InvestHealth ADU Summit:

Building with a Renovation Loans

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26 years lending experience

$100mil+ per year loan volume

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So, why am I here today?

Why haven't more traditional ADU lending tools been developed?

Differing Perspectives: Income

Homeowner

- It's easy to make an ADU cash flow.
- \$100k debt = \$400 to \$600/month payment
- Flexibility with long-term & short-term rental options

Lender

- Income is of no value to a lender — either receive payments or foreclose and resell.
- Income is largely ignored for loan qualifying.

Differing Perspectives : Equity

Homeowner

- Equity is not usually a priority. (In fact, initially there's a negative return.)
- Why go to all the bother and "over-improve" unless you plan to hold long term?
- Eventual resale with bump to value is bonus – after years of income &/or use.

Lender

- Value (as established by comps) is everything.
- Lenders want loans to perform, but if they don't, their remedy: foreclose and resell.
- That something similar sold, establishes marketability (that they can resell).
- How much something similar sold for establishes the value (how much they'll get).

Differing Perspectives : Intangibles

Homeowner

- Multigenerational housing — a place for mom, dad, even adult kids.
- Flexibility of use over time — many potential uses as family needs change.
- Relocate to ADU to lower housing expense.
- COVID-19: work from home, distance learning, self-quarantine, protect those medically at-risk.

Lender

- Unique or unusual is not desirable to lenders – no good comps means unknown value and/or marketability.
- Unusual properties may have a smaller pool of buyers and/or take longer to sell.

There is no one-size-fits-all ADU financing tool

Financing: where will the money come from?

Three categories of funding:

Outside funds

Existing equity

Created equity

Financing Options: Outside Funds

Cash on hand: congratulations, lucky you!

Retirement (loans or withdrawals): quick and easy (beware taxes!)

Gifts or private financing: Bank of Mom?

Credit cards or signature loan: beware of rates & impact on credit

Financing Options: Existing Equity

Home equity line of credit or loan: "second" mortgage programs

Refinancing: replace existing loan(s) with new, larger loan

Hard money: only if you're an investor, expensive!

Using existing equity: refinance your loan

The Good

- A low, stable fixed rate
- Can restructure existing debt
- Opportunity to restructure existing debt
- Opportunity to change loan term or roll in existing debt.

The Not-As-Good

- Full set of new closing costs
- Replaces currently loan (could be good or bad)
- Cash-back refinances are subject to "add-ons" that affect rate/costs
- Most you can borrow is 80% of the current value of your home.

Using existing equity: open a HELOC

The Good

- Low (to no) closing costs
- Draw only what you need
- Often offer interest-only minimum payments to begin
- Keep an existing low-rate loan
- Some programs allow a fixed rate on funds drawn

The Not-As-Good

- A variable rate that changes when the Prime rate changes
- Interest-only payment won't pay down your loan and/or fixed rates will be higher
- Loan generally limited to 80-90% of home value in aggregate with existing loan.
- Became harder to come by during COVID-19 pandemic

Financing Options: Equity Created

Construction loan: repurposing of loan type designed to build a brand-new home

Renovation loan: repurposing of a loan type designed to remodel an existing home, closest to a "one-size" option

Types of Renovation Loans: FHA & Fannie Mae

FHA 203(k) – The OG

- The OG renovation loan
- Lower credit scores allowed (GR minimum: 600)
- Debt-to-income ratios over 50% allowed

Fannie Mae HomeStyle

- Fannie's answer to FHA 203(k)
- 620 credit score (but 680+ preferred)
- Debt-to-income ratios 45% to 50%
- May combine with HomeReady "affordable" program

Benefits of Renovation Lending

Rate-term refinance… with a superpower

What’s so great about rate-term refinances?

