

# THE CASITA COALITION'S ADU Finance Guide for Homeowners



## Introduction

This guide is intended to help California homeowners better understand the many options for financing the construction or legalization of an Accessory Dwelling Unit (ADU). The financing options listed in this guide include both conventional financing options that aren't unique to ADUs and newer financing strategies that are specifically intended for ADUs.

Eleven different financing strategies are included in this guide, but you don't have to review them all. You might wish to skim the options first to identify which ones best fit your circumstances. The advantages and disadvantages of each strategy are included as bullet points following each summary. You may end up combining several sources of funding. Most people end up using savings or existing assets to cover part of their project cost.

**As a homeowner, your ability to secure financing for an ADU may depend on:**

- Your location
- Your credit score
- Your income
- Your existing debts
- Your existing home equity, and
- The amount of value your ADU adds to your property value, based on comparable sales (like a home sale with an existing ADU or a home sale with comparable square footage)

*The following table might help you find a good place to start in your financing option search. The options in the table are not ranked:*

	HIGH INCOME HOMEOWNER	LOW INCOME HOMEOWNER
HIGH HOME EQUITY	Cash-out refinance Home Equity Line of Credit (HELOC) Second mortgage	Cash-out refinance Ground lease agreement Home Equity Line of Credit (HELOC) Reverse mortgage Private money
LOW HOME EQUITY	Construction loan Renovation loan Existing cash/assets 401(k) loan	Existing cash/assets Borrow from family/friends 401(k) loan



In a **Cash-out refinance**, the homeowner replaces their existing mortgage with a new mortgage that is larger than their previously existing mortgage. This leftover cash can then be used to build an ADU. A **second mortgage** is a new mortgage added on top of the existing mortgage. A **Home Equity Line of Credit (HELOC)** is a flexible home equity loan that functions like a credit card—the homeowner has a limit they can borrow up to, but the homeowner can usually decide when and how much they want to borrow. A cash-out refinance offers great interest rates, but a second mortgage can be useful if the first mortgage already has a great rate. A HELOC helps homeowners borrow no more than they need, but HELOCs are often variable rate loans.

A **construction loan** is a short-term loan that uses the future, after-construction value of a house plus ADU to qualify a homeowner for the loan. This is useful for homeowners without much equity in their home, but the ADU must be completed on time and interest rates are higher than other mortgage options. A **renovation loan** is a

specific type of construction loan that allows for the cost of a home purchase and ADU construction to be combined in one loan.

Less common ADU finance options include: **ground lease agreements**, where the homeowner rents their backyard to an ADU builder for the builder to construct and rent an ADU, **shared appreciation agreements** where a homeowner receives money now and agrees to hand over a percentage of their future home appreciation, a **reverse mortgage** where a homeowner aged 62 or more borrows money with repayment coming due upon the eventual sale of their home, **private money** where a homeowner borrows money from a non-bank lender, or a **401(k) loan** where a homeowner borrows money from their own 401(k), repaying the 401(k) back over the course of a few years. This group of options may be more flexible than home equity loans and construction loans, but they may also have higher interest rates and/or be less regulated. Please read on for the full details on the options mentioned in this summary.

## Getting Started

Applying for a loan is a little like buying a car – it often pays to explore several options. The first step, after solidifying your project plans and reviewing this memo, is to call around. Although it may feel unfamiliar, you can call a bank, ask to talk to a loan officer, and explain what you want to do. A good place to start is your current mortgage company or your personal bank.

One important decision is whether you want to use a mortgage broker or work

directly with a bank. Mortgage brokers will get proposals from many banks and will look for the best deal for you. They have a fiduciary duty, meaning they must act in your best interest. Banks do not have that obligation. However, if you have an existing relationship with a bank, sometimes they will offer you a lower rate. Also, some products or programs may not be available through brokers. There is no reason you cannot simultaneously work with a mortgage broker and see what banks have to offer.



