Okay to inhale

In health-conscious America, there are fewer and fewer smokers. And on tapering-fretful Wall Street, there are fewer and fewer bond bulls. These facts being understood, we write to extol the speculative merits of certain tax-exempt securities backed by cigarette sales and protected from inflation. Complex and controversial, tobacco bonds are high-yielding for a reason.

In 1998, the four big tobacco companies, on the one hand, and 46 states, the District of Columbia and U.S. territories, on the other, entered into an agreement to settle the outstanding litigation between them. Philip Morris, R.J. Reynolds, Lorillard and Brown & Williamson comprised the big four, a.k.a., the “original participating manufacturers.” Since the settlement, another 40 manufacturers have signed on—call them, as the lawyers do, the “subsequent participating manufacturers.”

The “master settlement agreement,” or MSA, is the name stamped on this détent. It directs the companies to pay $9 billion a year, before applying a variety of adjustments, into a trust to compensate the plaintiff governments for the costs with which cigarette smoking has burdened them. Over the past 12 years, 22 states and some municipalities have issued securitized claims on anticipated MSA-derived revenue; $34 billion worth at face amount are outstanding.

Though states issue tobacco bonds, the credit of those states has nothing to do with the quality of the securities. Cigarette sales, rather, furnish the cash flows (it would therefore be a good thing if the currently solvent and profitable big cigarette makers remained that way). The wrinkle is how those sales—and, thus, required payments into the MSA-related trusts—are to be adjusted.

It’s not as simple as just writing checks. The $9 billion annual base payment is adjusted for inflation, tobacco consumption and the tobacco companies’ success (or lack thereof) in retaining market share, among other factors. Further complicating the situation is slow-drip litigation between the states and the manufacturers, as well as the advent of electronic cigarettes. There are two good reasons to try to penetrate the legalistic fog: the high proffered yields and the formidable inflation armor.

In 1998, 3% seemed a reasonable expectation for the annual minimum rate of increase in the CPI-U; accordingly, payments due from the manufacturers are slated to rise by the greater of 3% or the inflation rate in the year preceding the payment date. One may think of this as low-cost protection against the 21st-century paper dollar going up in smoke.

In 1998, tobacco consumption had already been falling for 17 years. In calculating the payment formula, the parties negotiated what they judged to be a reasonable allowance for continuing declines in cigarette smoking. The question is whether they were conservative enough. The formula for adjusting the cash flows to the MSA is not so interesting. More relevant—and for the would-be investor, more sobering—is the accelerating rate of decline in tobacco consumption. A “base volume” of cigarette shipments was written into the law in 1998; it was 475.7 billion cigarettes per annum. A measure of the success of the
A pack of tobacco bonds (in $ millions)

<table>
<thead>
<tr>
<th>issuer</th>
<th>coupon</th>
<th>mat. date</th>
<th>issue date</th>
<th>par out</th>
<th>rating</th>
<th>tax-ex</th>
<th>price</th>
<th>yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Railsplitter Tobacco Settlement (Ill.)</td>
<td>6.00%</td>
<td>2028</td>
<td>2010</td>
<td>361</td>
<td>A-/BB+</td>
<td>federal</td>
<td>$109.32</td>
<td>4.55%</td>
</tr>
<tr>
<td>TSASC (NY)</td>
<td>5.00%</td>
<td>2026</td>
<td>2006</td>
<td>138</td>
<td>B+/BB-</td>
<td>fed/state</td>
<td>82.98</td>
<td>7.07</td>
</tr>
<tr>
<td>Buckeye Tobacco Settlement (Ohio)</td>
<td>5.13%</td>
<td>2024</td>
<td>2007</td>
<td>842</td>
<td>B3/B-/B-</td>
<td>fed/state</td>
<td>83.66</td>
<td>7.40</td>
</tr>
<tr>
<td>Golden State Tobacco Securitization (Cal.)</td>
<td>5.00%</td>
<td>2033</td>
<td>2007</td>
<td>611</td>
<td>B3/B-/B-</td>
<td>fed/state</td>
<td>74.87</td>
<td>7.46</td>
</tr>
<tr>
<td>Tobacco Settlement Financing (R.I.)</td>
<td>6.25%</td>
<td>2042</td>
<td>2002</td>
<td>372</td>
<td>Ba1/BB/BBB-</td>
<td>fed/state</td>
<td>92.37</td>
<td>6.87</td>
</tr>
<tr>
<td>Arkansas Development Finance</td>
<td>5.25%</td>
<td>2041</td>
<td>2001</td>
<td>8.3</td>
<td>A1</td>
<td>fed/state</td>
<td>100.16</td>
<td>5.24</td>
</tr>
<tr>
<td>Niagara County Tobacco Asset Securitization</td>
<td>6.25%</td>
<td>2040</td>
<td>2001</td>
<td>15</td>
<td>Baa3/BBB+</td>
<td>fed/state</td>
<td>88.29</td>
<td>7.30</td>
</tr>
</tbody>
</table>

