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Tobacco Refundings Erode High-Yield Muni Debt, Squeeze Investors.

NEW YORK (Reuters) – A series of big tobacco bond refundings is reshaping the U.S. municipal junk bond market, taking what has been a high-yielding staple and slowly turning it investment grade.

The change means that investors are increasingly struggling to find the same high yields in comparable securities, a problem compounded by even more investors flowing into the asset class.

"One of the largest sectors in the high-yield universe is shrinking," said William Black, senior portfolio manager at City National Rochdale in Chicago.

The specialized bonds stem from a 1998 settlement with cigarette makers, which agreed to make annual payments to U.S. states to cover medical costs of sick smokers.

Over the intervening years, at least 21 states and territories, and separately some cities, securitized that stream of money by selling municipal bonds backed by the expected payments.

Since the start of 2016, states and cities have refunded more than $6.2 billion of their old tobacco bonds, according to Thomson Reuters data. Some of the deals are transforming junk-rated debt into investment-grade assets and squeezing high-yield investors.

When that money is returned to investors in a tobacco refunding, it is harder for them to find similar places to put it back to work.

"Mutual funds, along with the ETFs… are looking at the likelihood of seeing cash backing into the portfolio when these bonds are called away and not having a lot of choices for replacement," said James Colby, who manages muni ETFs for VanEck.

In Colby's custom high-yield reference index, the weight for tobacco is 15.25 percent, down from 20.70 in January 2016. The shrinkage is a direct result of tobacco refundings, he said.

Tobacco bonds comprised 15.5 percent of the S&P Municipal Bond High Yield Index at start of 2016 but have now fallen to 14.4 percent, a 7 percent decline.

Compounding the crunch is strong demand for high yield muni funds, with investors pouring money in for eight straight weeks and causing more people to chase after fewer tobacco bonds.

Flows into high-yield muni bond funds have been positive every year since 2014, with $7.5 billion of inflows last year alone, according to data from Lipper, a Thomson Reuters unit.

Those investors are likely chasing yield. The S&P Municipal Bond Tobacco Index returned 8.40 percent over the past year, compared with just 3.17 percent for the broader high yield index and 1.64 percent for the overall AMT-free national muni bond index.

For a factbox of refunding deals, click here:

PHOENIX FROM THE ASHES

In 2007, issuers sold $16.9 billion of tobacco bonds altogether, the biggest year of issuance on record, according to Thomson Reuters data.

Most bonds are callable after a decade, so some of these deals are coming back for reworking since last year’s 10-year anniversary.

Another $10.4 billion was issued in 2005 and 2006, adding to the pile of tobacco debt now being refunded.

For an interactive graphic of tobacco bond issuance, click here: tmsnrt.rs/2I3Joph

The same firm – Jefferies LLC – has underwritten every tobacco deal since 2016. Jefferies declined to comment.

Over the years, many tobacco bonds have been downgraded as more smokers than anticipated quit. That is because revenues to the states from the 1998 settlement are based on the volume of cigarettes shipped.

But now, the ratings are moving back up as old bonds get reworked.

The high ratings have mostly been driven by new cash flow structures and, in some cases, higher payments from the tobacco companies after the resolution of legal disputes, S&P structured finance analyst Christine Dalton told Reuters.

New Jersey refunded $3.15 billion of tobacco bonds in April, exchanging speculative ‘B’ rated debt for investment-grade bonds. The deal will generate $162 million in present value savings for the state, said New Jersey Treasury spokeswoman Jennifer Sciortino.

The state could use the cash. The second-lowest-rated U.S. state, New Jersey needs nearly $1.6 billion of tax hikes to cover its spending needs next fiscal year, Governor Phil Murphy has said.

States can benefit from using one-time revenues – like from a refunding – for one-time expenses.

“If there’s money on the ground, you can’t blame someone for bending over to pick it up,” said S&P public finance analyst David Hitchcock.

by Hilary Russ

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