## Best Practices for Financing Your ADU

- **Confirm that you can build an ADU on your property before you borrow money.** While relaxed planning regulations make it easier than ever before to build an ADU, you should still check with your local planning department to make sure there are no utility easements on your property. A utility easement is a special area, often near a major natural gas pipeline or major power lines, where you need special permission to build. Easements are not very common, but you should still check.
- **Talk to a knowledgeable architect, designer, project manager, or general contractor** to make sure your ADU construction budget is realistic. They can often tell you what similar ADU projects in your area cost to build. Some financing products require you to know your project budget before you borrow, so it is important to carefully consider the costs.
- **Shop around!** Even for the newer ADU finance options, you should usually try to find a second financing quote before signing your deal.
- **Include a small “contingency” in your budget.** This is a reserve that you can tap if something is more expensive than you expected.
- If you are applying for a loan from multiple lenders, it might be better for your credit score if you **apply from all the lenders in a short time period** (over a 30-day window or less).
- **Interest rates are important in comparing loans, but they aren’t the only factor.** Closing costs, private mortgage insurance costs, and similar expenses are also important to include when comparing different financial products.
- Remember that **as most ADUs will increase your home value, you may see a corresponding increase in property taxes.** Building an ADU should not affect your underlying property tax valuation (for your existing house and land) that is protected by Proposition 13. Any new taxes are based exclusively on the added value from the ADU. So, if your new detached ADU is valued at \$100,000 by your county’s assessor, you might expect to pay about 1.1% of that in added property tax each year (at the average state property tax rate). An ADU is part of the same parcel as the main house, so no extra payment is required for local parcel taxes.



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## Key Terms

*These terms may come up in the descriptions below and are defined here for easy reference.*

**Appraisal** An estimate of how much your property is currently worth or will be worth after construction.

**Fixed rate loan** The interest rate does not change for the life of the loan.

**Loan to value ratio** The ratio of the loan(s) on a property compared to the appraised value of the house. If a property has an appraised value of \$1,000,000, a \$600,000 mortgage and a \$100,000 HELOC, the loan to value would be 70%. Different banks/products will lend up to different loan to value ratios.

**Private mortgage insurance (PMI)** PMI is an extra charge banks may add on to loans they consider riskier. It can often add 0.5 to 1% to the interest rate. This is more likely to be added when the borrowers have low equity and/or a low credit score.

**Rate and Term Refinance** The most basic refinancing of your mortgage where no money is taken out. The only things that might change are the size of the loan, the interest rate and the term (length) of the loan.

**Variable rate loan or adjustable rate mortgage (ARM)** The interest rate will vary over time based on a published index (such as the rate banks charge each other to borrow money). Often the rate will be fixed for certain length of time before it start changing. There is a risk you could be required to pay more than expected if interest rates rise. These loans are sometimes abbreviated with numbers such as 5/1. The first number refers to how long the interest rate is fixed and the second number refers to how many times a year the rate changes.



# A

## Existing Savings and Assets

**Existing savings/resources** is one of the most common ways that people pay for part or all their ADU cost. An ADU can often yield an attractive return on investment, and not resorting to outside financing options can save time and hassle. A homeowner's ability to use existing savings and assets for ADU construction is naturally limited by what they currently own.

**Reasons why a homeowner might wish to pursue this option include:**

- Using money or assets you already own to pay for an ADU reduces the need for debt.
- In some but not all cases, an ADU can offer a competitive return as a possible investment.
- If you can avoid taking a loan or reduce the size of the loan you need, it may be good for your credit.
- Some homeowners may not qualify for any other financing option.

**Reasons why a homeowner might be cautious about this option include:**

- Depending on the specifics of your situation, stocks and other investments may provide a greater rate of return on your investment than building an ADU. It is important to consider the financial math carefully.
- It is important to work with your project team to have a realistic project budget to ensure you have the money you need.
- Some loan products available for ADUs may offer competitive interest rates.

*Image: San Mateo County Second Unit Center*



# B

## 401(k) Loan

Some people can **borrow from their 401(k)** to pay for part of their ADU cost. Not all employers allow a 401(k) loan, but those that do will typically allow the lesser of \$50,000 or 50% of the 401(k) balance to be borrowed within a 12-month period. These loans function similarly to a bank loan – you pay back the loan at regular intervals, and you pay interest on the money you borrow. However, your 401(k) receives both the repayment and the interest you pay. A homeowner’s ability to use a 401(k) loan depends on having money already in their 401(k) and on having a 401(k) that allows for loans (this varies from employer to employer).

