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THE BOND BUYER

Tobacco Bonds Could Become 'Gold Mine' in Wake of Refunding Rumors

By Elizabeth Albanese | 07-19-2005

DALLAS - Tobacco bond prices improved this week as rumors of impending refunding deals hit the market, with some bonds trading at yields as low as 4.2% in the secondary market yesterday.

While most of the larger trades in the secondary yesterday priced with yields in the mid to high 4.0% range, some retail trades dipped lower. Prices rose despite the fact that the Department of Justice on Monday asked the Supreme Court to reconsider an appellate court decision barring the DOJ from seeking $279 billion of past profits from tobacco companies. If the federal government were to win such a large verdict in its racketeering lawsuit against the tobacco industry, tobacco companies could find it difficult to make timely payments toward the 1998 Master Settlement Agreement.

Payments to states mandated by that agreement back the more than $27 billion of outstanding tobacco bonds issued by issuers in about 20 states.

"It's the rumors of refunding deals that has pushed these prices up," said B. Clark Stamper, president of California-based Stamper Capital & Investments. "There's a lot of upside potential because of the potential refundings - if rates go down and states refund, this outstanding paper becomes a gold mine."

On Friday, the Golden State Tobacco Securitization Corp. board authorized a debt issue that will refinance $3.3 billion of the state's double-barreled tobacco securitization bonds. The new debt will pledge lower debt-coverage ratios than the original debt issued in 2003. Officials say the deal will generate $525 million to help balance the state budget for the current fiscal year.

Dick Larkin, an analyst with J.B. Hanauer & Co., said he was concerned in looking at a draft preliminary official statement for the Golden State refunding that there was no mention of the fact that 11 small tobacco companies that pay into the MSA have asked to lower their payments for 2003 and 2004 based on lower-than-expected tobacco product shipments. In addition, the three major tobacco companies - Lorillard Tobacco Co., R.J. Reynolds Tobacco Co., and Philip Morris USA - have asked to reduce their payments for 2003.

"That's material regarding the cash flow," Larkin said. "Obviously for the investors in California, it's an enhanced deal - if the MSA revenues are insufficient, the state steps in and pays. But it seems odd that when they've disclosed everything else, the adjustments are not mentioned."

Other states are expected to offer refunding deals in the near-term.

"There's also the rumor that New Jersey will try to pre-refund some of its tobacco bonds," Stamper said. "It was written into the budget - the refunding is part of the way the New Jersey Legislature was able to balance its budget. They expect the refunding deal to generate $500 million."

In secondary market yesterday, tobacco bonds maturing in 2042 issued by the New Jersey Tobacco Settlement Finance Corp. in 2002 yesterday traded at a yield of 4.2%, down from around the 5% mark late last week.

"Yields are really compressed," Stamper said. "You can sell a low-quality bonds for a good price. The difference in the market between risky bonds and very safe bonds is incredibly small compared to the risk."

Trading of tobacco bonds in the secondary is very light compared to the amount of debt that remains outstanding in the sector, Stamper said.

"People are buying it and sitting on it," he said. "When you consider that there's about $25 billion of outstanding tobacco debt out there, trading is not at all heavy."

Other states, including Louisiana, are also considering taking advantage of current low interest rates to refund outstanding tobacco bonds. And just months after Virginia took the plunge with a new money tobacco bond issue worth $448.5 million, the Children's Trust of the Commonwealth of Puerto Rico earlier this month issued approximately $108 million of subordinate lien tobacco settlement revenue bonds in a private placement.

According to a pre-sale rating report released last week by Fitch Ratings, the debt was issued as $74.5 million of Series 2005A tobacco settlement asset-backed bonds, and $33.6 million of Series 2005B tobacco settlement asset-backed bonds. According to the report, both series are subordinate to the issuer's Series 2002 bonds, and no interest or principal payments will be made on the Series 2005 debt until the Series 2002 bonds are outstanding.

Instead, the Series 2005A bonds - rated BBB-minus by Fitch - will mature in 2050, and will accrue interest at 6.5%, compounded semiannually. The Series 2005B bonds - rated BB by Fitch - will accrue interest at 7.25%, compounded semiannually. They are subordinate to the Series 2005A bonds and no interest or principal will be paid on them until the Series 2005A bonds are repaid.

Stamper, a proponent of tobacco bonds, said that because new tobacco bonds proposed by Puerto Rico are subordinate, he probably would not buy any debt from the issue.

"I haven't seen the structure, but if the debt is subordinate to the 2002 bonds, I would bet that the downside protection is not too good from a credit perspective," he said. "I probably wouldn't buy it myself."

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