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Tobacco-Bond Deals Revived as U.S. States Conjure Up Budget Cash.

Almost two decades after U.S. states settled with tobacco companies on payments for health-care costs, officials are still finding new ways to tap the revenue stream to close budget gaps and fund programs.

Bond deals in the past 14 months from New Jersey and Rhode Island, and a planned offer from Louisiana, show how cash-strapped states are getting creative in using the dwindling money flowing from the 1998 accord. Yet the moves are drawing criticism from holders of older debt and officials who view the deals as budget gimmickry.

OppenheimerFunds Inc. sued Rhode Island, claiming it was diverting money from earlier bondholders. In New Jersey, Democratic lawmakers said the state's move to pledge tobacco revenue to investors in exchange for almost $92 million was a budget stunt. Louisiana's plan for more debt backed by cigarette cash is "an act of desperation," according to its treasurer.

"You're seeing aggressiveness here because it's almost like there's no downside for the state to do this," said Paul Ricotta, a partner in Boston at law firm Mintz Levin who specializes in distressed debt and restructuring. "It's a really painless way for politicians to get more cash."

Tobacco Tradeoff

In the settlement, 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 have about $94 billion of securities backed by the revenue, data compiled by Bloomberg show.

The sales gave officials cash upfront and let them offload the risk that the money would dry up as smoking rates drop. Most of the bonds get junk grades.

New Jersey, which sold about $7 billion of tobacco bonds from 2002 to 2007, adopted a new approach in March last year. Grappling with a budget shortfall, the state pledged its remaining settlement payments from 2017 through 2023 to some debt due in 2041. In return, it got $91.6 million for expenses.

The bonds rallied to an average of 24 cents on the dollar by the end of March 2014, from 9 cents the previous three months, Bloomberg data show, as investors bet the debt will be repaid on time. Standard & Poor's raised it 10 steps to A-, seventh-highest, after the agreement.

Paved Way

"New Jersey kind of paved the way for other people to say there are ways to look at restructuring outstanding bonds," said Kym Arnone, a managing director who heads tobacco securitization in New York at Barclays Plc, which handled the deal.

Rhode Island's tobacco-bond offer last month showed the risk perceived by investors. OppenheimerFunds questioned the deal, partly because the state, which projected a $190 million deficit for next fiscal year, received $30 million of the proceeds. A judge ruled in January that the issuer was within its rights to adjust the payments.

The money manager said in a statement that its lawsuit "increased value over the originally proposed bond sale."

Kimberly Weinrick, an OppenheimerFunds spokeswoman, declined to comment further.

Rhode Island tobacco bonds maturing in June 2025 priced to yield 2.99 percent, about 0.8 percentage point more than benchmark munis, in line with similarly rated debt.

Risk Seeking

Investors have sought tobacco bonds as interest rates in the $3.6 trillion municipal market hover close to five-decade lows. Junk-rated tobacco securities rallied 11.5 percent in the past 12 months, compared with 5.9 percent for all munis, Barclays data show.

"States that securitized portions or all of their Master Settlement Agreement payments in the past are looking at their outstanding debt portfolio and seeing if they can take advantage of the current low rates," said Thomas Green, head of infrastructure finance in Citigroup Inc.'s public-finance unit. The bank led underwriters on Rhode Island's sale.

Louisiana may be next. Its tobacco agency has used 60 percent of its revenue stream to back bonds, said Kristy Nichols, the commissioner of administration. It's seeking approval to use the remainder for a deal as large as $875 million to fund scholarships and coastal restoration, she said. Citigroup would lead underwriters.

Money Grab

"Market rates are good, the spreads are good, and tobacco revenue overall has some risks," Nichols said. The state would consider the deal if it can use the proceeds over seven or eight years, instead of in one shot, she said.

John Neely Kennedy, Louisiana's treasurer, said in an interview that he worries the estimated $1.6 billion deficit for the year starting July 1 will pressure officials to use the funds as a one-time plug.

"They're trying to rush this through so they can get their hands on the money to spend it," Kennedy said. "The administration can't give any assurance beyond their word that they won't dump the money into their operating account."

Louisiana last issued tobacco debt in 2013 for refinancing. With investment grades from S&P and Fitch Ratings, the securities differ from those that Moody's Investors Service projects will default, including bonds from Ohio and Virginia.

In the seven years through 2006, cigarette shipments fell 1.7 percent annually on average, National Association of Attorneys General data show. The pace of declines almost tripled in the following seven years. At a 4 percent annual decline, four of five bonds would default, according to Moody's.

Bondholders want to be paid on time. States want to make the most of tobacco funds. That's why they'll come to an agreement, Arnone said.

“Absent an additional infusion, restructuring or inflation igniting in the future, some of these outstanding bonds are not going to be able to withstand the huge smoking declines that have occurred,” she said. “People are going to be looking at alternatives to refinance more tobacco bonds.”

Bloomberg

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April 12, 2015