If you pay the loan back on time, you do not pay penalties like you would on an early 401(k) withdrawal. If you fail to repay the loan on time (typically over a 5-year period), the remaining loan balance will be taxed as an early 401(k) withdrawal. 401(k) loans are typically handled by the brokerage or investment company that administers your 401(k). Before pursuing this option, homeowners should very carefully consider the impact of a 401(k) loan on their retirement strategy. Talking to a qualified retirement advisor could add valuable perspective to that consideration.

### Reasons why a homeowner might wish to pursue this option include:

- A 401(k) loan is essentially a loan to yourself – so no interest is lost to an outside party.
- There are generally no credit score minimums, and taking a 401(k) loan will usually not appear on your credit report or hurt your credit score.
- If repaid, a 401(k) loan is cheaper than an early 401(k) distribution.

### Reasons why a homeowner might be cautious about this option:

- Either you are paying a very high interest rate back to your 401(k), or your 401(k) is likely losing value compared to a scenario where you took no 401(k) loan.
- 401(k) loans have short repayment periods – often five years.
- Unlike some other ADU finance options, you must begin making payments while construction on the ADU is ongoing. This would require a source of temporary repayment before any ADU rent becomes available.
- If you fail to repay the loan, you could be responsible for tax penalties.
- In some cases, leaving your current employer will force you to pay the entire remaining balance of the loan at once.
- There are typically fees associated with creating a 401(k) loan.



# C

## Cash-Out Refinance

The **cash-out refinance** is refinancing your current home mortgage and pulling cash out of the equity in your home. This will increase your loan amount but hopefully allow you to add to your home value by building an ADU. Once the ADU is built, you should expect to refinance again into a rate & term loan product. The rate & term loan will be a lower rate than a cash-out refinance and you might be able to use the new ADU's value for that new loan.

The cash-out refinance is by far one of the most popular ways to pay for an ADU – if you have the equity in your home to draw from. To qualify, a homeowner will need enough equity in their home to cover the amount they are withdrawing plus a small buffer of extra home equity. A cash-out refinance is often the loan option with the lowest fees. The main drawback to the cash-out refinance, and its key difference from a HELOC (Home Equity Line of Credit), is that you receive the cash as a lump sum at closing. It's up to you to be diligent about releasing those funds to your builder and keeping to your budget. Terms for a refinance are available in both fixed interest and adjustable rate options. Banks and mortgage brokers can often assist with a cash-out refinance.

### Reasons why a homeowner might wish to pursue this option include:

- The homeowner has full control over the funds for the project.
- The interest rates are usually lower than a construction loan, private money, or a HELOC.
- The homeowner is maximizing their equity.
- There is no restriction on how the ADU is used.

### Reasons why a homeowner might be cautious about this option include:

- The homeowner needs to make sure they're able to stay on budget because they usually can't go back to the bank and ask for more.
- This approach may take more time and attention than other mortgage loans since the homeowner will usually refinance to a rate & term loan once the construction is complete and the property assessed.
- The homeowner will have to pay fees to do a cash-out refinance– it can be wrapped into the loan, but it does cost money.



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# D

## Second Mortgage

A **second mortgage** is exactly what it sounds like – a second home mortgage that sits on top of your existing mortgage. For a second mortgage, which you can get from a bank or mortgage broker, you will pay both mortgages simultaneously. While some people would consider a Home Equity Line of Credit (HELOC) a type of second mortgage, this section focuses specifically on a lump sum second mortgage. A dedicated HELOC section can be found later in this guide.

A second mortgage can be from either the same company that issued your primary mortgage or a different company. Homeowners usually shop around for a second mortgage to see who will offer the best deal. A second mortgage will often come with a slightly higher interest rate than a primary mortgage because it is riskier for the bank. You may need the permission of your first bank to add a second mortgage. Similar to a first mortgage refinance, a homeowner will need to have enough equity in their home to cover the new mortgage balance plus a small buffer of extra home equity.

