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Drop in Smoking Threatens Embattled Tobacco Bonds.

A bearded man in a fisherman's sweater leans back in his swivel chair and adjusts his headset. He skims the computer screen that displays caller information.

"That's a really good product," he says to the voice on the other end. "But did they talk to you about the possible side effects?"

The operator is one of several dozen employees at the Illinois Tobacco Quit Line, a $2 million-a-year call center on the western outskirts of downstate Springfield, Ill.

The 85,000 calls the center handled last year reflects a steady drop in tobacco use.

But while the downturn in smoking is good news for cancer rates and tobacco-related deaths, it could soon mean trouble for municipal bond investors.

Tobacco taxes, e-cigarettes and a decline in smoking threaten the viability of tobacco bonds, already one of the weakest areas of municipal debt.

As security for the sale of the bonds, many states pledged future revenue from a 1998 lawsuit settlement, known as the "Tobacco Master Settlement Agreement."

This ended a landmark case in which attorneys-general from 10 states sued the nation's major tobacco companies seeking reimbursement of state Medicaid funds used to cover smoking-related medical care costs.

A key clause of the agreement provided for payments to states, in perpetuity, based on the volume of cigarettes sold annually.

In 2010 Illinois lawmakers used the expected cash to back the sale of $1.50 billion in municipal bonds. The bonds helped shore up a $2 billion budget deficit.

But they also marked a troubling chapter in the state's growing budget crisis, said Peter Matuszak, a senior policy analyst at the tax watchdog group Civic Federation.

"Every time you see a government borrowing or using bonds to pay for its operations, you know it's in terrible shape," he said.

While Illinois landed the fifth-largest settlement — initially projected at $9.12 billion through 2025 — payouts have increasingly dwindled as smoking rates decrease.

The payments are adjusted each year for inflation and market share, so as cigarette sales have declined, so have payouts from tobacco companies.

From 1998 to 2013, Illinois received $4.25 billion in actual payments, according to the National Association of Attorneys General. That's only 47 percent of the total payments originally projected from the settlement.

Illinois was among 10 states and Washington D.C. to issue bonds against their entire tobacco proceeds, according to Standard & Poor's Ratings Services.

Illinois' tobacco bonds — known as "Rail-splitter Bonds" — built insurance into the deal. While the state's settlement payments are set to increase by 3 percent each year, it also accounts for a 10 percent slip through 2028.

That's put the state in a better position than most tobacco bond issuers, according to Richard Larkin, director of credit analysis at Herbert J. Sims & Co.

"Illinois built in a much bigger cushion. Other states aren't as lucky," he said.

Still, Fitch Ratings Inc. currently has Illinois tobacco bonds graded at BBB-plus — "Outlook Negative" — three notches above the non-investment speculative grade ranking.

A 10 percent jump in cigarette prices would cut smoking rates by more than 3 percent, according to the Congressional Budget Office.

In July 2012, Moody's Investors Service Inc. predicted nearly 75 percent of the highest-rated tobacco settlement bonds would default if cigarette sales slipped at that 3 percent rate.

Cigarette shipments in the U.S. have dropped about 4 percent annually since 1997, according to the National Association of Attorneys General.

In Chicago, whose $7.17-per-pack tax leads the nation, cigarettes can cost close to $13 per pack.

Price hikes and health concerns have many cigarette smokers calling it quits.

Kate Silver, a freelance writer in Chicago, smoked cigarettes — Marlboro Light 100s and later Camel Light 99s — on and off for a decade.

"I thought nothing of standing in triple digit temperatures to smoke a cigarette in the summer," she said. "Cigarettes started to feel like a leash that kept tightening."

After repeated attempts to quit, she finally succeeded after distancing herself from friends who smoked and "wasn't around any temptations."

Other smokers have instead trended toward other tobacco products, such as battery-powered nicotine inhalers, "e-cigarettes.

That shift could also jeopardize the future of the bond repayments, Larkin said.

Since e-cigarettes were not included in the settlement, cigarettes for all major companies will continue to lose market share as the product gains popularity.

That would mean even less money from the settlement payments, which accelerates the odds that some states will default on bond obligations.

E-cigarette use could jump up to 50 percent in the next year, according to Fitch.

Bloomberg Finance LP reported in October that worldwide e-cigarette sales could surpass traditional cigarettes by 2040.

A slip in tobacco settlement income could also impact the programs they currently fund.

Tobacco companies paid Illinois about $300 million last year in settlement payments, approximately half of which went to Medicaid funding.

Much of the rest goes toward other public health programs, according to the Illinois Office of Management and Budget.

And as tobacco settlement coffers tighten, those programs could also face budget cuts.

At Evanston Township High School, slated to get $39,258 this year in settlement money, administrators plan to launch several wellness programs.

The initiatives could include body-mass index measurements in gym classes and health seminars for staff, said William Stafford, chief financial officer at the school.

“We get the fact that it’s from the settlement and we plan to use it to improve the health of our students and staff,” he said.

But Illinois isn’t the only state with an uncertain future regarding its settlement funding. In January Moody’s placed 31 tobacco settlement bonds under review.

The ratings agency said in a statement those states could receive just 54 percent of the $4 billion in question, “significantly less than the 100 percent [they] expected.”

Twenty-two states in 2013 reached settlements on back-payments from tobacco companies, which increased total settlement income 21.6 percent, according to Fitch.

Tobacco producers had withheld more than $7 billion in payments from 2003 to 2012.

Six states lost in arbitration proceedings, while Illinois, in September, was among nine states that won.

But it could be a double-edged sword. As more states win arbitration, their refunds will increase, which could reduce as much as 65 percent of their normal annual settlement payment, Larkin wrote in a September report.

“If you’re a tobacco bond holder, you’re smoking in the wind,” he said.

BY MATT MCKINNEY

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