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Slowing Cigarette Sales Could put Virginia Tobacco Bond Payments at Risk.

The company that funded Virginia's tobacco commission is spending more money than it takes in, which could leave some big investors feeling burned because they bet people wouldn't quit smoking as fast as they have.

But the Virginia Tobacco Settlement Financing Corp.'s red ink isn't likely to be a headache for the state or its tobacco commission. When Virginia sold investors a half-interest in the annual payments tobacco companies promised it under their multibillion-dollar settlement with states, the paperwork very carefully said the state would not be on the hook if that flow of funds wasn't as big as people expected.

And it hasn't been.

The Settlement Financial Corp. paid Virginia more than $1 billion in return for half the tobacco companies' annual payments to the state. To finance that payment, the Settlement Financial Corp. sold bonds – it raised about $1.2 billion in 2007 by selling bonds with a face value of just over $2 billion, but marketing them at a deep discount to that face value. That translated to a return to investors of nearly 9 percent on its tax-exempt bonds – about twice the rate on U.S. Treasury bonds – and nearly 11.7 percent on its taxable bonds, assuming they are repaid in full in 2047.

That's not looking too likely these days, said Evelyn R. Whitley, the state's director of debt management, who oversees the financing corporation's operations.

Virginia's not alone. In a recent report, Moody's Investor Services estimated that 80 percent of the $97 billion that states raised by selling similar bonds won't be repaid in full if cigarette sales slow even more.

The big cigarette companies have been making smaller payments to states than most experts had forecast when the settlement was negotiated in 1998.

The reason is that smokers have been quitting or shifting to discount brands that aren't participating in the agreement in larger numbers than expected. The participating tobacco companies' payments are based on sales. Last year saw a particularly steep dip. A decline that had averaged about 3 percent a year since 2000 amounted to nearly 5 percent in 2013, in large part because of the rapid growth of e-cigarettes according to municipal bond analysts at UBS Financial Services.

That means revenue from the financial corporation's share of the state payments has been running as much as $20 million a year below the interest payments it makes on its bonds in recent years.

The corporation got a bit of breathing room in July, when it negotiated a settlement of claims from the bankrupt investment bank Lehman Brothers. That brought in a $13.6 million payment in October, and should mean additional payments in the future, Whitely said.

But shortfalls are likely to continue as more and more smokers quit, and it won’t take many years to run through the corporation’s $85 million reserve fund, which it taps when its revenue falls short of the interest it has to pay on its bonds, Whitely said.

When that happens, she said, the state has three choices:

- It can let the corporation pull the plug on itself and go into default.
- It can see if the investors who bought the bonds – mostly hedge funds and other investment pools specializing in high risk securities – might be interested in refinancing them, basically by agreeing to accept less than the face value of the bonds.
- The General Assembly could consider giving the corporation a larger share of the state’s tobacco settlement revenue.

New Jersey took that third step in March, pledging to pay investors in its tobacco bonds the remaining $60 million a year in tobacco settlement funds that it had been using for other state spending, such as the health programs the settlement was originally designed to fund.

“Investors understood the risks,” Whitely said. And with the hefty interest they’ve received since buying the bonds, “they’ve been pretty well hedged against the risk.”

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