### Reasons why a homeowner might consider this option include:

- If you have a low interest rate locked in for your primary mortgage, it may make more sense to get a second mortgage than to refinance.
- Fees may be lower than for refinancing a primary mortgage.
- Locking in a fixed interest rate can protect you from inflation.
- The use of the funds is flexible.

### Reasons why a homeowner might be cautious about this option include:

- If your existing primary mortgage has a high interest rate, it may make more sense to refinance.
- If you don't need the money right away, a Home Equity Line of Credit might be less expensive. Under a HELOC you only withdraw money (and start paying interest) when you need to.
- You will likely need to begin making payments on your second mortgage while construction on your ADU is ongoing, unless a second mortgage is combined with a different financing strategy.



Image: ADU Marin

# E Home Equity Line of Credit (HELOC)

The **HELOC** or Home Equity Line of Credit is pulling a Line of Credit (loan) based upon the equity in your home. The homeowner will qualify for a certain amount based upon the existing equity in the home. The borrower will only pay interest and payments to the bank if and when the HELOC is used. This structure provides the flexibility of only borrowing money and paying interest when payments to your ADU builder are due.

The HELOC is a great way to build an ADU – if you have the equity in your home to draw from. As in all home equity loans, you will need to have enough home equity to cover the size of the HELOC plus a little extra home equity to serve as a safety margin. Rates for a HELOC are low but are sometimes even lower if you were to pull cash-out in a mortgage refinance instead. It will pay to do your research and get quotes from multiple lenders.

## Reasons why a homeowner might wish to pursue this option include:

- The homeowner has full control over the funds for the project.
- The interest rates are usually lower than a construction loan or private money.
- The homeowner doesn't pay interest until the funds are actually withdrawn.
- The homeowner doesn't have to borrow more money than is needed for the project.

## Reasons why a homeowner might be cautious about this option include:

- The homeowner needs to make sure they're able to stay on budget because it can be difficult to go back to the bank and ask for more.
- The homeowner will have two payments to make every month – one for their mortgage and one for their HELOC repayment; a homeowner may want to consider refinancing once the ADU is built and pay-off the HELOC with the new added equity/value of the home.
- A HELOC can be used for other expenses like emergencies, higher education, etc. If the HELOC is intended for building an ADU, it is important to have a rainy-day fund you can use on these other expenses instead of raiding your HELOC.
- Many, but not all, HELOCs have variable interest rates. If interest rates rise, the amount of money you pay to the bank could go up too.

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# F

## Construction Loan

Construction loans are a short-term financing option that can help you pay for construction costs when you build a new structure or add on to an existing structure. Unlike a traditional home loan, which is based on the fair market value of the home and determined by the home's condition in comparison to other recent sales, construction loans are based on what the projected value of the home will be once the work is complete. To make a construction loan possible, a homeowner will usually need a cost and schedule for the ADU construction, an appraisal that confirms the added value of the ADU will cover the size of the loan, and a funding source for interest payments during construction.

There are three different types of construction loans that you can choose from:

- **Construction-to-permanent loans** These loans are good if you have definite construction plans and timelines in place. In this case, the lender pays the builder as the work is being completed. Then, that cost is converted to a mortgage at closing. This type of loan allows you to lock interest rates at closing, which makes for steady payments.
- **Construction-only loans** Construction-only loans must be paid off in full once the building is complete. It's a good choice if you have a large amount of cash to work with or you're confident that the proceeds from the sale of your current home will cover another build. Here, if you need a mortgage to cover the cost, you'll have to search for the lender yourself and be approved a second time.
- **Renovation construction loans** This type of loan is used if you're buying a fixer-upper. In this case, government programs are available and the projected cost of any renovations you plan on doing to the property is wrapped up in the mortgage, along with the purchase price. This option is covered in more depth in the "Renovation loan" section of the guide.

For example, Housing Trust Silicon Valley offers a construction to permanent loan to assist homeowners in Santa Clara County who want to build an accessory dwelling unit (ADU) in their backyard. These ADU's can be used to house their aging parents, adult children, teachers, nurses etc. – anyone who meets the income qualification guidelines. The goal of this program is to create an "affordable" unit (ADU) in your backyard, and to make this unit available to people who may not otherwise be able to pay market rate rent and afford to live in this area. By doing so, homeowners will be making a big impact in the community by increasing the local affordable housing supply and will also create an additional source of income for themselves.





