

Subject: *This* is why we have empty commercial spaces!

From: Seth Peterson
Sent: Thursday, May 22, 2025 8:32 AM
To: Planning <Planning@a2gov.org>
Subject: *This* is why we have empty commercial spaces!

Hi Planning Commission,
Many of you are probably familiar with why so many of new ground floor commercial spaces sit empty, but I was not and I was completely perplexed about it until I read this article:

<https://www.strongtowns.org/journal/2025/5/21/why-do-commercial-spaces-sit-vacant>

It is a great explainer as to what the problem is and, I would think, worth sharing with the community in some form. I'm not sure what the solution is, but the more people aware of the problem, the more likely we might find one. I appreciate all your time working to improve our community.

Thank you,
Seth Peterson

Why Do Commercial Spaces Sit Vacant?

Andrew Burleson · May 21, 2025

This article was originally published, in slightly different form, by Strong Towns Chairman Andrew Burleson on his Substack [The Post-Suburban Future](#). It is shared here with permission. Image provided by the writer.



This post was inspired by a question that another Substack blogger received earlier this month. I felt that his answer started off on the right track, then veered off course. So I decided to write my own response.

To start, here's the question that inspired this post:

Can you explain why it makes economic sense for landlords in high-priced metros to keep commercial real estate empty for years at a time? ... I understand there's a

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The short answer is both simple and surprising: In many cases, lowering the rent on a building will **force the bank to foreclose on it**.

Foreclosure is very bad for both the bank and the operator, so both parties would rather “extend and pretend,” leaving the building vacant while they wait and hope for the market to change.

This seems absurd. Surely everyone would be better off if they just lowered the rent and got some use out of the building — getting *some* rent must be better than getting *no* rent, right?

Intuition fails because normal people think of a building as a building, when in the majority of cases, a building is not a building but a financial product. Behavior that makes no sense for a building can make perfect sense for a financial product.

To understand this, I’ll offer a simplified explanation of commercial real estate, and the “extend and pretend” dilemma.

Commercial Loans Aren’t Like Residential Mortgages

The first reason our intuition fails us is that very few normal people buy and sell building-sized financial products — or financial product-sized buildings. But most of us will buy or sell a home, or know people who have. This gives us some intuitions about how “property” works:

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- Home mortgages are mostly based on the *purchaser's* ability to pay.
- Thanks to extensive federal government programs, most residential mortgages are long-term amortized, meaning they're designed to be fully paid off by regular payments over time.

These ideas lead us astray because *none of this* applies to the commercial, or “income-producing” market. For commercial property:

- The value is determined by the income the building will produce.
- The loan is based on *the building's* ability to pay.
- Loans are typically short-term balloon notes, meaning they are *not* designed to be fully paid off by regular payments over time.

Let's walk through a toy example to explain how these three factors can lead to an “extend and pretend” situation.

What Is a Building Worth?

The story starts with a building operator and a bank deciding what a building is worth. To figure this out, the operator is going to make a financial model that projects the income that a building will generate.

First, the operator forecasts that the net rent (after expenses) will be \$1 million per year.

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percentage of the building's value that it will generate in income each year. So, if we say the cap rate is 5%, that means the building will generate 5% of its total value as income each year.

The operator forecasts the building will generate \$1 million a year in net rent. If that's 5% of the building's value, then its total value is \$20 million ($\$1\text{M} / 0.05 = \20M).

If that's confusing, another way to think of the cap rate is the "payback time" for the investment — $100 / \text{cap rate}$ (as an integer) = payback time: $100 / 5 = 20$ year payback.

You may wonder how the cap rate is determined. The simple answer is the owner and the bank negotiate and agree on a number.

The important thing to understand here is that the actual building is not an important part of the value calculation. We're not really looking at the replacement cost, the unique design, the amenities, the location, etc. Those things influence the assumptions about the gross rent we can get or the cost of operating the building (higher cost means less net rent), but at the end of the day it isn't *the building* that has value, it's the *income stream*.

Terms of the Loan

We've decided that our income stream (aka building) is worth \$20 million. Now let's make a loan.

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...and security, in most persons, and commercial loans are risky, so the terms they can offer are designed to limit risk.

First, the [loan term will be shorter](#) than a residential mortgage, anywhere from 5-20 years, with most in the 5-10 year range. Second, the bank must keep a strict loan-to-value (LTV) ratio — so they won't lend more than 80% of the value of the building (and often less than that).

For this example, let's assume the bank offers an 80% LTV loan, with a 5-year term, interest-only at 4%.

That means the building operator has to pay \$4 million, and gets \$16 million from the bank, to buy the building for \$20 million. They then have to pay \$640k in interest every year, and in five years they have to either pay off the \$16 million balance or refinance it. (The plan will be to refinance.)

The operator buys the building and gets to work filling it with tenants.

