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California Taps Investors' Craving for Yield With Tobacco Bonds.

- Tobacco debt beat the market four times in past five years
- Buyers snap up bonds after Trump rout as yields scarce

California's taking advantage of investors' taste for tobacco.

Tobacco bonds are returning 10 percent this year, over seven times that of the municipal market as a whole, as buyers itching for yield pick up the securities and drive prices higher. California on Thursday plans to sell \$619 million to refinance a portion of a deal from a decade ago.

The new securities, which are backed by payments from tobacco companies under a settlement based on nationwide cigarette shipments, come just days before smokers in California will see state taxes on each pack jump to \$2.87 from 87 cents on April 1.

"This is probably the top" of the market for tobacco bonds, said Alan Schankel, a managing director at Janney Montgomery Scott. "There's not a lot of supply. Yields are hard to find."

Tobacco bonds have been rallying since a rout in November sparked by Donald Trump's presidential victory forced fund managers to sell the securities to meet redemptions. Tobacco bonds have outperformed the overall market four of the past five years, according to S&P Municipal Bond Indices.

Municipal high-yield funds have seen inflows for the past 11 consecutive weeks, according to Lipper US Fund Flows data. New York took advantage of the improved appetite in January by selling \$1.1 billion in tobacco refunding bonds. Some of the securities have since traded with less in extra interest, or spread, indicating demand.

The securities come with unique risk. Higher cigarette taxes have contributed to declines in smoking, and nine states are considering raising them, according to an analysis by forecasting firm IHS Global Inc. The fewer cigarettes the tobacco companies sell, the less in revenue the governments get to pay bondholders.

The firm projects cigarette consumption to drop by an average of 3.1 percent annually through 2029. National shipments of cigarettes in the year ended in December totaled 258 billion, a 28 percent decline from 2007, bond documents show.

S&P Global Ratings gave an A rating, the sixth-highest level, to the California securities maturing through 2020, and rated the longest maturities three steps lower at BBB, based partly on the credit quality of the two largest participating tobacco manufacturers, Altria Group Inc. and Reynolds American Inc.

The refinancing would lower the overall 2007 deal's carrying costs, which would improve the performance of the bonds not being taken out, said New York-based underwriter Ramirez & Co.,

which is working on the transaction.

The bulk of the offering isn't being refinanced, demonstrating there are limited arbitrage opportunities, noted Janney's Schankel. With the market expecting the Federal Reserve to continue raising rates this year, states are facing a smaller window to retire higher-cost tobacco bonds.

Last year, \$474 million in bonds were issued, compared with \$2.7 billion in 2013, data compiled by Bloomberg show.

"They're squeaking out these refundings," Schankel said.

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