## Construction Loans, cont.

**Reasons why a homeowner might consider this financing strategy include:**

- These loans will consider the after-construction value of your home, which can help you qualify.
- Some organizations offer special construction loan options for ADUs.
- There are flexible options – you can either choose a loan that automatically converts to a permanent mortgage, or you can go for a short-term loan that can lead into a different loan from a different lender.
- The funds may be placed in an “escrow” account that can only be used when the different stages of construction are completed. This can help you make sure your contractor completes their work before being paid.

**Reasons why a homeowner might be cautious about this financing strategy include:**

- The interest rates are sometimes higher than regular mortgages.
- Most construction loans will require you to complete the ADU construction in a timely manner.
- A short-term construction loan is risky if you don't already have a strong plan for how to refinance it or pay it off.
- ADU appraisals can vary significantly, and appraisals have historically undervalued ADUs. It is possible you may not qualify for a construction loan if your ADU is judged to not add enough value to your property. This is most likely to be an issue when you are converting bedrooms into an interior ADU or a JADU.

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## Renovation Loan

A **renovation loan** is a special type of mortgage that specifically includes funding for repairs or upgrades to the property, in addition to the purchase or refinance of the property itself. If you are buying a property and looking to build an ADU, then a renovation loan could finance both with one loan.

Two of the most prominent renovation loan products are the 203(k) loan supported by the Federal Housing Administration (FHA) and the HomeStyle<sup>®</sup> loan supported by Fannie Mae. The Federal Housing Administration and Fannie Mae don't directly issue these loans. Instead, a bank, mortgage broker, or independent loan agent will connect you with these loan products. Not all banks offer such specialized loans, so you may need to shop around to find renovation loan options.

A 203(k) and a HomeStyle<sup>®</sup> loan have some key differences. A 203(k) loan will typically have looser credit score requirements than a HomeStyle<sup>®</sup> loan, but a 203(k) loan is only available if you agree to live in either the ADU or main house. It is also unclear if a 203(k) loan can be used for a detached ADU. The loan requires construction work to be completed in a six-month period.

A HomeStyle<sup>®</sup> loan may have higher credit rating requirements, but it can be used to build any type of ADU and can sometimes be used on investor-owned or vacation properties. The loan requires construction work to be completed in a twelve-month period. HomeStyle<sup>®</sup> loans may involve paying less than a 203(k) loan in private mortgage insurance, especially if you have good credit.

Both 203(k) loans and HomeStyle<sup>®</sup> loans have a maximum loan size based on which county you live in. In the highest cost areas, the limit for a single-family home loan is \$822,375 in 2021. In the lowest cost areas, the single-family home loan limit is \$548,250. You can look up the current official loan limits in your county for both 203(k) and HomeStyle<sup>®</sup> loans [at this link](#). Duplexes and triplexes have higher loan limits than single-family homes. Only U.S. citizens and documented immigrants are eligible for the 203(k) and HomeStyle<sup>®</sup> loans.

*Image: Napa Sonoma ADU*





## Renovation Loans, cont.

**Reasons why a homeowner might consider this ADU financing option include:**

- This option allows a home buyer to purchase a house and build an ADU with one loan.
- 203(k) loans may have more relaxed credit requirements than other ADU financing options.
- Both loans allow very high loan-to-value ratios. A HomeStyle® loan will typically have a loan-to-value ratio of 97%. A 203(k) loan may allow a loan-to-value ratio of up to 110% of the after-construction home value. Individual lenders may set lower loan-to-value ratios, so shopping around can be helpful.
- The need to carefully determine a fixed project budget and timeline ahead of time can help ensure your ADU arrives on time and on budget.

