ADU Financing Guide for Homeowners

This guide is intended to help current Omaha homeowners understand options for financing the construction of an Accessory Dwelling Unit (ADU) on their property.

We will explore four options in this guide – though other options may be available to you. These options work for homeowners with high home equity or financial resources.

1. **Existing cash or assets**
2. **Cash-out refinance**
3. **Second mortgage**
4. **Home Equity Line of Credit (HELOC)**

As homeowners in other communities with a thriving ADU market have found, you may end up combining several sources of funding, and using savings or existing assets to cover part of your project cost.

Your ability to secure financing depends on:

- **Your home's location**
- **Your credit score**
- **Your income**
- **Your existing debts**
- **Your existing home equity**
- **The amount of value your ADU adds to your property value, based on comparable sales**

Currently in Omaha, there may be a lack of comparable sales for homes with ADUs near your location. This may create challenges for securing financing involving the appraisal process, as such we are not exploring those options in this guide.

*This guide was adapted for an Omaha audience by **Partners for Livable Omaha** (Livable Omaha), from information created by Casita Coalition in California, and then reviewed by Omaha-based lenders for accuracy. For more information about Livable Omaha, visit **www.Livable.org** or contact Jessica Scheuerman at **jessica@livable.org**.*

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Best Practices for ADU Financing

Before you borrow money, confirm with the Planning Department that you can build an ADU on your property. While relaxed regulations make it easier to build an ADU, you should still check to make sure your project works for your site. Contact the Omaha Planning Help Desk at (402) 444-5150 x2063 or planning.desk@cityofomaha.org.

Make sure your construction budget is realistic and comprehensive. Talk to a knowledgeable architect, designer, project manager, or general contractor. Include a small “contingency” in your budget. This is a reserve you can tap if something is more expensive than expected.

Shop around and get a second financing quote before signing a deal.

It might be better for your credit score if you apply to all the lenders over 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.

Consider your property taxes. Adding an ADU will increase your home value, and you may see a corresponding increase in property taxes.

Existing Savings and Assets

In other communities, existing savings and resources is one of the most common ways that people pay for part or all of their costs. 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 limited by what they currently own.

Potential benefits:

- Using money or assets you already own 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, it may be good for your credit.
- Some homeowners may not qualify for any other financing option.

Reasons to be cautious:

- 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.

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.

In other states, the cash-out refinance is by far one of the most popular ways to pay for an ADU. 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, 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.

Potential benefits:

- 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.
- Homeowner is maximizing their equity.
- There is no restriction on how the ADU is used.

Reasons to be cautious:

- 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. Those can be wrapped into the loan, but it does cost money.

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 a type of second mortgage, this section focuses specifically on a lump sum second mortgage.

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.

Potential benefits:

- 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 to be cautious:

- 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.
- Homeowner will likely need to begin making payments on the second mortgage while construction is ongoing, unless a second mortgage is combined with a different financing strategy.

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 on 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 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 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.

Potential benefits:

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

Reasons to be cautious:

- Make sure you're able to stay on budget because it can be difficult to go back to the bank and ask for more.
- Homeowner will have 2 payments to make every month – 1 for the mortgage and 1 for the HELOC repayment. Homeowner may consider refinancing once the ADU is built and pay-off the HELOC with the new added equity/value of the home.
- HELOC can be used for other expenses like emergencies or higher education. 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.
- Many, but not all, HELOCs have variable interest rates. If rates rise, the amount of money you pay to the bank could go up.