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WSJ: Tobacco Bonds Feel Heat From E-Cigarettes.

Hit to Traditional Cigarette Sales Threatens Revenue Flows that Back Securities

John Miller isn't quitting tobacco bonds, but the growth of electronic cigarettes means he might get burned.

Mr. Miller, co-head of fixed income at Nuveen Asset Management LLC, which oversees about $90 billion in municipal bonds, is among those buying even as a steeper-than-forecast drop in smoking and the increased popularity of e-cigarettes threaten the revenue that backs the securities. In 1998, tobacco companies agreed to settle lawsuits by paying states to offset the health-care costs of smoking, with the payments based on shipments of cigarettes.

Some states and municipalities from New Jersey to California sold tax-exempt bonds backed by that money, including many zero-coupon bonds that don't pay interest until maturity. The settlement was reached long before the existence of e-cigarettes, which aren't included in any payments.

Mr. Miller still sees the debt as a bargain, saying borrowers will have plenty of cash to make scheduled interest payments even if smoking continues its decline. He has spent about $50 million to add California tobacco bonds to the Nuveen High Yield Municipal Bond Fund this year. Mr. Miller likes the fact that the bonds are easily tradable even though declines in smoking mean he risks not being paid back on schedule.

"Estimates of the average lives of the bonds and final maturities can lengthen and shorten depending on a variety of events, e-cigs being just one, but are very likely to be repaid eventually given enough time," he said.

He isn't alone. Bill Gross's Total Return Fund, the largest bond fund in the world with $229 billion in assets, holds about $301 million of tax-exempt debt from Ohio's Buckeye Tobacco Settlement Financing Authority, as well as tobacco bonds from California and West Virginia. The Pacific Investment Management Co. fund increased its exposure to tobacco bonds in 2013, according to Morningstar Inc. data. A high-yield fund at BlackRock Inc. increased its exposure to tobacco bonds in the first four months of this year, according to Morningstar.

"Tobacco bonds can provide yield in a low-rate environment, and the sector offers some liquidity at a time when supply is scarce," said Timothy Milway, a director and credit analyst at BlackRock. Pimco didn't respond to a request for comment.

The interest in the junk-rated securities underscores the risk some investors are taking in a bid to boost income at a time of low interest rates and uneven economic growth. High-yield debt backed by tobacco companies' settlement payments is the best performing sector in the $3.7 trillion municipal-bond market. It has returned 16.5% this year, which includes price appreciation and interest payments, compared with 9.3% for all below-investment-grade municipal bonds, according to Barclays.

Still, the $87 billion tobacco-bond market has been hit in recent years by faster-than-expected declines in smoking, which has reduced payments. Now, some analysts said the rise of electronic cigarettes could lead to further shortfalls and eventual defaults by tobacco-bond issuers.

The prospectus for a 40-year tobacco bond issued by Ohio in 2007 was among those that cited a study estimating a 1.8% annual decrease in cigarette use. Instead, consumption has declined at an annual average of 3.3% since 2000, according to Moody's Investors Service, which said in 2012 that about three-quarters of the tobacco bonds it rates may default if smoking continues to decline at 3% or 4% a year.

In a report last month, Moody's said that the rapid growth of electronic cigarettes and other smokeless tobacco products could further reduce cigarette shipments. The market for electronic cigarettes and other vaporizing devices is expected to reach $2.5 billion this year, up from $1.8 billion in 2013, according to Wells Fargo. The market could surpass the projected $78 billion in sales this year of traditional cigarettes within a decade, according to Wells. That has got tobacco makers, including Altria Group Inc., Reynolds American Inc., and Lorillard Inc., moving into the market.

"Over the years, we've witnessed demand for combustible cigarettes drop steadily year in and year out, and that's prior to the introduction of what can be considered a competing product," said Robert Amodeo, head of municipal debt at Western Asset Management Co., which manages about $30 billion in state and municipal debt and doesn't hold tobacco bonds.

Others said the price of the securities already accounts for the growth of electronic-cigarette alternatives. "The amount of stress, both from the decline in consumption as well as the prospects of the competition of e-cigarettes, is priced into the marketplace in our view," said Hector Negroni, co-founder of hedge fund Fundamental Credit Opportunities in New York. He declined to discuss the fund's tobacco holdings.

Credit-rating firms in 2003 downgraded a variety of tobacco-settlement bonds, leading investors to sell the bonds and states to delay issuing new debt. States have since adjusted expectations for smoking declines when selling bonds or refinanced debt to account for drops in traditional cigarette sales. In March 2012, Alabama sold about $93 million in tobacco debt, maturing from one to nine years, that will default only if sales fall more than 25% each year. Minnesota and Illinois have also sold bonds that can withstand declines of about 9% a year.

Bill Newton, acting director of finance for the state of Alabama, said the bonds refinanced existing tobacco debt at lower interest rates after data predicted continuing declines in smoking. Electronic cigarettes weren't considered, he said.

Not all observers believe that usage of e-cigarettes will continue to increase. Morgan Stanley said in an April report that electronic cigarettes "are clearly not a disruptive technology."

Meanwhile, lawmakers in states including New Jersey and Minnesota are taking measures to tax electronic cigarettes like traditional tobacco products, which could reduce growth.

"Something that might slow this down is if more legislation gets implemented to tax or ban e-cigarettes, which would be beneficial to the sale of combustible cigarettes," said BlackRock's Mr. Milway.

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Updated June 24, 2014 9:05 p.m. ET