**Reasons why a homeowner might be cautious about this ADU financing option include:**

- Interest rates may be higher than a conventional mortgage product.
- Both a 203(k) and HomeStyle® loan require you to work with a licensed contractor. These options may be less good if you plan to do much of the ADU construction yourself.
- The limited project timelines and fixed loan amounts require a very clear plan to ensure the ADU is completed on time and on budget. It may be difficult to change your plans once you commit to them.
- A 203(k) or HomeStyle® loan may require more paperwork and close slower than other mortgage options.
- Working with a lender who hasn't already funded several renovation loans could cause additional challenges. Ask for references of past renovation loan projects when working with a lender/ loan officer.



## Reverse Mortgage

A **reverse mortgage** is a form of financing where a homeowner over the age of 62 borrows money and builds more debt over time. The loan is usually not repaid until the home is sold, often after the borrower passes away. This type of loan is usually bad for somebody who wants to give their house to their heirs (like friends or family) after their death. A homeowner's ability to qualify for a reverse mortgage depends in part on existing home equity (which must be more than any existing mortgage on your home) and on the homeowner's age (older adults may qualify more easily). Borrowers must also be able to pay their property taxes and any Homeowner Association fees on their property.

In a traditional 'forward mortgage', the borrower pays the loan off over time, regaining equity with each payment. In a reverse mortgage, the borrower enters more debt over time as they are not paying the loan back. Borrowers can choose to receive the loan as a lump sum, in regular monthly payments, or as a line of credit they can draw against as needed. The line of credit is one of the more popular options between the three for the purpose of building an ADU. It can give you the cash you need to build the ADU when needed, and you might be able to pay down the line of credit and stop accruing interest. Details like this can differ a lot, and it is very important to understand the terms before taking out a reverse mortgage.

### Reasons why a homeowner might wish to pursue this option include:

- Reverse mortgages often have no income requirements.
- The homeowner is over 62 and wants to live in this home for the rest of their life.
- The homeowner does not plan on giving the home to an heir after their death.
- The homeowner creates 2 sources of cash flow (the loan, and the potential ADU rental income).

### Reasons why a homeowner might be cautious about this option include:

- If you want your heirs to inherit your home, this type of loan is not well-suited for you.
- The interest rates tend to be higher than comparable HELOC and Home Equity Loans.
- The effect of compounding interest works against you, increasing your debt over time.

- If you let a relative move into the ADU or primary house, they will often be displaced upon your passing.
- Reverse mortgages are sometimes used to scam the elderly and you should be vigilant around this type of loan.
- If you need to move out of your home, for example for health reasons, the loan may complicate your situation and push you to sell your home before you are ready.
- Payments from a reverse mortgage can affect Medicaid eligibility. Your home equity does not usually limit Medicaid eligibility. However, cash you get from a reverse mortgage might be counted against the asset limit for Medicaid participation.

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# Ground Lease Agreement

A **ground lease** is a form of ADU financing where the ADU builder pays for the construction of the unit instead of the owner. In this agreement, the builder recommends a tenant that the homeowner may approve. The builder then collects the rent from the unit. In return for renting the land the ADU sits on, the homeowner gets two main benefits. First, the homeowner gets a small portion of the monthly rent. Second and much more significant, the ADU is usually given to the homeowner at no additional cost after the lease ends.

The length of the lease varies by builder but is usually 15-25 years. Please note that only a few builders currently offer ground leases as a financing option. Ground lease financing is currently an option for only new detached ADUs built in backyards, but the market continues to change over time. Other factors that may affect your eligibility for ground lease financing include where you are located, the terms of any existing mortgage, and the amount of home equity you have.

## Reasons why a homeowner might wish to pursue this option include:

- The homeowner gets monthly income with no upfront investment or debt.
- The builder handles the entire construction process, reducing stress.
- The homeowner usually gets a free ADU at the end of the lease (though a homeowner should ask the builder about whether any taxes or fees may apply).
- The builder can make sure the ADU design will be profitable.
- The builder provides rental management, so homeowners don't have to serve as the landlords.
- The builder is responsible for finding the tenant and handling issues that come up.
- This might be an attractive option if your income is insufficient to refinance and buy the unit outright until after you have rental income from the ADU.