1

2

3

Rate-term Refinance Perk #1

No cash-out refinance "add-ons"

Fico	<=60.00%	60.01-70%	70.01-75%	75.01-80%
>=740	0.375	0.625	0.625	0.875
720-739	0.375	1.000	1.000	1.125
700-719	0.375	1.000	1.000	1.125
680-699	0.375	1.125	1.125	1.750
660-679	0.625	1.125	1.125	1.875
640-659	0.625	1.625	1.625	2.625
620-639	0.625	1.625	1.625	3.125
<620	1.625	2.625	2.625	3.125

Rate-term Refinance Perk #2

Lower Risk Layering

- One less “risk layer”
- Higher probability of approval
- Higher debt-to-income ratio permitted

Rate-term Refinance Perk #3

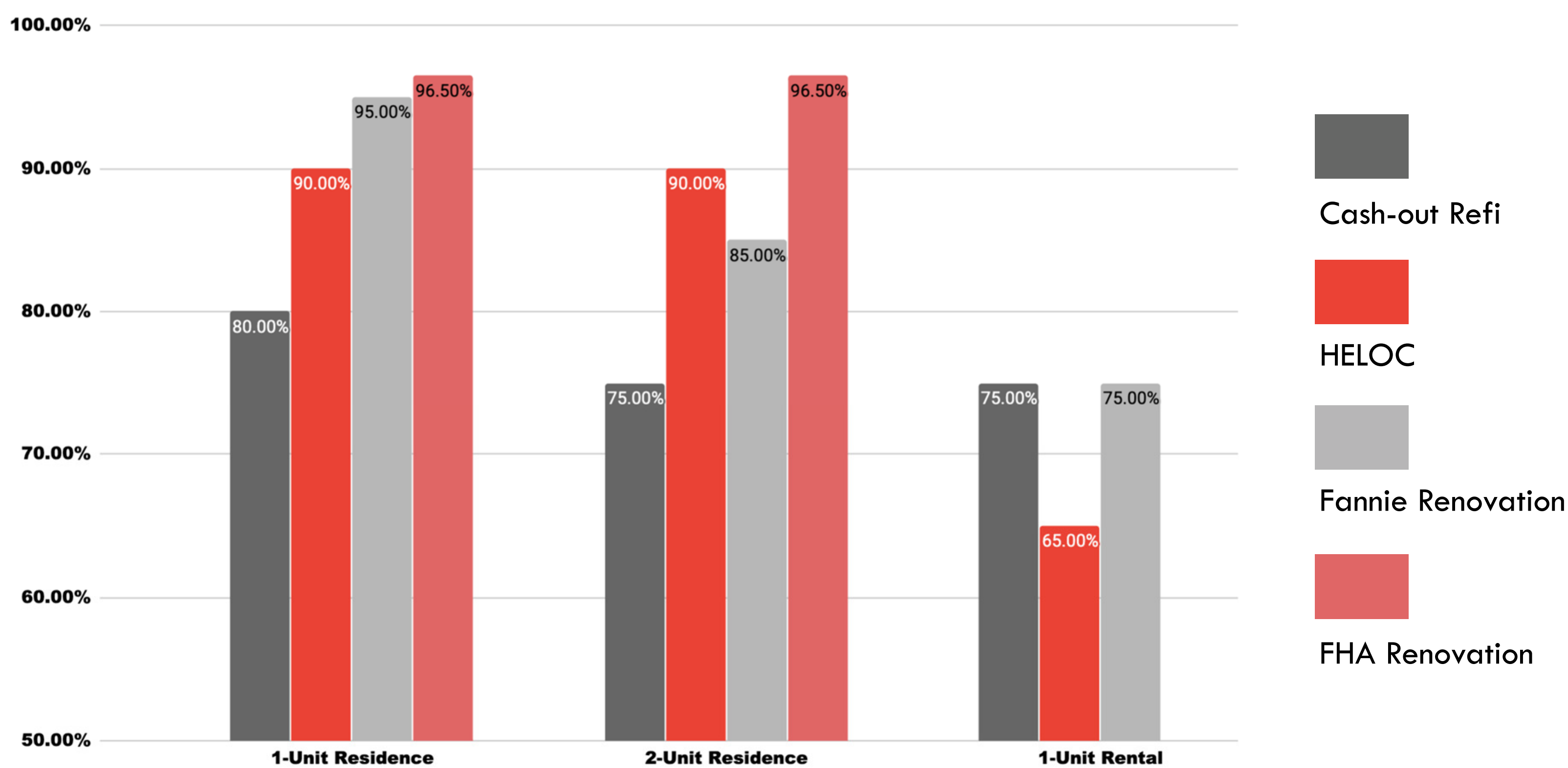
Higher Loan-to-Value Ratio

Loan type	**Maximum loan-to-value ratio (LTV)**
Home equity line / loan	Commonly 80% (less common:90% to 100%)
Cash-out refinance (FHA or conforming)	80%
Conforming rate-term refinance	95%
FHA rate-term refinance	97.75%

So what about that superpower?

