just interest. When construction is complete, they convert to your long-term financing (most often a 30 year fixed rate).

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When doing a construction loan, your lender is going to get all up in your business about what you plan to build and who will be building it and then babysit the construction process.

Construction loans involve some extra logistics and take longer to close. I recommend applying for your construction loan as you are are finishing up your ADU design and getting quotes for the cost to build it. Although they can close faster, you'll feel less rushed if you allow 90 days from application to closing.

When applying for a construction loan, you'll provide your lender with the construction documents for your ADU ("specifications and plans"), as well as the bid from your contractor. The appraiser receives a copy of the plans and bit and completes an appraisal report indicating the market value for the finished project. The loan can be up to 80% of the future value of the property.

You must work with a licensed, bonded contractor and your lender will research your contractor to make sure they have good references and a resume that supports their ability to handle your project. So don't plan on doing the work yourself or hiring your newly-licensed cousin. The contract with your contractor must be for a fixed price ("cost plus" contracts are not allowed).

Closing on your construction loan can happen after you have your permits in hand. (And do not start work before closing on your construction loan or it may never close!) When you close, your old mortgage will be paid off and the funds for the project will be held by the bank. As work progresses, each month, you submit a "draw" request asking for your builder to be paid for work completed. The bank will make a visit to the site, verify the work is done and issue a check.

A construction loan can be done as a purchase or a refinance, but due to the lead time required to design and permit an ADU, they are almost always done as a refinance. All the extra administrative costs your lender has to do to lend on the future value of your home comes at a cost — closing costs for construction loans can be 2x to 3x as much as for a traditional refinance. Interest rates tend to be pretty similar to a standard refinance, however.

Renovation loans

Renovation loans function pretty similarly to construction loans, but have a few key differences and tend to be quicker to close and a bit more user-friendly. Both FHA and Fannie Mae offer great renovation loan programs.

FHA's is called a 203(k)* (super-creative name based on the paragraph of legislation that created the loan) and has been around since the 1970's, making it the OG renovation loan program. The 203(k) program allows you to borrow up to 97.75% of the as-improved value of your home up to FHA loan limits (currently $448,500 for a single-family home in the Portland metro area). The 203(k) program is only available for primary residences.

Fannie Mae created their own renovation program, called HomeStyle. In January 2018, Fannie Mae made some sweeping revisions to the HomeStyle program. One exciting change is that Fannie Mae now permits free-standing ADUs to be financed using the program.

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HomeStyle loans permits financing options of up to 97% of the improved value on a single-family home (or 85% on a duplex) for owner-occupants, 90% for a second home and even 85% for investors (single-family only for investors). The current loan limit for a single-family home is $453,100. Fannie Mae limits the construction budget to 75% of the improved value of the property.

Similarly to a construction loan, you will provide your plans and contractor's bid to your lender and your lender will request an appraisal that includes the value. Your contractor's bid must be for a fixed amount, but your loan will include a built-in "contingency" fund of 10-20% of the construction costs. If you're worried about the "what-ifs" of an ADU that involves work to an older home, the contingency reserve makes for added peace of mind (and contingency funds that are not spent on unforseen costs, can be spent on upgrades or will be paid down on your loan when work is done).

Your contractor will be vetted by the lender and the bid will be reviewed by a trained consultant, who will act as your lender's liason to the construction process. The consultant will review your bid, provide a construction timeline and can even offer assistance in comparing bids and picking materials.

Work must start within 30 days of closing, but "work" includes submitting for your permit. Renovation loans allow 6 months for completion of work, but extensions can be granted if permitting causes delays.

Unlike a construction loan, standard monthly payments start right away on your new loan. However, if you can't live in your home while work is being done, you are allowed to finance up to 5 months of payments into the new mortgage, eliminating the pressure to pay for a mortgage and rent elsewhere.

The draw process for a renovation loan is much like a construction loan: submit a draw request to your lender, your consultant swings by to verify the work is complete and your lender cuts a check.

Interest rates on construction loans tend to be .5% to .75% higher than that of a similar non-construction loan (be it FHA or Fannie Mae) and there are a few additional closing costs (approximately $2500-4000).

One huge difference between construction loans and renovation loans is that renovation loans do not require a permit to close. For experienced lenders, renovation loans are speedy to close. Closing will generally occur about 30 days after you order your appraisal. Improbable as it may sound, it is entirely possible to finance an ADU with the purchase of a home. A pre-designed ADU, a bid from your contractor and the consultant's report are all a lender needs to move forward to closing.

A word on appraisals

Whenever you are relying on the value your ADU will add to your property to finance it, it's important to note that ADUs are notoriously tricky to value. The appraisals on which lenders must rely use "comparable" sales as the indication of value. Appraisers must find homes that are nearby and similar to yours, that have sold in the past 3 to 6 months (maybe 12), to show the value of your home. Although there are lots of homes out there with ADUs (more and more every day), people generally build an

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ADU because, well, they want it. Comparable sales with ADUs are sometimes a little hard to come by.

As you plan your ADU, you may want to keep an eye on the area around your home, perhaps enlisting the help of your favorite Realtor, crossing your fingers that a home or two with an ADU has sold recently. That will make the appraiser's job significantly easier.

Whatever you do… plan ahead

I highly recommend doing your homework and planning ahead. Paying a bunch of money to an architect to design an ADU you can't afford to build is disappointing (and happens). And diving into construction without a handle on the budget and a sound plan for financing, can be a recipe for disaster. The easiest short-term solutions if you run short on funds (such as credit cards) can make long-term financing expensive or difficult to obtain (or both). And if you run short of funds in the middle of construction avenues that would been open to you earlier may be closed… banks generally won't lend on in-process construction sites.

We're here to help

My team and I love brainstorming with anybody considering building an ADU.

Portland changed the zoning code to permit ADUs in 1997. My experience with renovation and construction lending dates back to a few years before that (I'm gettin' old, I guess!), so it's not a stretch to say I've just about seen it all.

Doing a little legwork up front with a creative and seasoned loan officer (like yours truly) can lead to a cost-effective, sound game plan for making the ADU of your dreams a reality.

We look forward to hearing from you!

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