## Reasons why a homeowner might be cautious about this option include:

- If a relative lives in the unit, they will need to pay rent.
- This model isn't very regulated by the government because it is so new. Homeowners should review the contract and ask what happens if the builder goes out of business.
- The builder may decide which ADU design is used.
- Borrowing money, paying a builder to build an ADU, and then directly collecting rent on the unit may generate more cash than the rent-share offered in a ground lease.
- If the lease is for 35 years or more (which is very rare), the homeowner should consult a tax attorney or your county assessor's office about whether the ground lease would trigger a full property tax reassessment of your entire property. For leases under 35 years, a ground lease should not trigger a reassessment of your entire property.
- Some mortgages prohibit ground leases.



## Private Money

**Private Money** (aka Bridge Loan) is a short-term loan that can range from roughly 6-12% interest depending on the circumstances. A homeowner would need to refinance once the construction was complete, as you'd want to, to get the private money loan paid off. Private money is different from a construction loan because a construction loan normally takes place through the normal banking/mortgage system, while private money is funding made available by private investors (hence the name). Rates have fallen significantly and in combination with building modular or prefab, where the build time is greatly reduced, private money may be a viable option. This is particularly true for investors.

Private money is not for everyone – but it is viable for some circumstances and many private money lenders embrace forward thinking construction, whereas some banks are not quite there. Private money financing can be arranged through some mortgage brokers and specialized private money lenders. It is hard to generalize about eligibility for private money but having collateral – something you can pledge to turn over if you default on your loan – is often important.

### Reasons why a homeowner might wish to pursue this option include:

- The homeowner has full control over the funds for the project.
- If an investment property, transactions tend to be interest-only and might be a tax write-off.
- The homeowner gets a quick loan close and less paperwork.
- Private money can be especially useful if there's something unique about the scenario/borrower.
- The homeowner can cross-collateralize another property if the existing property they want to build on doesn't have the equity (in other words, you pledge one piece of land you own as security for a loan to build on a second piece of land).

### Reasons why a homeowner might be cautious about this option include:

- The homeowner risks paying a much higher interest rate than what may be available to them if they were to go with a standard refinance, second mortgage, or HELOC.
- The homeowner needs to make sure they're able to stay on budget because it can be difficult to go back to the lender and ask for more.
- The homeowner will have two payments to make every month – one for their mortgage and one for their repayment; homeowner will have to refinance once the ADU is built to close out the short-term private money loan.

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# K

## Shared Appreciation/Shared Equity Agreement

A **shared appreciation agreement** or a **shared equity agreement** is a relatively new form of ADU financing. In this option, private companies that specialize in this type of product will pay you a certain amount of money at the start of the agreement. At the end of the agreement term, or when the you sell the property, the homeowner pays the company an amount of money linked to the change in home value. A step by step numerical example is provided later in this summary.

If your home value went up during a shared appreciation agreement, you pay more than the company originally gave you. If your home value declined, you will (sometimes) pay less than they originally gave you. The companies that provide this financing sometimes claim it is “debt free” financing as there are no monthly or installment payments during the agreement term. However, you will be responsible for paying a large lump sum (balloon) payment at the end of the agreement. An important note – shared appreciation products are not subject to the regulations and consumer protections found in regular mortgages. Historically, some homeowners were not treated fairly when they used similar products. This means it is extra important for the homeowner to do their research and carefully review the agreement terms.

A shared appreciation agreement is usually for between 10 to 30 years. Homeowners can end the agreements early, but there is typically a waiting period of 1 to 3 years after the agreement is first made. If you want to end an agreement early and your home value has declined, you may still be required to pay back the amount you were initially provided. If you build an ADU, the value of the ADU might count as “appreciation” and result in a higher repayment. Some companies may exempt home improvements from the appreciation calculation, but the agreement details can limit such exemptions. You can typically use the funds from a shared appreciation agreement without restriction, so you can spend the funds on non-ADU purposes too. Eligibility for shared equity or shared appreciation products are partly based on location and home equity. Some companies offering these products do not operate in areas where home prices are expected to hold steady over time.