Financing based on *future value*

Loan to Value Ratios: Cash, HELOC, Fannie, & FHA



Case Study: Refi vs. HELOC vs. Reno Loan

Assumptions:

$400,000 current home value

$250,000 existing mortgage

$150,000 cost to build ADU

ADU will add **$75k** to home value when complete

Case Study: Refi vs. HELOC vs. Reno Loan

Cash out refi at 80ltv

$400,000 value

x 80% loan-to-value

= $320,000 new loan (replaces old loan)

- $250,000 old loan payoff

- $7,000 closing costs

= $63,000 cash back

Deficit of $87,000

Assumptions: $400,000 current home value • $250,000 existing mortgage • $150,000 cost to build ADU • ADU will add $75k to home value when complete

Case Study: Refi vs. HELOC vs. Reno Loan

HELOC at 90ltv

$400k value

x 90% loan-to-value

= **$360k max total loans**

- $250k existing loan (will not be paid off)

- $1k closing costs

= **$109k HELOC limit**

Deficit of $41,000

Consideration:

$109,000 borrowed

at higher and/or

variable rate

Assumptions: $400,000 current home value • $250,000 existing mortgage • $150,000 cost to build ADU • ADU will add $75k to home value when complete

Case Study: Refi vs. HELOC vs. Reno Loan

Fannie Mae HomeStyle renovation loan

$475k as-improved value

x 95% loan-to-value

= $451,250 maximum new loan

- $250,000 old loan payoff

- $10,000 closing costs

= $191,250 available renovation budget

$150,000 budget covered, with room to spare

Assumptions: $400,000 current home value • $250,000 existing mortgage • $150,000 cost to build ADU • ADU will add $75k to home value when complete

Case Study: Refi vs. HELOC vs. Reno Loan

FHA 203(k) renovation loan

$475k as-improved value

x 97.75% loan-to-value

= $464,312 maximum new loan

- $250,000 old loan payoff

- $10,000 closing costs

= **$204,312 available renovation budget**

$150,000 budget covered, (even more) room to spare

Assumptions: $400,000 current home value • $250,000 existing mortgage • $150,000 cost to build ADU • ADU will add $75k to home value when complete

Closest to a silver bullet:

Fannie Mae HomeStyle + HomeReady

Lending Matters

The Devil's in the Details: Lending Matters

Definitions: what exactly is an ADU to a lender?

Zoning: how do local rules impact lending?

Loan Limits: how high can we go?

Appraisal challenges: the Catch-22 of comps

Qualifying Income: can borrows use rent to qualify?

According to Fannie & Freddie: an ADU is…

Freddie Mac says…

- An additional living area with "at least":
  - A kitchen
  - A bathroom
  - A separate entrance
- Freddie points to zoning and land use as the primary factors differentiating an ADU from a multi-unit dwelling.

Fannie Mae says…

- "Typically" an additional living area:
  - That is independent of the primary dwelling unit
  - And has a fully functional kitchen and bathroom
- Fannie leaves the decision up to the appraiser.

According to Fannie & Freddie: An ADU is…

Fannie and Freddie do agree on a couple things:

1) More than one ADU **is not** permitted

2) A multi-unit property with an ADU **is not** permitted

Sneaky…. I've had luck financing properties with multiple ADUs as 3- or 4-unit properties.

Zoning out: appraisers, zoning, and financing

Legal conforming: complies with current zoning

Legal non-conforming ("grandfathered"):

non-compliant with zoning, but can be rebuilt as-is

Illegal use: non-compliant with local zoning

No local zoning: do whatcha, whatcha want

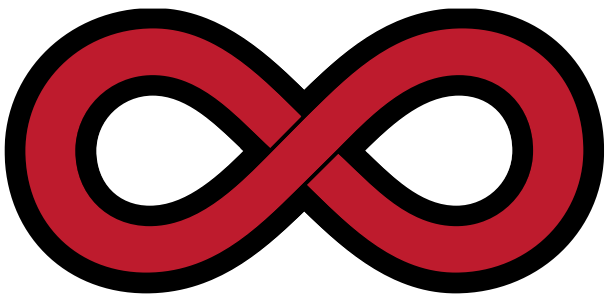
Zoning out: appraisers, zoning, and financing

All zoning uses can be financed if:

1) Comps show there is market acceptance

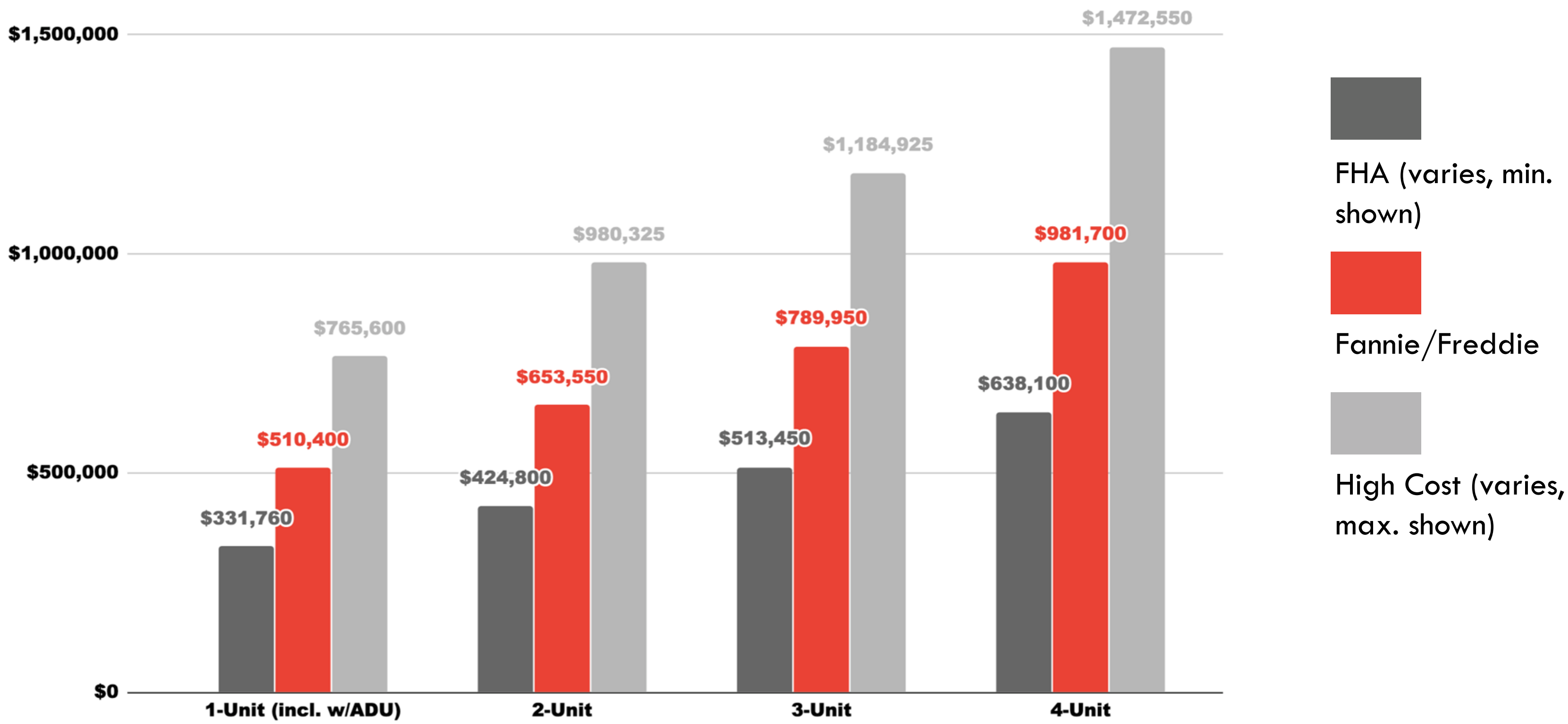
2) ADU doesn't jeopardize future insurance claims

Why are there no comps?

