Strong economies, unaffordable housing

In big cities across North America, rapid job creation has contributed to sharp increases in housing costs. The San Francisco Bay Area is a showcase for both phenomena: home to many fast-growing tech companies, the region built only 125,000 new homes while adding over 500,000 jobs between 2011 and 2017.1 With demand for housing significantly outstripping supply, people are forced to move more and more of their budgets to shelter. The median home price in San Francisco rose 91% to $1.6M from 2013 to 2018.2 In 2015, more than 40% of California households faced unaffordable housing costs—defined as spending more than 30% of income on shelter.3

These rising housing costs constrain regional economies and run counter to environmental goals. Rising costs push people to live in suburban outskirst further from work, increasing their reliance on carbon-intensive transportation. These myriad negative impacts tend to fall most heavily on low-income and minority individuals.

Similar affordability crises have exploded around the continent, from Seattle to Toronto. A necessary piece of the solution to this complicated problem is to build more housing. Corporations, foundations, and governments are awakening to this fact. In January 2019, Microsoft announced $500M in funding for Seattle-area affordable housing4 while a Facebook-led coalition of regional employers and private foundations made a $500M commitment to fighting the Bay Area’s housing crisis.5 Many city and state governments with the most pressing crises have turned to accessory dwelling units (ADUs) as part of their solution, passing proactive legislation and revising antiquated planning and building regulations to spur ADU development.

The promise and potential of ADUs

ADUs are secondary housing units added to lots containing single-family homes. Four key benefits help ADUs stand out as one partial solution to housing crises:

1. ADUs are smaller in size, so rent for less per month—creating affordable housing without the need for government subsidization.
2. ADUs provide homeowners who build them with a new stream of income; in high-cost cities, this can keep vulnerable households in place by offsetting rising expenses.
3. ADUs are built in existing single-family neighborhoods, making them denser and more environmentally efficient—especially contrasted with new urban-spray construction.
4. ADUs share land—plus street, transit, and utility networks—with existing houses in established neighborhoods, leveraging existing infrastructure to house more people (and saving taxpayers money).

Market failure

Despite the potential of ADUs, not enough are being built. A survey of ADU early adopters suggests that it costs upwards of $200K to build an ADU, a high bar for many homeowners to cross from their personal resources. As such, most homeowners would need to finance the construction of their ADU. In theory, financing should be simple because ADUs are valuable—they both add to the resale value of a home and generate rental income. Yet, underwriting standards make it difficult for most banks to recognize this value. To recognize the resale value of the home, then there must be a comparable home in an ADU in the neighborhood which has sold recently. To recognize the rental income, the borrower must have two years of documented rental income on their tax returns. Because of this market failure, the construction of the majority of ADUs built to date has been funded by homeowners’ cash resources.6

Strategic opportunity

A handful of mission-driven, locally-focused lenders—mostly small credit unions (CUs) and community development financial institutions (CDFIs), such as the Housing Trust of Silicon Valley and Portland’s Consolidated Community Credit Union—have launched ADU-focused home loans. These loans cover construction costs with payments over a short term, typically 3 years, which fills a key gap for the homeowner by providing one year to build the ADU and two years to operate the ADU and document rental income. These loans are repaid by refinancing the primary mortgage on the home to include the balance once rental income has been established. These institutions lend with strict underwriting standards—such as requiring a contractor with experience building ADUs, form leases to protect landlords and tenants, and compliance with specified construction draw timelines.

ADU permits issued per city per year

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<th>City</th>
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<td>San Jose</td>
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Investment thesis

These lending institutions have limited resources which means they have limited ability to move the needle on the housing crisis. To infuse the market with liquidity, DoubleUp plans to purchase ADU loans from these lending institutions to create private securities backed by said loans. Securitization allows lenders to sell loans otherwise held on their balance sheets to a secondary investor market, unlocking liquidity to enable further lending.

In addition to the societal benefits of ADU proliferation outlined above, we believe that DoubleUp ADU-backed securities can:

1. Provide a wider range of investors access to high-performing rental markets without requiring large-scale participation
2. Create a mission-driven, return-generating short-term strategy for large, cash-rich corporations (such as tech companies) to manage their liquid investments
3. Prove the existence of a market for ADU lending, attracting larger institutions to the space and further enabling wider ADU penetration
4. Kickstart ADU-centric start-up ecosystems to support new jobs

Financial instrument

DoubleUp ADU-backed securities will be based on a standard asset-backed security structure, closely resembling that of private-label mortgage-backed securities. DoubleUp will utilize a special purpose vehicle (SPV) managed by our team of real estate finance experts. It will then work with CUs/CDFIs to purchase their existing asset-backed ADU construction loans. DoubleUp will package these loans into collateralized debt obligations (CDOs) to sell onwards to institutional investors.

DoubleUp has standard underwriting criteria for these second mortgages it plans to purchase that are in-line with recent regulation of CDOs. Underwriting criteria will include:

1. Interest rate of 6.75%
2. Up to $250,000 and 90% loan to cost
3. 3-year term on a 15-year amortization schedule
4. Homeowner must work with an approved ADU contractor
5. Minimum FICO score of 620-680, depending on loan amount and LTV

Market opportunity

DoubleUp’s securitization platform can easily scale with market growth. We project a multi-billion dollar total addressable market, limited initially by the size of lending programs. Initially, we would capture a fraction of total ADU construction, but we expect to scale aggressively over the next 5-10 years as the financing market grows.