*Image: Napa Sonoma ADU*



## Shared Appreciation/Shared Equity Agreement, cont.

Consider the following illustration of how a shared appreciation agreement works:

1. The owner obtains \$100,000 to build an ADU in the backyard of a house that is currently worth \$1 million.
2. At the end of the agreement term, the homeowner will have to make a payment based on the home value change. Let's assume:
  - Home values rose by 6% per year,
  - The shared appreciation agreement lasted 10 years,
  - Repayment was the original \$100,000 plus or minus 30% of the appreciation change,
  - The ADU added \$100,000 to the initial home value.
3. In this case, the final home value would be about \$1,969,932 ( $\$1,100,000 \times 1.06^{10}$ ). Therefore, the final amount the homeowner would have to repay would be about  $30\% \times (\$1,969,932 - 1,000,000) = \$290,979$  due to the appreciation, plus the \$100,000 of the initial investment, for a total of \$390,979. This is equivalent to a roughly 14.6% annual interest rate on the original \$100,000 the homeowner received.

Reasons why a homeowner might wish to pursue this ADU financing option include:

- A homeowner has strong home equity but limited income and cannot qualify for a first or second mortgage or home equity loan.
- The investment underwriting criteria are usually less strict than for a similar traditional loan amount. Small business owners and 1099 contractors might have a better chance to obtain shared appreciation funds than a loan from traditional lenders.
- There are no monthly payments for the received funds.
- The investment amount should not affect the homeowner's FICO credit score as it does not formally constitute a new debt.





## Shared Appreciation/Shared Equity Agreement, cont.

Reasons why a homeowner might be cautious about this option, include:

- The overall cost can be very high, especially when home values in your area increase rapidly.
- There is a lump sum payment due at the end of the agreement term. The homeowner might be forced to sell the property to make the payment if they haven't saved up enough and cannot access another loan.
- Most shared appreciation vendors discount the initial property value by approximately 15% to calculate shared appreciation. For example, if the property value increases by 30% on a \$500,000 home, they may calculate a "starting value" of \$425,000 (85% of \$500,000) and calculate appreciation as  $(\$650,000 - \$425,000) = \$225,000$ .
- A homeowner faces considerable repayment uncertainty and could pay a lot more if home prices in their area appreciate quickly. For example, if the house is worth \$1,000,000 and the homeowner obtains a \$100,000 investment, holds funds for ten years, and her home appreciates 2% per year, the payoff at the end of the transaction will be approximately \$195,700 (it can be more or less dependent on the vendor used), \$100,000 for the upfront investment + \$95,700 due to the appreciation. However, if the house appreciates 4% per year, the owner will pay \$274,100 at the exit, and if the property value increases 6% per year, she will pay \$367,250. Home prices in the San Francisco metropolitan area increased 67.6% and in the San Jose metro area by 67.5% between 2012 and 2020.
- If you receive a larger amount of money from the shared appreciation company, the share of future appreciation you give up can be significantly higher. In return for a \$100,000 payment, a homeowner might expect to give up roughly 20% to 40% of the future property value increase. For a \$200,000 payment, some vendors charge as much as 70% of the future property value increase.



## L Alternative Funding Strategies

This section covers several less prominent ADU financing options that some people use for funding their project. Individually, these may not be enough to cover an ADU construction project's cost, but they are sometimes a part of a homeowner's broader strategy:

- I. Borrow money from friends or family. This is relatively common, especially if the relative will live in the ADU. If borrowing funds from friends or family, you should be sure to write down the terms of the loan. This will help avoid any future misunderstandings. There are some companies that can handle all the documents and payments, which makes the loan feel more formal.
- II. Personal loans. This is a bank loan where someone is offered a loan purely based on the amount of income they make and their credit score. The property they own isn't used as collateral in this case. Personal loans typically require a high income and a steady job.
- III. Credit cards. Due to the extremely high interest rates found on most credit cards, this strategy is almost always inadvisable as anything except a last resort. Since many contractors do not accept credit cards payments, homeowners may need to get a cash advance from their credit card, which often comes with large fees.
- IV. A limited number of local governments and nonprofits have begun offering financing programs to help homeowners, especially low-income homeowners, afford an ADU. To find out if there are any in your area, try searching online or calling your local planning department.

## M Acknowledgements

**Questions or Comments? Want to help develop new solutions to finance ADUs?**  
Please email the Casita Coalition at [info@casitacoalition.org](mailto:info@casitacoalition.org).

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