The Promise and Pitfalls of Accessory Dwelling Units as an Affordable Housing Panacea

Lead article from Housing News Report by ATTOM Data Solutions

A paucity of affordable housing that threatens to inflame a burgeoning homelessness crisis and trigger an exodus of well-paying jobs is forcing local governments to consider creative solutions to this intractable problem.

One such solution is to streamline the development of accessory dwelling units (ADUs) in the hopes that real estate developers and single-family homeowners can create more affordable housing inventory one granny flat at a time.

A trio of California laws that took effect in January 2017 is one example of such an attempt to streamline ADU development. The laws (SB 1069, AB 2299, and AB 2406), encourage cities to ease some of the common hurdles to the permitting and building of accessory dwelling units (ADUs) — also known as granny flats, in-law units or just second units — most notably parking requirements, setback requirements, and utility connection fees.
An Accessory Dwelling Unit Memorandum published in December 2016 by the California Department of Housing and Community Development claims that these "changes to ADU laws will further reduce barriers, better streamline approval and expand capacity to accommodate the development of ADUs."

The legislation certainly appears to be accomplishing its goal of accommodating the development of ADUs. Statewide in California, building permits for ADUs increased 63 percent in 2017 compared to 2016, the biggest increase among 20 states with at least 100 ADU building permits issued in 2017, according to an ATTOM Data Solutions analysis of building permit data from Buildfax. Nationwide, building permits for ADUs were unchanged in 2017 compared to 2016.

California had the most ADU building permits issued in 2017 of any state, with 4,352, followed by Oregon (1,682), Washington (1,110), Florida (944) and Maryland (872).

“As affordability worsens, the incentive for homeowners to build ADUs becomes greater. But the cities just have to let them. That’s the only barrier,” said Holly Tachovsky, CEO at Buildfax, who noted that the rise in ADU building permits in some inventory- and affordability-challenged cities reflects a larger trend she has noticed in remodeling in the wake of the Great Recession. “Americans are now spending more money remodeling homes than they are building new ones. This flipped in 2009 and it has stayed flipped since then. The previous trend in all of recorded data before that — decades and decades — was new construction dollars were more than remodeling dollars.”
Money" in ADUs

Among 30 California metropolitan statistical areas analyzed, the biggest increase in ADU building permits was in Santa Barbara (up 314 percent). Three other Southern California cities posted increases in the top five among the state’s metro areas: Oxnard-Thousand Oaks-Ventura (up 179 percent); Los Angeles-Long Beach-Anaheim (up 127 percent); and San Diego (up 71 percent).

One Southern California developer smells opportunity for a new niche in real estate development thanks to the state’s legislative changes.

"I think there’s a ton of money to be made in these ADUs," he said, asking not to be identified by name in the article to prevent other investors from copycatting his strategy. "It’s sort of like a gold mine. You don’t want to tell the other miners where to look."

The Southern California developer was willing to provide a general, high-level outline of his strategy to the Housing News Report. He said he dove into the legislation and determined which type of streamlined ADU would work best for him as a developer and then identified cities that have a large number of properties with good potential for that specific type of ADU and are most accommodating to ADU development.
"Go where they are going to roll out the red carpet for you," he said, noting that some cities have resisted the statewide legislation. He highlighted Inglewood as one city that refused to issue any ADU permit in 2017 — confirmed by the ATTOM analysis of building permit data from Buildfax. "There are other cities that actively want this type of development. Go do development there."

The ADU Advantage
Focusing on ADUs provides real estate investors a competitive advantage on several fronts, according to the Southern California developer.

First, it provides a less risky alternative for investing in a housing market boom that has overstayed its welcome.

"We are far closer to the top of this real estate cycle than we are to the bottom ... how can we get in and out of things quickly so if the party ends we aren't left holding the bag," he said, noting that ADU development allows for this because it typically involves little or no actual addition of square footage. "The envelope is already there so the construction time is relatively short compared to adding square footage from scratch."

Secondly, because most homeowners and other investors aren't familiar with the law, they often undervalue properties that are prime for ADU development.

"Most developers don't know the ADU law exists. Homeowners don't know it exists ... it isn't priced into the home," said the Southern California developer, adding that most flippers avoid oversized homes, but those overdeveloped homes could now be good candidates for a streamlined ADU. "You can't just keep doing the same thing all the time and expect the world is going to remain the same."

Addressing Affordability
Lastly, the Southern California developer also believes the end-product of a home with an ADU will be in high demand in highly unaffordable housing markets such as Southern California.

