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Puerto Rico Sets Sights on Tobacco Bonds in Long-Shot Money Grab.

Most tobacco bonds are destined for default, including those issued by Puerto Rico. Investors just never thought it could come this way.

Included in the commonwealth's debt moratorium law passed this month: Children's Trust, a not-fo--profit entity created to issue debt backed by legal-settlement money that U.S. states and localities receive from cigarette companies. Its presence is puzzling in that unlike almost every other Puerto Rican bond, some of the tobacco securities still carry investment-grade ratings because the cash that pays investors is deemed out of the government's reach.

As Puerto Rico tries to cut its $70 billion of debt, investors are learning nothing is off-limits, with even constitutionally guaranteed general obligations staring down losses. While Governor Alejandro Garcia Padilla has yet to halt any payments — and creditors have yet to file the inevitable lawsuits — the threat of default on even the most-secure bonds by claiming police powers shows how far the commonwealth is willing to go to restructure its debt burden.

"The tobacco financing speaks in the language of true sale and trust agreements, and was created specifically to insulate bondholders from the general fund," said Matt Fabian, a partner at Concord, Massachusetts-based Municipal Market Analytics. "Legal hurdles aren't what Puerto Rico is focusing on right now."

Island's Perspective

The moratorium law is meant to give Puerto Rico the tools it needs to weather its crisis while providing citizens with essential services, said Barbara Morgan, a representative at SKDKnickerbocker in New York who represents the commonwealth's Government Development Bank.

"The inclusion of an entity, like the Children's Trust, in the act does not automatically mean these tools will be applied to that entity," she said in an e-mail.

Tobacco securities are one of the few corners of the $3.7 trillion municipal market where default isn't just possible — it's probable. They're mostly considered junk because when governments first sold them more than a decade ago to get instant cash from the 1998 settlement revenue, they didn't anticipate how quickly Americans would give up smoking.

Moody's Investors Service last projected that a 4 percent annual decline in the cigarette shipments that back the bonds would cause 80 percent of them to fail to pay on time. That wouldn't cause a default on Children's Trust debt issued in 2002, the strongest of its obligations, according to the forecast.

Money Flow

Tobacco bonds were structured as asset-backed securities, with the settlement money flowing straight to a trustee to pay the debt, rather than passing through government coffers. With so many of the obligations poised to ultimately default, states and cities have touted that they're not on the hook to make up for investor losses because of the setup.

In Puerto Rico's case, it looks like the bondholders will be the ones praising the structure.

OppenheimerFunds Inc. is by far the largest owner of Children's Trust debt, with about $9.9 billion of exposure when including the full maturity value of zero-coupon bonds, according to the most recent holdings data compiled by Bloomberg. That's 82 percent of the $12 billion in outstanding securities, held across 17 mutual funds.

Meredith Richard, a spokeswoman for New York-based OppenheimerFunds, declined to comment.

Next up are Invesco Ltd., MacKay Shields and Nuveen Asset Management, which hold $211 million, $148 million and $131.5 million in maturity value of zero-coupon tobacco bonds, respectively, Bloomberg data show. In all, at least 12 fund companies own the debt.

Bond documents for the 2008 sale of zero-coupon debt contemplate a Puerto Rico money-grab.

"It is also possible that the commonwealth could attempt to claim some or all of the pledged TSRs for itself or otherwise interfere with the security for the Series 2008 bonds," according to the documents. "In that event, the bondholders, the trustee or the trust may assert claims based on contractual, fiduciary or constitutional rights, but no prediction can be made as to the disposition of such claims."

The documents also stipulate that Citibank N.A., the master settlement agreement escrow agent, must send all money directly to Deutsche Bank Trust Company Americas, the trustee, under terms that are "irrevocable until after all bonds have been repaid."

For now, the credit raters aren't ready to change their view on the Children's Trust bonds.

"Unfortunately we're not going to be able to provide insight here," Joe Mielenhausen, a Moody's spokesman, said in an e-mail. "It's a complex legal question that we just can't comment on at this time."

Standard & Poor's is looking into how the debt moratorium affects the bonds and doesn't yet have an update, said April Kabahar, a spokeswoman for the credit rater.

Sandro Scenga, a spokesman for Fitch, didn't return a voicemail or e-mail seeking comment. It's the only credit rater to give investment grades to all of Children's Trust's 2002 debt.

Some of those securities that mature in May 2033 rallied Wednesday, trading at an average 100 cents on the dollar, the highest since April 12, data compiled by Bloomberg show. With the shortest maturity of all outstanding obligations, they're the only ones to carry investment grades from all three credit raters.

In some ways, Puerto Rico's tobacco securities are like its sales-tax debt, Fabian said. The bonds, known by the Spanish acronym Cofina, had long been a favorite of investors because they had a first claim on sales-tax revenue.

Now Cofina bondholders would recover just 57 percent in the commonwealth's latest restructuring proposal. Otherwise, the debt would likely stop paying on Feb. 1 because of the moratorium law, according to S&P.

“Puerto Rico has been flouting the rule of law for the last 12 months or so — I can’t tell you they wouldn’t try to take” tobacco-bond funds, said Jason Diefenthaler, who runs a $106 million high-yield muni fund at Wasmer Schroeder & Co. in Naples, Florida. “It’s tough when you have such a political outcome determining the forward direction of a situation like Puerto Rico.”

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