The Rent Is Too Damn High

Now suppose that three years into this project it turns out the building operator was wrong, there isn't enough demand at the building's high rent, so the building is 50% vacant.

Half empty, the building is only generating \$500k per year in net income instead of \$1 million.

The owner is paying \$640k in interest, therefore losing \$140k per year operating the building. That sucks, surely he should [lower the rent](#), right?

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Now the net rent is \$700k. The owner is still paying \$640k on the loan, therefore earning \$60k per year. So everyone is better off, right?

Wrong!

Remember, the building isn't a building, it's an *income stream*. Before, the operator and the bank had a model that said the operator would be able to make \$1 million per year. Now, *reality has proven* the operator can only make \$700k per year.

700k per year is not worth \$20 million. Given our agreed-upon cap rate of 5%, this proven \$700k per year income stream is only worth \$14 million ($\$700K / 0.05 = \$14M$).

An Upside-Down Building

In this scenario, the building has proven to only be worth \$14 million, but the operator owes \$16 million to the bank, so he is now \$2 million underwater on the loan. In two more years, he'll have to pay off the full \$16 million, and he doesn't have that much cash, so he'll need to refinance.

Since the building (income stream) is worth \$14 million and the bank can only lend 80% LTV, the maximum new loan will be \$11.2 million, meaning the owner has to put another \$4.8 million cash in to keep the building ($\$16M - \$11.2M = \$4.8M$).

The hard truth at this point is that the operator overpaid, and the most logical thing to do would be to walk away from the

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It also *really sucks* for the bank, because the bank now has an asset (the loan) they paid \$16 million for and can only sell for \$14 million, so the bank is also taking a \$2 million loss in this scenario.

The thing is, both the operator and [the bank can do this math](#) too, so they know this is coming and want to avoid it.

Extend and Pretend

When year five rolls around and the loan on the building comes due, both the original bank and the owner would like to avoid losing a combined \$6 million. And so long as the operator can afford to keep losing \$140k per year on the building... they can!

What they need to do is stick to the original model. **Don't lower the rent.** Just claim that there was a blip in the market, nobody could have seen that coming, it's all going to be fine.

The bank can offer to extend the operator's loan on the original terms, based on the original model, and give the income stream more time to materialize.

The only sticking point here is that the building operator is still losing \$140k per year. But remember that, if he gives up, he loses the \$4 million he's already put into the building. Even if he ended up paying \$140k per year for 10 years before things turned around, losing \$1.4 million is still better than losing \$4 million.

This Sucks, What Could We Do About It?

A reader asked if I could add “some thought about an alternative to the status quo, because the situation we have is CLEARLY suboptimal.”

Honestly, I don’t think there’s a simple fix here.

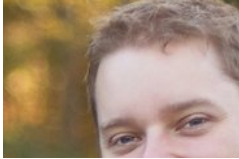
Financialization means we have way more capital available to [build much bigger](#) and nicer buildings than we did in the past. But it turns buildings into financial products. It’s not obvious to me that we could stop that without also killing the supply of capital to build and buy large buildings. I can’t guess how that would play out, so I also can’t say if it would be worth it.

The obvious thing cities could try is to put more pressure on building operators to fill their spaces, but the building operators are already under a ton of pressure — they’re losing a bunch of money! So, cities could do something like put a [vacant storefront tax](#) and... make them lose even more money? If that “worked,” the mechanism would be to force a lot of commercial property to default, which could put a lot of new space on the market at lower prices, which should lower the commercial rent. But it would also hurt the banks a lot, which has a history of leading to bad consequences and subsequent bailouts.

I’ll give this some more thought, but if any actual commercial real estate professionals have ideas, I’d love to hear from you



**And come back tomorrow for a response article by
commercial real estate developer Seth Zeren.**



Andrew Burleson

Andrew Burleson has served as Chairman of the Board for Strong Towns since 2014. Andrew's professional work has spanned several fields, from newspaper publishing and urban planning to real estate and financial technology. Before Strong Towns, Andrew founded the Houston chapter of the Congress for the New Urbanism in 2009, and he met Chuck Marohn through CNU. Andrew has been a key advocate for Strong Towns' evolution from an engineering-centric blog to a broader, movement-building organization. Andrew lives in Denver, Colorado, with his wife and four children.





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John Hawkins

19 hours ago

I think we need to stop accepting the banks whining that they are untouchable. If they can't be held accountable for their mistakes without damaging society as a whole, then we should consider them undesirable entities.

If they don't want to be considered undesirable, they need to stop externalizing their costs.

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Reply 



Earthbound and Down → John Hawkins

10 hours ago

The most likely result is they'd avoid making those mistakes in the future -- by no longer making commercial loans in that area. Redlining, basically.

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Reply 



Dustin Pieper

20 hours ago

Don't a lot of building owners offer temporary assistance, like "Free rent for the first 3



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