Source: The Bloomberg

national anti-smoking juggernaut is that, in 2012, shipments totaled only 290 billion. And now come e-cigarettes.

Tobacco bonds have been issued in a variety of structures and maturities. Typically, revenue is apportioned to different classes of securities in hierarchical, or waterfall, fashion. First claim is interest on all the coupon bonds, senior and subordinated. Available cash is next apportioned to redeeming the serial, or bullet, maturities. Remaining funds go to redeeming the so-called turbo bonds in the order of their maturity. Last in the queue for dollars are the zero-coupon bonds, a.k.a., capital-appreciation bonds; they get nothing until all senior maturities are repaid. California, New Jersey, Virginia, Michigan and Ohio are among the foremost issuers of CABs.

Ohio’s 2007-vintage Buckeye Tobacco Settlement Financing Authority bonds make a good illustrative case. The issue comprises $211 million in senior bonds ($72 million of which have already been redeemed), $5 billion in turbo bonds ($130 million of which have been redeemed) and $319 million, face amount, of zeroes. The senior revenue bond due 2017, which carries an investment-grade rating from three agencies and is exempt from federal taxes (and from state taxes for Ohio residents), trades at 106.35 to yield 3.09%. At the other end of the credit spectrum, the Buckeye zeroes of 2047, which Fitch rates single-B-minus, are quoted at 3.2 to yield 10.7%—they came to market at 5.94 to yield 7.25%.

“Date of issuance matters for credit quality,” colleague Charley Grant observes. “In general, securities that came into the world in the early part of the decade are likely to pay off by maturity or sooner, whereas issues from 2006 to 2008 were structured with a lower margin of safety. Examples of the latter, higher-risk vintage include the 2006 New York City TSASC 5s of 2026, quoted at 82.98 to yield 7.07%; the Golden State Tobacco Securitization Corp. 5s of 2033, quoted at 74.87 to yield 7.46%, and the Buckeye 5s of 2024, quoted at 83.66 to yield 7.4%. Examples of safer and saner bonds—ones that could withstand a much steeper plunge in tobacco consumption—include the Illinois Railsplitter 6s of 2028, quoted at 109.32 to yield 4.55%, or the Arkansas Development Finance Authority 5s of 2041, quoted at par.”

Could smoking go the way of dueling, medicinal bleeding or bearbaiting? Governments the world over seem determined to snuff it out. Thirty states, the District of Columbia and Puerto Rico have banned smoking from the workplace, including restaurants and bars. The New York City Council just voted to raise the minimum age for buying cigarettes to 21. The mayor of Chicago, Rahm Emanuel, is proposing to lift the city’s $3.68 per-pack excise tax to 75 cents. As it is, a pack of Marlboros in the south Loop will set you back $11.95. In lower Manhattan, the price is $12.71. Loosies—cigarettes sold illegally by one—fetch between a quarter and a dollar each. And now the Web site of Americans for Nonsmokers’ Rights is on the rampage about a here-tofore unknown menace it calls “third-hand” smoke, e.g., the kind you smell on the sweater you wore to the party the night before. Since the MSA went into effect in 1998, cigarette shipments have declined at a compound annual rate of 3.18%. In 2009 and 2010, respectively, they plunged by 9.2% and 6.5%.

