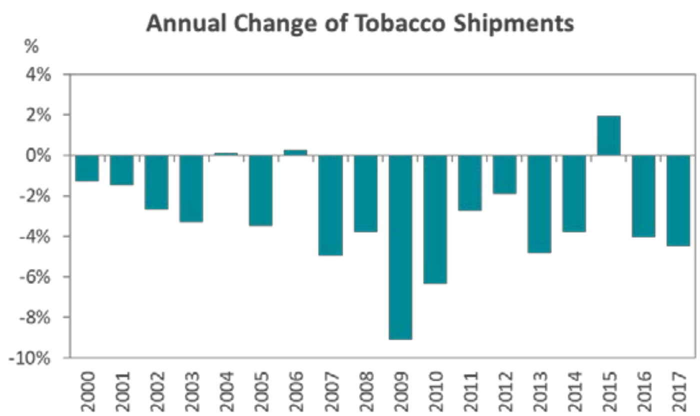
BBH Strategy Insight

May 2018

Where There's Smoke, There's Fire

In early April, New Jersey completed a landmark tobacco master settlement bond refunding by placing over $3 billion of new securities and calling all of their outstanding debt. Tobacco settlement bonds from New Jersey and other states have represented core holdings in our municipal portfolios for years. We initiated our positions in New Jersey tobacco settlement bonds in early 2014 and we were sad to see them go. While conducting our research for the new deal, we identified a number of red flags regarding the decline of structural protections and the pricing of tobacco settlement debt.

First, some brief background on tobacco settlement bonds. In the late 1990s, the attorneys generals (AGs) of 46 states settled their lawsuits with the four largest tobacco companies at the time, Philip Morris, R.J. Reynolds, Brown & Williamson, and Lorillard. The settlement featured perpetual annual payments from the tobacco companies as well as advertising restrictions. States soon began issuing bonds backed by these payments. Today, there are approximately $90 billion tobacco settlement bonds outstanding. Most states used the proceeds of these issuances to plug budget gaps instead of for their intended purpose, tobacco-related health care costs and education about the dangers of smoking.



Data reported year-end from December 31, 2000 to December 31, 2017
Source: http://www.naag.org;/assets/redesign/files/Tabacco/2018-04-26%20MSAI%20Shipments%20and%20Total%20Market%201999-2018.pdf

These annual payments are derived formulaically and are linked to tobacco shipment volumes. In other words, declines in tobacco shipments reduce revenues available for debt service. Cigarette producers and consumers have known for decades about the detrimental health effects of tobacco. Consumption in the U.S. has been declining for a long time, averaging 4% for the past decade. The single worst year of declines was 2009 when shipments declined 9.1% following an increase of tobacco excise taxes. All tobacco bonds use built-in assumptions about usage decline rates. Stronger bonds can withstand higher rates of decline than weaker ones. For example, our longest maturity Railsplitter tobacco settlement bonds from Illinois can withstand over 15% *annual* declines. Our recently-called New Jersey bonds offered similar protection.

Red Flag #1: A "scoop and toss" refunding

The catalyst behind the recent New Jersey refinancing was the opportunity to free up cash flow, rather than achieve any true interest savings, by using a budgetary gimmick known as a "scoop and toss". By extending maturities on its tobacco settlement debt, New Jersey freed up cash that would otherwise been used for short-term debt service payments. We understand why the State's new Governor, Phil Murphy, executed the maneuver. He has a broad spending agenda and is looking to raise revenues from a variety of sources: a millionaire's tax, a higher sales tax, and marijuana legalization.

It is not clear whether New Jersey's legislature will support any, let alone all, of these measures. The newly enacted federal tax reform's limitations on state and local tax (SALT) deductibility has effectively raised tax burdens for many high-earning residents of states like New Jersey. As a result, initiating new taxes or raising rates on existing taxes has become more difficult. For Governor Murphy, refunding outstanding tobacco debt was a sure thing and painless for residents.

Red Flag #2: A weak structure with fluffed-up ratings

The math of shorter-maturity tobacco bonds is usually friendly as was the case with the recent New Jersey deal. Maturities of seven years or less satisfied our criteria of remaining durable to at least a 10% annual decline in tobacco shipments. We were concerned about the weak structure supporting longer maturities and subordinates. Through a structural sleight of hand known as a turbo structure, the deal created an illusion of strength. In a turbo structure, excess tobacco payments are assumed to pay down bond principal, making the bonds particularly sensitive to changes in payment assumptions. Long-maturity senior bonds will pay off on time and in full only if tobacco shipments decline less than 7.6% a year. This is an aggressive assumption for an A-minus rated bond. Our existing bonds had the same rating and far more strength. The subordinates are weaker and require declines of less than 5.6%.