"In certain demographic pools, multi-generational housing is common and coveted. Now we've just given them a legal way to do it," he said.

"It could allow some people to get into neighborhoods that they otherwise could not afford," he continued, noting that as of January 1, 2018, Freddie Mac will allow income from an ADU to be counted when qualifying for a mortgage. "When you're done with it you're going to have two properties to rent rather than one."

The promise of more affordable housing inventory with streamlined ADU development was echoed in the December 2016 memorandum published by the California Department of Housing and Community Development.
“ADUs are a unique opportunity to address a variety of housing needs and provide affordable housing options for family members, friends, students, the elderly, in-home health care providers, the disabled, and others,” the memorandum reads. “Further, ADUs offer an opportunity to maximize and integrate housing choices within existing neighborhoods.”

![METROS WITH MOST 2017 ADU BUILDING PERMITS](image)

step further, Los Angeles County last year launched a pilot program to incentivize homeowners to build ADUs to house the homeless. The program, approved by the LA County board of Supervisors in August 2016, allows qualifying homeowners to receive up to $75,000 to construct an ADU — as long as they agree to rent to formerly homeless individuals, according to Curbed Los Angeles.

**ADU Pitfalls in Portland**

But the promise of ADUs as a solution to homelessness or even affordable housing has fallen flat further up the coast in Portland, according to local real estate investor and developer Justin Grubb.

“Portland is one of those cohesive love-thy-neighbor, liberal type of towns. Let the homeless guy live in your backyard. But there was a certain naivete to letting someone live on your property,” said Grubb, managing partner with Bulldog Capital, a real estate investment firm based in Portland.

According to Grubb, Portland made a big push for more ADUs about three to five years ago, promoting them as a way to create more affordable housing in the city.
"They discounted the cost for permitting the ADU. They really were encouraging them," he said, noting that his firm initially jumped on the ADU bandwagon. "We were doing them, we were putting ADUs in the basement; we weren't even doing stand-alones."

But then some realities hit for homeowners and real estate developers — particularly in predominantly single family residential areas attractive to families, according to Grubb, who said that because single family homes in Portland tend to fall on the smaller side, it severely limits the size of the ADU that could be built given that an ADU cannot exceed 30 percent of the existing home’s square footage.

"If I have a 1940s home that is 900 square feet, there’s not much you can do," said Grubb, adding that homeowners with children quickly cooled to the idea of having a stranger living in their backyard, even if that stranger represented a source of rental income. "A lot of people may see it as a rosy upside, but you don’t want to deal with it every day; especially if you have children you don’t want strangers living in the backyard.

"People thought they could Airbnb these things, but then they found out that this wasn't legal to do or if you did it you had to pay hotel tax, and that kind of wilted it a bit," he added. "It all depends where your home is and who your client is. As far as homeowners building ADUs on their lots, I think it’s more of a nice-to-talk about sort of thing."

Grubb recounted that he recently acquired two similar properties, one with an ADU and one without. The one without an ADU sold quickly for $775,000; the one with an ADU is still on the market listed at $759,000.

"Three years ago people were asking for ADUS. Now three years later I have an ADU and I can’t sell it," he said.

Grubb noted that ADUs continue to be popular in parts of Portland that already have more dense development and cater to younger, creative types.

"They absolutely do want an ADU. There are two different types of generations. The families, they don’t want it. Those in the gentrifying areas, they want the ADU and they want top rent for the ADU," he said, recalling a recent property with an ADU that he sold. "The one I did was four stories high, ADU behind the back. Those areas have always been must-have ADUs."

The continued popularity of ADUs in select parts of Portland is evident in the building permit data from Buildfax, which shows ADU building permits in the greater Portland metro area increased 21 percent in 2017 compared to 2016. Portland’s 1,540 ADU building permits in 2017 were the most of any metro area nationwide, ahead of Los Angeles, Washington D.C., San Francisco and Seattle.

Still Hopeful in Seattle

Building permits issued for ADUs increased 20 percent in Seattle in 2017 to 845, according to the ATTOM Data Solutions analysis of Buildfax building permit data.

Bryan Copley would like to see at least two zeros added to that ADU building permit number.
Copley, CEO and co-founder of CityBldr, a company that identifies underdeveloped properties for homeowners and developers, estimated that about 10 percent of the approximately 762,000 properties his firm has analyzed in the Seattle area are good candidates for streamlined approval of ADUs.

"The goal here is to look at every single home...you have homes that have a big back yard and you can put accessory dwelling units in that," he said, explaining that CityBldr is in the midst of a pilot initiative in Seattle to streamline the creation of ADUs on a larger scale by using data to quickly identify "single family homeowners with a lot that we can automatically approve ... we are looking at parcel shapes, topography, distance to transportation, things like that."