Nor does this exhaust the list of reasons a risk-intolerant investor might choose to steer clear. The tobacco companies do not passively remit funds to the MSA but pay lawyers good money to find reasons not to remit them. For instance, the basic agreement protects participating cigarette manufacturers against competitive inroads made by producers who operate outside the MSA. By law, the latter must remit escrow payments in the approximate sums required of MSA participants. Whether or not such funds are duly paid in—it’s the states’ responsibility to collect them—is a matter of controversy. If an arbitrator finds that a state’s failure to enforce the law has caused economic loss to a participating manufacturer, that manufacturer is entitled to recoup some or all of its payments to the MSA; about $2.5 billion remains in escrow for disputed payments.

“Some idea about the pace of conflict resolution is suggested by the fact that an arbitration panel’s ruling about $1.1 billion in disputed 2003 MSA payments was handed down 10 years later—just two months ago, in fact,” Grant relates. “It happens that New York, Ohio, Illinois and Iowa, all with tobacco bonds outstanding, were among the winners. But a half-dozen states lost at arbitration, though none is a tobacco-bond issuer. Richard Larkin, director of credit analysis at the Fairfield, Conn., bond house of H.J. Sims, contends that—based on continued 4% per annum declines in tobacco consumption, and inflation remaining below 3% per annum—several tobacco-bond issuers will suffer at least partial defaults.

“It certainly didn’t help that the bankruptcy of Lehman Brothers resulted in the voiding of the state’s guaranteed investment contracts,” Grant goes on. “When these contracts and their mid-single digit yields evaporated, MSA payments had to be invested at post-Lehman money market rates. Ohio, along with Virginia and California, was forced to draw down cash reserves to make an interest payment. Which explains why when you punch up the Buckeye 5s on a Bloomberg terminal, the machine answers with a red flashing message on the
What might cause the light to stop flashing? A bout of inflation could do the trick. The mandated inflation adjustment—the greater of 3% or the year-over-year rise in the CPI-U—is that most prized feature among value-seeking investors, namely, the free, or low-price, option. In this case, it’s an option on the inflation-seeking economists featured in a *New York Times* story of a couple of weeks ago finally getting their wish (Grant’s, Nov. 1).

Another bullish possibility concerns the aforementioned tussle over that $2.5 billion escrow fund. To the holders of a “leveraged” tobacco security—that is, a bond that will be hard-pressed to redeem on time if the falloff in cigarette smoking accelerates much beyond the 3.5% or 4% rates seen so far—receipt of a few hundred million dollars in a legal settlement can spill relief. Ohio’s victory in the September arbitration ruling, which will boost the state’s 2014 MSA receipts by 11.9%, gave a 15-point lift to the Buckeye 5/16s of 2047. Before the news, the bonds changed hands at 62.61 to yield 9.6%; today, they trade at 77.62 to yield 7.7%. Another arbitration victory, this one for New York State, produced an even bigger rally in New York City’s TSASC 5/16s.

Then, too, cigarette smoking may or may not decline by 4% a year until nobody smokes and everybody runs marathons and eats bean sprouts. “Maybe smoking a cigarette will seem less risky in the future than it does today, either through advances in manufacturing or medicine,” Grant speculates. “Or maybe declines in cigarette consumption will level off at a rate lower than 4%.”

On this score, bulls can point to the history of American drinking. So astoundingly high was whiskey consumption in the early Republic that you wonder how the pioneers found the Allegheny mountains, let alone crossed them. In 1851, Maine passed a prohibition law, and by 1855 a dozen states had followed suit. There was a second, better-remembered experiment with national prohibition between 1920 and 1933. Per-capita alcohol consumption fell over the course of the centuries, but it never went away. May-