S&P's BBB ratings on the subordinate securities left us experiencing déjà vu to pre-crisis days when ratings were regularly shopped. We firmly believe these are not investment grade bonds.

Red Flag #3: A deal with very aggressive pricing

Despite their weak structure, long-maturity senior bonds only offered a yield just above 4%. The long subordinate bond, which faces a material risk of impairment, offered a paltry yield of 4.9%, a spread of only 200 basis points[1] over the AAA-rated benchmark. Irrespective of their aggressive pricing, the long subordinate bond spreads tightened significantly post-issuance, pushing their yields to below 4.4%. In our view, this reflected strong demand and perhaps a little FOMO (fear of missing out), rather than hidden value in the securities. Indiscriminate demand for muni credit is alive and well.

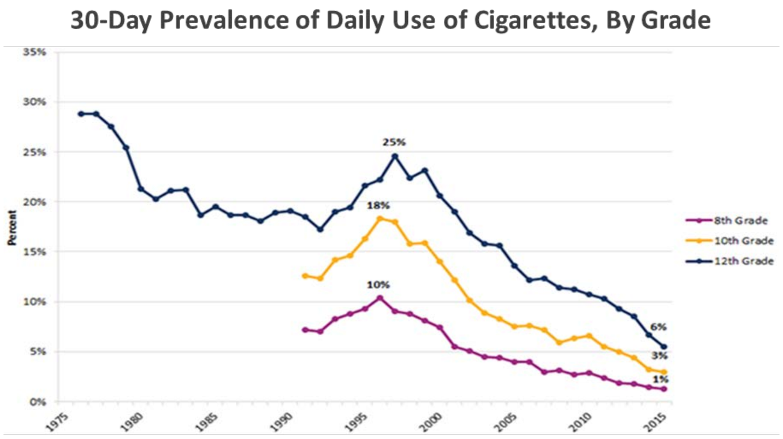
Red Flag #4: Implications for the rest of the tobacco market

When tobacco bonds were first issued during the late-1990s (legacy bonds), they were structured assuming tobacco shipment declines of below 3%. This assumption was aggressive and legacy bonds are now frequently rated below investment-grade and face likely impairment. We find it ironic that many of these bonds may never mature even though the tobacco companies have to make payments in perpetuity!

We analyzed several of these legacy bonds, including large issues from Ohio and Virginia. Our findings were disturbing. We made two major assumptions. First, based on our long-term shipment decline assumption of 5%, these bonds would not mature on schedule and thus would enter default. Second, we assumed an expected return of 6%. We acknowledge that others will have different return requirements. Given these assumptions, bond prices in the market are 25% too high. Many junk-rated or unrated, coupon-bearing tobacco bonds trade near par, and would need to fall to 75 cents on the dollar to offer a more respectable return. There are many zero-coupon legacy tobacco bonds outstanding as well, and our conclusion is similar. There are roughly $75 billion of these mispriced securities outstanding. High yield muni funds are large holders of these securities. Even though these bonds and the funds that own them have enjoyed strong performance in recent years, we advise caution.

We remain focused on owning durable credits that we purchase with attractive yield and return potential. Our original New Jersey tobacco settlement bonds fit the bill. They offered significant credit protection, high yields and were among our largest positions. Investors who own weak structures at high prices are playing with fire. Earning your return by relying on a higher bid in the future from another investor is a much different proposition than relying on conservatively-modeled cash flows.

Only time will tell. The math is not friendly and the recent Philip Morris earnings call does not bode well for the legacy tobacco bond sector. While good for society, tobacco consumption declines pose increasing risk for bondholders. The aging demographics of existing smokers, the growing anathema of smoking among America's youth, and the rise of vaping place a premium on owning strong structures. Opportunities are scarce in today's market and we look forward to when the smoke clears.



Data reported year-end from December 31, 1976 to December 31, 2015
Source: Johnston, L.D., O'Malley, P.M., Miech, R.A., Bachman, J.G., & Schulenberg, J.E. (2016). *Monitoring the Future national survey results on drug use, 1975-2015: Overview, key findings on adolescent drug use.* Ann Arbor, MI: Institute for Social Research, The University of Michigan. Retrieved June 3, 2016, from http://www.monitoringthefuture.org/pubs/monographs/mtf-overview2015.pdf

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[1] A unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument.

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