Copley said the initiative, which he has dubbed Add a Unit, rose out of talks with local governments about how to solve the problem of housing affordability without taxing developers or requiring developers to build a certain amount of affordable units — a policy which often backfires by pushing developers to build elsewhere.

"As prices go up and the margins on developable land goes down, we've got to create market-based solutions, and I think one of the best market-based solutions are ADUs," Copley said. "It's great for the property owner; it's great for the city because we are creating new homes, and these ADUs are kind of a good bridge to homeownership."

Tachovsky, the Buildfax CEO, said she was part of a housing council in her hometown of Austin, Texas tasked with finding solutions to the affordability crisis there. The council landed on ADUs as one of the best solutions.

"In order to keep the soul of our city, we had to figure out how to address affordability in our city," she said, acknowledging that ADUS are a fairly "narrow solution to the affordability crisis...(but) I think it's the best solution I've heard of out of any of them because it's a market-based solution which is usually better than government-based solutions."

Zoning Roadblocks
Copley noted that three of four visitors to the CityBuilder website own properties that don't have zoning for multi-family, limiting the development options for those properties. But ADUs are one option still available for single family zoning.

"(Streamlined ADU development) could drastically increase the housing stock in places like Seattle, Portland, LA, the greater Bay Area ... all of those are great areas for creating ADUs," he said. "I could see this as being the next housing revolution."

Matthew Gardner, chief economist with Windermere Real Estate in Seattle, agrees that zoning limitations are a hurdle to more affordable housing inventory in the region.

"Without a doubt Seattle has an issue," said Gardner, noting that 68 percent of the city is zoned as single family. "That might have been appropriate in the 1980s. Is it appropriate now? Absolutely not."

But Gardner doesn't believe streamlining ADU development — which he noted the city of Seattle is proposing — will significantly solve the housing inventory and affordability problems the area is facing.

"If it offers any help at all, it's going to be de minimis. Every little bit helps but I don't see it as any form of panacea," he said, adding that more aggressive zoning changes that allow for much denser housing development is more likely to make an impact. "You can put five or six single family homes on an acre if you can find it. Or you can put 18 to 22 townhomes. We've got to densify the land."

Stacked Development in Portland

Justin Grubb, the Portland real estate investor and developer, said market forces have pushed him to denser development. His company started out several years ago with fix-and-flips of existing properties, then moved to new construction, tearing down properties and rebuilding them as luxury homes. But he found the nearly million-dollar price points on those homes were getting too rich for buyers.

"When you sit on a million-dollar property for a few months waiting for a buyer, you get a little nervous," he said, noting that he was building on lots zoned R-1, which allow for as many as 1 unit for every 1,000 square feet. "I've got all these great lots, we're not maximizing density and it really was looking like the market was saying this was too much money."

So Grubb pivoted his strategy and started focusing on building smaller complexes of up to 15 units, depending on the lot size.

"I think stacked development makes sense," he said. "We're doing three-story, four units on each level. I'm trying to get as large of units as possible ... nobody wants to live in IKEA. The goal is just to make smaller and smaller pieces and make it more affordable.

"Put in a little less house and a little more building in there; we could still hit our numbers," he continued. "You've got to be able to pivot."
or Die?
That evolution from fix-and-flipper to full-fledged real estate developer is a common trajectory in recent years, according to Ross Hamilton, CEO with Connected Investors, an online community for real estate investors.

"A lot of fix-and-flip real estate investors are going to become builders. ...not necessarily because they want to but out of necessity," Hamilton said. "There is a lot less competition to get a lot and to build on it. And the profits are a lot more predictable."

A bonus to Grubb's new strategy: investors in higher-priced markets looking to cash out of their investment properties there started contacting him.

"We started getting 1031 money contacting us like crazy," he said. "They are able to buy a lot more here than they are in other areas. Maybe I roll out of a duplex in LA or San Francisco. I have enough money from that rollover that I can buy a new construction multi-unit building that I'm building (in Portland)."

Gardner said "classic NIMBYism thinking" is keeping Seattle from a bigger push toward denser housing development. But he warned that thinking could lead to harmful long-term impacts for the region.
"At what point do we become too expensive? At what point do companies say I can create my widget in Boise, Idaho, where it is significantly cheaper," he cautioned. "Both from a demand standpoint as well as from a demographic standpoint, zoning should not be the same as it was 30 to 40 years ago. The world is changing."

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