McKinsey estimates that California could add up to 790,000 housing units through ADU creation.7 A Bay Area poll suggests that 25% of homeowners would be open to an ADU—which could lead to an estimated 600,000 housing units.8 Assuming an average loan size of $200K in line with reported ADU construction costs, California alone would have a $155B addressable construction lending market for CUs and CDFIs to serve.
The prospects for ADU expansion beyond California are robust. Other states, including Connecticut, Illinois, Massachusetts, Oregon, Vermont, Florida, Washington, D.C. and Washington State as well as several high-cost Canadian cities have adopted strategies to facilitate urban and suburban ADU growth. DoubleUp’s securities, like mortgage-backed securities, will be location-agnostic, allowing them to take in loans from around the country and thus participate in the expansion and diversification of the market over time.

**Program**

DoubleUp would focus initially on partnerships with CDFIs and CUs providing ADU loans in Seattle, Portland, San Francisco, Oakland, and San Jose. All five cities have large areas of single-family zoning, regulations and governmental support enabling and encouraging ADU construction, and demand sufficient to warrant lender participation.

We aim to purchase $100M worth of ADU loans in our pilot fund. We are flexible in pilot fund size based on the available loan base and investor appetite at time of execution, but believe this is achievable based on the following assumptions:

- Average loan size: $200K
- Total permitted ADUs in pilot cities: 600 / city / year
- Share of market: 16.7% (500 ADU loans worth $100M)

DoubleUp will enter into an agreements with partner CUs/CDFIs to purchase their ADU construction loans once they have amassed enough to construct each round of the security, thus avoiding costly investment banking warehouse fees. Given the strength of the market, we expect to be able to construct the first security in about 6-8 months, eventually declining to 2-4 months as the market matures.

DoubleUp will pay a small servicing fee of 0.25% of outstanding principal per month to the CUs/CDFIs to cover the cost of servicing the loans. DoubleUp will make its money in one of two ways. First, it will pay itself a management fee of 0.50% on outstanding principal. Second, DoubleUp will co-invest in 5.0% of each tranche to align DoubleUp’s interest with that of the CUs/CDFIs to cover the cost of servicing the loans. DoubleUp will make its money in one of two ways. First, it will pay itself a management fee of 0.50% on outstanding principal. Second, DoubleUp will co-invest in 5.0% of each tranche to align DoubleUp’s incentive with the success of the project and to meet Frank-Dodd Act requirements. This co-investment is projected to generate $280,000 in the first year of operations.

**Capital structure, pricing, and target investors**

- **Senior tranche** (targeting $75M, offered at $106, 3.74% interest): This tranche will be structured to meet the needs of firms seeking alternatives for secure management of liquid investments and will be particularly attractive to large firms in high-cost cities (e.g., $1B+ tech firms such as Apple’s Braeburn Capital and Microsoft/PFIF) that stand to benefit from association with support of solutions to their local housing crises. The payments will follow a standard payment waterfall and will benefit from around $25 million of credit enhancement from the lower tranches more than enough to cover conservative assumptions regarding default, prepayment, and other risks. Additionally, this tranche will benefit from covenants that will accelerate cash flows towards the senior and junior tranches, in the case cash flows fall below the contracted rates, including an interest coverage test and collateralization tests.

**Risks and mitigations**

**Type**

**Risk**

**Mitigation strategy**

**Financial**

- Real estate market volatility in high-cost regions that could result in decrease in increased loan default.
- Correlation of defaults.
- Diversification to markets in different geographic regions, including multiple West Coast cities in the pilot, and expanding nationally thereafter. Tranching based on risk/return profiles, specifically consolidating risk in mezzanine tranche for investors that have that risk appetite.

**Policy**

- Cities are slow to adopt zoning and regulatory changes to expand ADU feasibility.
- Start pilot in multiple cities simultaneously that have recently adopted ADU-friendly regulations and programs; expand thereafter as regulatory barriers in other cities are reduced. (dozens are in the process)

**Market**

- Assessors of houses after ADU construction do not account for full value of ADU, hurting the homeowner’s ability to refinance.
- CUF/CDFI provide short-term loans that allows homeowners to build and begin leasing ADUs, which provides a bridge to the two-year rental income standard that Fannie Mae requires to include ADU rental cash flow in primary mortgage financing. Home appraisal standards may similarly shift as ADU market grows.

**Operational**

- Successful construction of ADUs relies too much on individual homeowner’s ability to implement.
- The underwriting standards of CUs/CDFIs mitigate this risk. We have reviewed a term sheet from a prospective partner CDFI; their requirements included that the borrower contract with an experienced ADU designer/builder, successfully complete an ADU workshop and property management class (or engage a third-party PM), and have permitted plans.

- There is little renter protection considering this new dwelling type and new landlords.
- Similar to the standards mentioned above, homeowners might be required by loan terms to use a standard lease and are restricted from setting the ADU lease above 100% AMI (including utilities) during term of loan. Additionally, underwriting criteria could require the homeowners add additional, specific insurance to cover the ADU, a product that is increasingly available.