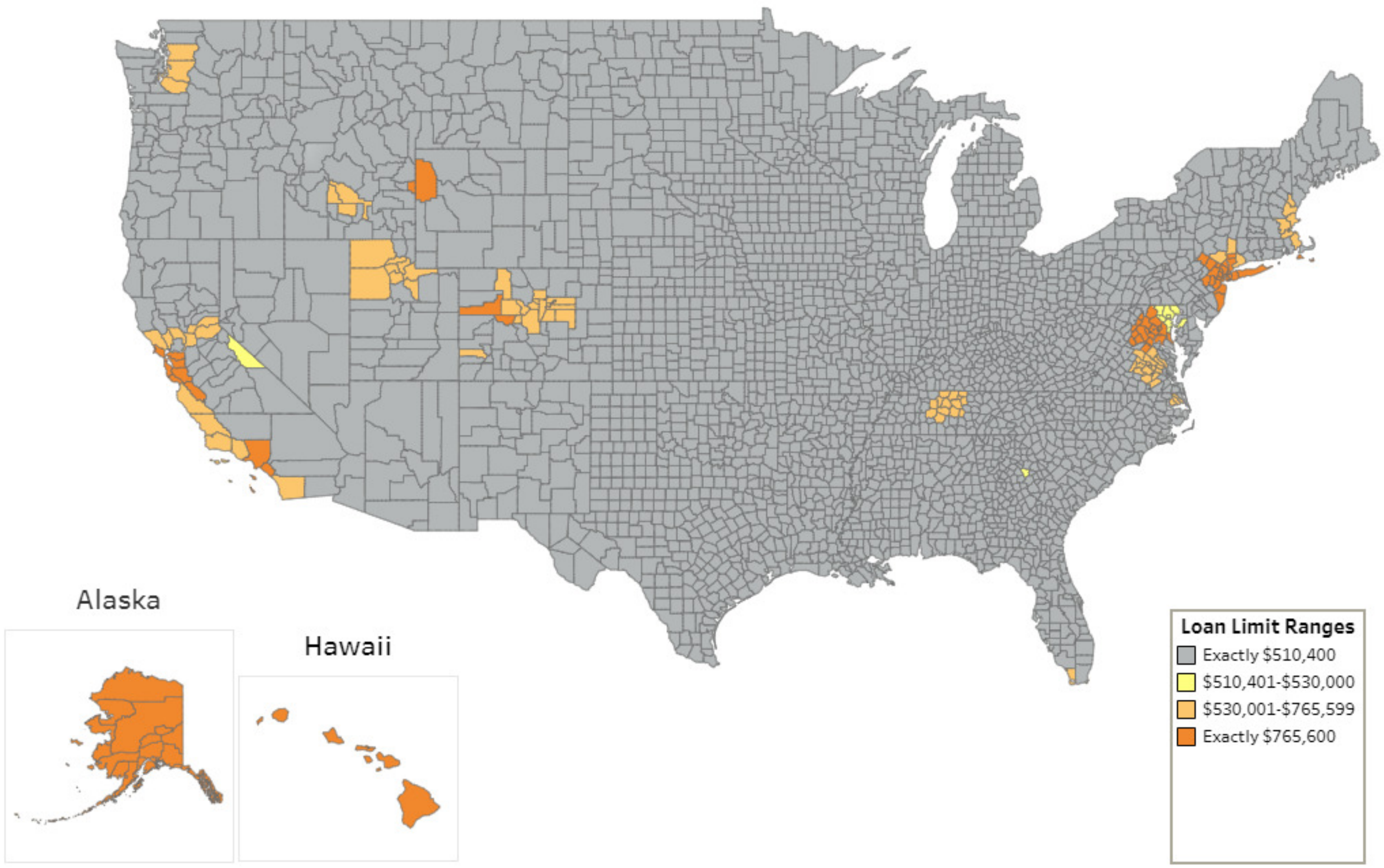


There are no comps because there are no comps.

Loan Limits: FHA, Fannie/Freddie, & High Cost



Loan Limits: Where are these high cost areas?



Qualifying Income: Can ADU rent be used?

FHA 203(k) allows if…

- 2-year history of ADU income on tax returns
- Financed as multi-unit property

Fannie Mae allows if…

- Borrower with disabilities receives rent from a live-in assistant (up to 30% of qualifying income)
- Financed as multi-unit property
- Under the HomeReady program for borrowers at 80% AMI

How do construction & renovation loans work?

The Process

1. Prequalify for loan based on income and credit
2. Design ADU
3. Select contractor and obtain fixed-price bid
4. Renovation consultant prepares Work Write-Up
5. Lender reviews and approves contractor, bid and work write-up
6. Appraisal(s) performed
7. Final underwriting
8. Signing and closing
9. Rehab account established
10. Renovation commences with draws paid from rehab account
11. Renovations complete
12. Final inspection performed

Thank you!

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