California Tobacco Bond Sale a Hit With Investors.

California on Tuesday had little trouble selling $380 million in municipal bonds backed by revenue from tobacco companies, even as litigation deepens over a payment dispute related to the companies' lost market share.

Taking advantage of low interest rates, the Golden State Tobacco Securitization Corp. will use proceeds from the sale to refinance a portion of about $3.1 billion of tobacco bonds issued in 2005. On Tuesday, a 2030 bond was initially offered with a yield of 3.78%, but California lowered it to 3.70% later in the day, reflecting good demand from investors. Bond prices move inversely to yields.

The bonds will be backed by payments from tobacco companies, including Philip Morris USA Inc., Reynolds American Inc. RAI +1.15% and Lorillard Tobacco Co., LO +0.86% to the Golden State under a 1998 settlement agreement. That agreement resolved health-related claims by 46 states against the tobacco companies, and payments are based on annual cigarette shipments in the U.S. Many other states have also sold bonds backed by the tobacco payments.

Tobacco bonds, however, have run into some trouble in recent years. Cigarette consumption declined faster than expected in the wake of the recession, and last summer, Moody's Investors Service MCO +1.09% said it expected about three-quarters of the tobacco bonds it rates to default should consumption continue to decline 3% to 4% annually. New tobacco bond sales recently have built in a bigger buffer, with larger annual declines needed before the bonds default.

Still, with extra risk comes extra yield, and that has attracted some investors to tobacco bonds at a time of low interest rates. The S&P Municipal Bond Tobacco Index has returned 2.15% so far this year, compared with the broader S&P Municipal Bond Index, which has returned only 0.61%.

California's bond deal Tuesday is considered more secure than other tobacco bonds because it also carries an "appropriation pledge" from the state, meaning California promises to put money in its budget to pay the bonds back if tobacco revenue isn't enough. The tobacco bond deal was rated A2 by Moody's, single-A-minus by Standard & Poor's Ratings Services and triple-B-plus by Fitch Ratings.

As a result, the price of the California tobacco deal is more closely tied to California state bond prices in general. State bonds have generally increased in value relative to the rest of the market after voters approved tax increases in November; though the bonds took a hit last month when the state brought a $2.5 billion deal to market.

Initial pricing Tuesday had the California tobacco bonds offering about 40 basis points, or hundredths of a percentage point, in extra yield compared with regular California state bonds. Michael Schroeder, chief investment officer at Wasmer Schroeder & Co., said that seemed fair. Typically, he said he would expect California tobacco bonds with the appropriation pledge to trade with between 25 to 50 basis points of extra yield over state bonds.

"We'll probably focus on it for our California portfolios," said Mr. Schroeder, whose firm oversees

$3.5 billion in municipal bonds, adding that it is cheap enough to consider for non-California accounts as well.

Bill Black, who helps manage the $7.2 billion Invesco High Yield Municipal Fund, said the fund would likely skip the California deal because yields were too low. But he said the fund added some tobacco debt to its portfolio last year, noting that a December agreement between some states and the tobacco companies over a disputed portion of the payments is generally positive for the bonds. The dispute centered on a provision in the original agreement that allowed the tobacco companies to reduce their payments if they lost market share and certain other conditions were met.

Under the accord reached in December, the 17 states and two territories signing on will get 54% of their share of the money in dispute. At least one state, however, has moved to derail the agreement: Colorado filed a motion in state court to vacate the settlement, according to bond documents.

“What’s fun about tobacco bonds is it’s a never-ending story,” said Mr. Black, adding that he expected the settlement will ultimately go into effect. “You’re always looking for the next thing to try and figure out what’s going on.”

California’s tobacco deal follows a $170 million tobacco-refinancing issue from South Dakota’s Educational Enhancement Funding Corp. earlier this year. Louisiana is also looking into refinancing more than $800 million in outstanding tobacco debt.

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