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Tobacco Leads Yield Chase as Smoking Decline Abates: Muni Credit.

(Bloomberg) — The owners of the riskiest tobacco-backed municipal bonds would like to thank Americans who haven't quit smoking.

High-yield tobacco debt has surged 5.2 percent this year, more than any other area of munis and beating the entire market's 1.6 percent return, Barclays Plc data show. The securities, backed by revenue from U.S. cigarette shipments, are one of the few segments of the tax-exempt market where default isn't just possible — it's expected. Moody's Investors Service predicted in September that 80 percent of the bonds will fail to pay in full.

Yet there are signs the drop in consumption is waning: Philip Morris USA projects cigarette volume fell 2.5 percent in the final quarter of 2014 and 3.5 percent for the full year. That's less than the 4.8 percent average slide the prior seven years. With tobacco debt yielding more than almost all munis outside of flailing Puerto Rico, the bonds are a buy for MacKay Municipal Managers, Nuveen Asset Management and OppenheimerFunds Inc.

"People fear 5 and 6 percent declines, which are actually pretty rare," said John Miller, who oversees $100 billion of munis as co-head of fixed income at Nuveen in Chicago. "Yet the bonds are priced to account for some outsized risks like those."

Unanticipated Decline

Tobacco bonds share a revenue stream from a 1998 settlement in which Lorillard Inc., Philip Morris USA and Reynolds American Inc. agreed to make annual payments to states in perpetuity to settle liabilities for health-care costs tied to smoking. States and cities borrowed against the funds, selling $93 billion of debt when factoring in the full value of zero-coupon obligations.

The securities, particularly those issued in the first few years after the settlement accord, didn't build in the current decline in cigarette consumption. In the seven years through 2006, shipments dropped an average of 1.7 percent a year, data from the National Association of Attorneys General show. The pace of declines almost tripled in the next seven years.

That's left four out of five bonds at risk of default if declines average 4 percent annually, according to Moody's. With a drop of 3.5 percent, which Altria Group Inc., parent of Philip Morris USA, estimated for 2014 in its Jan. 30 earnings report, a smaller portion of debt will be unable to meet obligations, according to Moody's.

Buckeye Yields

Because of the threat of nonpayment, the debt is the only frequently traded part of the tax-free market that offers yields comparable with Puerto Rico, the junk-rated U.S. territory that along with its agencies has $73 billion of obligations.

For example, bonds issued by Ohio’s Buckeye Tobacco Settlement Financing Authority and maturing in June 2047 traded Tuesday with an average yield of 7.31 percent, data compiled by Bloomberg show. By comparison, Puerto Rico general obligations due in July 2041 changed hands at 8.5 percent.

At B3, six levels below investment grade, Moody’s rates the Buckeye bonds one step lower than Puerto Rico. Benchmark 30-year munis, by contrast, yield about 2.63 percent.

“Puerto Rico has so much more event risk and political risk that tobacco looks relatively better,” said Nuveen’s Miller. Nuveen usually holds from 3 percent to 6 percent in tobacco bonds across its funds, while it owns almost no Puerto Rico debt.

Payment Probabilities

In the view of Standard & Poor’s, tobacco bonds are getting safer. The company cited the pricing power of the biggest cigarette brands as lending stability, offsetting smoking declines.

Last week, the company raised 25 ratings on shorter-maturity debt, while affirming 78 and lowering one. The grades are typically based on maturity because of the risk that payments will diminish.

In some cases, the higher marks make the debt investment grade. Children’s Trust Fund tobacco debt issued in Puerto Rico and maturing in May 2039 won an upgrade to BBB- from BB+.

“The rating agencies don’t see any changes for the negative on the tobacco front,” said Scott Cottier, who helps oversee $26 billion of munis at OppenheimerFunds in Rochester, New York. “The yield you’re earning on these bonds far outweighs the risks.”

Threat Vaporized

One of the main threats to cigarette use has been the rise of alternatives such as electronic cigarettes, which emit water vapor instead of smoke. While traditional smoking fell in 2013, the use of smokeless options climbed 4 percent to a record. The yearly increase, however, was the smallest since 2009.
The threat is waning as state officials voice skepticism about claims that the products are healthier choices.

The top health official in California said in a report last week that e-cigarettes contain toxic chemicals. New York Governor Andrew Cuomo last month proposed banning the devices, which burn liquid nicotine, from restaurants, offices and anywhere cigarettes are prohibited.

Robert DiMella, who manages $13 billion as co-head of munis at MacKay, predicts tobacco debt will be one of the best-performing parts of the market in 2015. The bonds will grow in appeal as issuers refinance higher-yielding bonds with interest rates close to the lowest since the 1960s, he said. He accurately predicted in 2014 that high-yield would outperform.

With individuals adding $3.7 billion to muni mutual funds in the year’s first four weeks, Cottier at OppenheimerFunds and Nuveen’s Miller predict tobacco bonds can extend gains.
“You have a couple of tailwinds for tobacco and I don’t see anything that’s going to change those in the coming months,” Cottier said. “People feel more confident about the long-term prospects of a 2.5 percent or 3.5 percent consumption decline.”

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