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Tobacco Bond Issuers Refinance Amid Smoking Decline.

Tobacco bonds may be on their way to the biggest volume since 2007, led by Wednesday's $1.7 billion sale from California, as issuers take advantage of historically low interest rates to refinance.

Amid a decline in smoking that's cut deeply into revenue, tobacco bond issuance this year is also highlighted by a $621 million sale last month in Rhode Island and a possible $875 million deal from Louisiana later in 2015.

Under the 1998 Master Settlement Agreement, tobacco companies agreed to pay 46 states for expenses related to smoking illnesses. Many states then formed corporations to raise cash by selling bonds backed by future settlement revenue streams from the tobacco firms.

Since 1999, more than $62 billion of tobacco bonds have been sold, according to Thomson Reuters. Most of the issuance took place in 2005 and 2007 when about $6 billion and $17 billion were issued, respectively. In 2014, only about $175 million of tobacco bonds were sold. Assuming all three deals are completed, 2015 issuance would bring the most supply in eight years.

Many of the older bonds were sold when U.S. cigarette consumption was higher, boosting revenue to the tobacco companies — the basis of their payments to the states. The revenue decline combined with lowered ratings on some issues has led market professionals to look at the sector as a source of both consternation and opportunity.

"One key thing to look at with these bonds is: `Who is doing the study of cigarette demand and consumption and how accurate is it?'," said Michael C. Craft, managing director of credit at Lumesis, Inc.

Craft said that original tobacco bonds performed acceptably, based on the assumption of consumption declines. The problem is that the declines have now outpaced the predictions.

"Within the tobacco sector, the bonds that were issued earlier have better credits for two main reasons: one is that the financial structure and degree of leverage was conservative," he said. "The other is that they have had a chance to pay down some of the bonds before factors became an issue, such as [non-participating manufacturer] adjustments and more rapid decline in consumption."

Legal experts caution investors to know what they are buying — both now and in the future.

"Whether investors are buying new bonds in the primary or existing bonds in the secondary, they would be well advised that after doing their credit analysis to look at the bond indentures," Leonard Weiser-Varon principal at the law firm of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo told The Bond Buyer. "They should look at the plumbing as to determine what the true risks are in what they are getting."

Both Weiser-Varon and colleague Paul Ricotta also foresee some legal skirmishes ahead.

"Many expect debt service defaults on some tobacco bonds to occur within the next five years," they wrote in a March 18 Bond Buyer commentary. “Although such defaults have not yet occurred, it is not too early for holders to take a hard look at the applicable bond documents to evaluate their rights and leverage in the restructurings or refinancings that have begun and which may proliferate in the years ahead.”

Rhode Island Roughhouse

On March 11, Citigroup Global Markets priced the Rhode Island Tobacco Settlement Finance Corp.’s $621 million of asset-backed bonds. But the bonds weren’t issued without a legal fight.

OppenheimerFunds Inc., in its capacity as a holder of Series 2007 B and C bonds, had filed a suit to halt the sale. It had argued the offering wrongfully created an amendment of the 2007 indenture and would have constituted a fraudulent transfer intended to circumvent a subordination structure.

In January, a judge dismissed the suit. The new issuance resulted in a $36 million payment to the corporation and the state, said Timothy Mungovan, a partner in the law firm of Proskauer Rose who represented the TSFC. The state is expected to save almost $1 billion over 40 years, he added.

Citi priced the TSFC’s $15.26 million Series 2015A taxables at par to yield 0.59% in 2015 and 0.80% in 2016. The bonds were rated A by Standard & Poor’s and triple-B-plus by Fitch Ratings. The TSFC’s $288.64 million Series 2015B were priced at par to yield 2.25% in 2041, as 4 1/2s to yield 4.625% in 2045 and as 5s to yield 4.80% in 2050. The bonds were rated triple-B-plus by Fitch.

The TSFC’s $317.05 million Series 2015A tobacco settlement asset-backeds were priced to yield from 0.46% with a 3% coupon in 2016 to 3.81% with a 5% coupon in 2030; a 2035 term was priced as 5s to yield 4.09% and a 2040 term was priced as 5s to yield 4.34%. The bonds were rated A by S&P and triple-B-plus by Fitch except for the 2026 to 2030 and 2035 maturities which are rated A-minus by S&P and the 2040 maturity which is rated triple-B-plus by S&P.

According to the Municipal Securities Rulemaking Board’s EMMA website, the TSFC’s Series 2015A 5s of 2040 were last traded on March 18 at a low yield of 4.14%.

California: Different, Yet the Same

This week, California’s Golden State Tobacco Securitization Corp. will be coming to market with its $1.7 billion tobacco bond deal.

The bonds are enhanced by a pledge from the state to seek an annual appropriation for debt service and operating expenses should settlement payments fall short. Proceeds will be used to repay existing tobacco bonds that do not benefit from a pledge from the state and so are more vulnerable to a shortfall in settlement payments.

“My sense is that the ‘state backed’ tobacco bonds trade more like state debt (particularly state appropriated), than like ‘pure’ tobacco bonds,” Craft said. “The investors in these bonds are exposed to MSA payments only if the state doesn’t meet its appropriation obligations to bondholders.”

The asset-backed bonds, scheduled to be priced by Citi on Wednesday after a one-day retail order period, are rated A1 by Moody’s Investors Service and A by both S&P and Fitch.

The Golden State Tobacco Securitization Corp. originally sold tobacco settlement bonds in 2003 to provide one-time resources for the state general fund under two separate, parity indentures, according to Fitch. The master indenture for series 2003B, to which 43.43% of the state’s future tobacco settlement revenues under the master settlement agreement are pledged, was enhanced with the state appropriation backup. The other bonds originally issued under a separate 2003A master indenture do not carry the state appropriation enhancement.

The official statement for the $1.7 billion for the CGSTC offering includes a research report prepared by James Diffley, a senior director at IHS Global Inc., that forecasts a continued decline in U.S. cigarette consumption through 2045.

"Our forecast indicates that total consumption in 2045 will be 104.0 billion cigarettes (or 104.6 billion including roll-your-own tobacco equivalents), a 61% decline from the 2014 level," the report said. "From 2015 through 2045 the average annual rate of decline is projected to be approximately 3.0%."

The report includes key factors affecting cigarette consumption such as electronic cigarettes, medical cessation benefits, price elasticity of demand, disposable income and smoking bans, to name a few.

The report also stated that in April 2013, IHS Global presented a similar study — a forecast of U.S. cigarette consumption (2012-2045) for the Tobacco Settlement Financing Corporation. That report projected consumption in 2045 of 105.7 billion cigarettes (including roll-your-own equivalents), reflecting an average decline rate of 3.0%.

"The difference, 1.1 billion, is primarily due to weaker than expected consumption in 2013," according to the report.

Louisiana TSFC Gives Preliminary Bond OK

The Louisiana Tobacco Settlement Financing Corp. is moving ahead to securitize the remaining 40% of the state's share from the Master Settlement Agreement with tobacco companies.

The deal, in which $875 million of bonds would be issued to raise funds for the state's higher education scholarship program, still must be approved by the Legislature and other state agencies.

Louisiana securitized 60% of its tobacco settlement revenue in 2001 with the sale of $1.2 billion in bonds. The agency will retain the same finance team that worked on a $660 million tobacco bond refunding in 2013. The professionals on the 2013 deal were Public Resources Advisory Group Inc. as financial advisor, Citi as senior underwriter, and Foley & Judell LLP and Hawkins Delafield & Wood LLP as co-bond counsel.

The new securitization is expected to go before the State Bond Commission April 16, and the Joint Legislative Committee on the Budget May 20. A bill authorizing the deal is expected to be filed and assessed in the legislative process. If lawmakers approve the issuance, the bonds likely would be sold in June.

Rating Agencies Perspectives

In May 2014, Moody' Investors Service published a report on the impact of declining cigarette shipments on U.S. tobacco settlement bonds. Moody's based the projections of declining shipments (4.9% in 2013) and performed a break-even analysis that estimates the annual rate of decline in cigarette shipments that would lead to bond defaults under its base-case cash flow assumptions. Moody's expects that 65%-85% of the aggregate outstanding balance of all tobacco settlements bonds that Moody's rates, will default.

Earlier this month, Standard & Poor's released a rating direct presale report on the tobacco settlement financing corp. Series 2015. S&P conducted a cigarette volume decline test, which is intended to assess the transactions ability to withstand steeper than historical average annual declines in U.S. cigarette consumption. S&P used the cash flow assumption that cigarette shipments will decline 5.25% in the transactions first year two years and 4.75% thereafter.

“Based on our calculations, the results of our `standard’ stress tests indicate that all rated classes in this transaction were able to withstand the rest, with a sizeable cushion to absorb additional potential disruptions or reductions of the MSA payments,” the report stated.

Market Performance, Trading

Tobacco bond performance has been characterized in general by stability in between bouts of volatility combined at times with illiquid trading conditions.

“Liquidity has been an issue lately for tobacco bonds,” an analyst at Markit said. “The usual factors pressuring tobacco are decreased consumption and credit risk. The latest pressure is now the uncertainty as to when the Federal Reserve will increase rates.”

Looking at two separate issuers, the Buckeye Tobacco Settlement Financing Authority, Ohio, and the Golden State Tobacco Securitization Corp., Calif., the patterns of trading activity are similar.

The Buckeye Series 2007 A-2 asset-backed 6 1/2s of 2047 starting off 2015 trading yielding 7.54% on Jan. 2 and yielding 7.38% on March 16. The bonds traded as high as 7.535% on Jan. 5 and as low as 7.14% on Jan. 30, according to Markit.

The Golden State Series 2007 A-1 asset-backed 5 3/4s of 2047 started off the year trading at a yield of 7.11% and ending on March 16 at 6.96%. The bonds traded as high as 7.11% on Jan. 2 and as low as 6.61% on Jan. 30, according to Markit.

THE BOND BUYER

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