

TOBACCO SECTOR UPDATE

JANNEY FIXED INCOME STRATEGY

JUNE 22, 2011



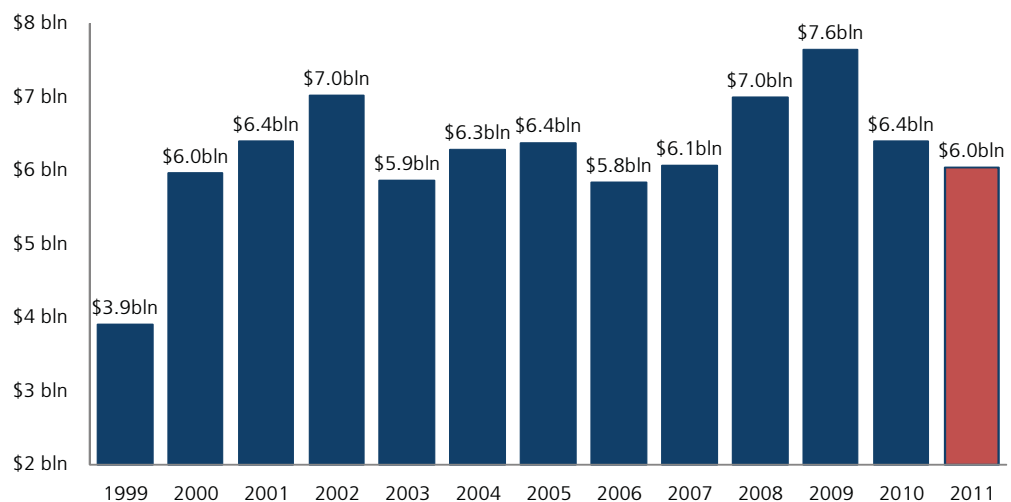
The butt of market jokes, tobacco bonds may have put the worst behind, but uncertainty continues to permeate the sector.

MSA payments dropped in 2011, but there may be better days ahead for tobacco settlement backed issues.

- MSA payments in April 2011 were the lowest in five years, impacted by declining cigarette shipments and holdbacks for NPM adjustment.
- Virginia, Ohio and California issuers announced they will tap liquidity reserves to make up shortfalls in needed revenues for December interest payments.
- We expect NPM disputes to move towards resolution, with recent reports indicating that an agreement between cigarette manufacturers and states may be close.
- Excise tax increases at both state and federal levels as well as legislation from the majority of states, restricting smoking in public places, are largely behind, with fewer new constraints expected in future.
- Tobacco settlement revenues are perpetual, and will continue to support bonds, even beyond scheduled maturity dates, if necessary.
- Bonds secured by tobacco settlement revenues are clearly in the high risk category. Future cash flows could be negatively impacted by changes in consumption, taxes and regulation.

In mid April, the National Association of Attorney Generals (NAAG), in accordance with the 1998 Master Settlement Agreement (MSA), processed its annual release of data on cigarette consumption in 2010 and the amount of tobacco settlement revenues (TSRs) distributed to states in 2011. The numbers were not favorable for tobacco bonds. Cigarette consumption declines exceeded historical and expected levels (negative for bondholders, but positive for US population health), and payments to states were lower due to declining consumption as well as Phillip Morris's decision to disperse the amount of 2008 payments by making a \$260 million deposit to the disputed payment escrow account, rather than distributing the money to the states.

MSA Payments to Support Tobacco Bonds Down 6% for 2011



Source: Janney Fixed Income Strategy, NAAG

ALAN SCHANKEL
 Managing Director
 215 665 6088
 aschankel@janney.com

See page 5 for important information and disclaimers.

JANNEY MONTGOMERY SCOTT
 www.janney.com
 © 2011 Janney Montgomery Scott LLC
 Member: NYSE, FINRA, SIPC

NON PARTICIPATING MANUFACTURER (NPM) DISPUTE

The MSA was executed by 46 state attorneys general¹ on the one hand, and four Original Participating Manufacturers (OPM)² on the other hand. Subsequently about fifty smaller cigarette manufacturers signed on to the agreement. Together they are Participating Manufacturers (PM). To protect the PMs against competition from manufacturers not making payments to states, a section of the MSA provides that Non Participating Manufacturers (NPM) be coerced by states to (1) agree to join the MSA and make payments, (2) make alternative payments to an escrow account which the state can attempt to tap to cover healthcare related expense or (3) cease the sale of cigarettes in the state. Every state passed so-called model statutes, which required NPMs to adhere to these provisions. If competition from NPMs (who can charge lower per pack prices since they don't have the expense of MSA payments) is found to diminish sales of PMs **and** if it's determined that states are not policing NPMs and aggressively enforcing compliance with model statutes, PMs can reduce payment amounts. PMs dispute whether states have been diligent in enforcement of the statutes.

Resolution of NPM disputes has been the largest uncertainty overhanging tobacco bonds. Potential NPM adjustments going back to 2003, exceed \$7.0 billion, with \$3.1 billion now held in a disputed payments escrow account. If the dispute were resolved entirely in favor of manufacturers, moneys in the escrow account plus a claw back from future MSA payments would be due manufacturers. If state attorneys general are entirely successful in arguing that they diligently enforced the model statute, then states will receive amounts now held in the escrow account in addition to future payments.

Arbitration commenced in July 2010 for \$1.1 billion in dispute over 2003 sales. A recent report suggests that resolution of the entire dispute is near, with cigarette companies receiving \$2 billion of the amount held in escrow. The agreement as outlined in a recent Wall Street Journal report, would establish rules as to how states collect fees and taxes from the companies who are not signatories of the MSA.

The report notes that a "critical mass" of states and companies will need to sign a memorandum of understanding before the final deal terms are drafted, but the broad outline, as reported, is encouraging for tobacco bond holders. For one thing, if the agreement is finalized, about \$1 billion now held in escrow should be distributed to the states. More importantly, future NPM disputes should be minimal, allowing for more predictable payment streams.

\$7 billion in Disputed Payments

Sales/Payment Year	Potential Adjustment
2003/2004	\$1,148 mm
2004/2005	\$1,137 mm
2005/2006	\$753 mm
2006/2007	\$700 mm
2007/2008	\$791 mm
2008/2009	\$920 mm
2009/2010	\$859 mm
2010/2011	\$854 mm
Total	\$7,163 mm

Source: Janney Fixed Income Strategy, NAAG

CONSUMPTION DECLINES – HOW DRASTIC?

The NPM adjustment can move payments higher or lower, but the most significant input into the amount of yearly payments is cigarette shipments in the US, as defined by the NAAG. Cigarette consumption dropped from a 640 billion "stick" peak in 1981, to below 300 billion last year. After average annual declines below 3% in the years since 2000, a July 2009 increase in the federal excise tax of 62 cents to \$1.01 per pack, drove a 9.2% consumption drop in 2009 followed by 6.4% last year. Further tax increases at the state level plus the spread of limits on smoking in public places added to the erosion in demand. Projecting cigarette consumption going forward is fraught with problems, with many variables, both predictable and unpredictable, potentially influencing consumption and revenue streams.

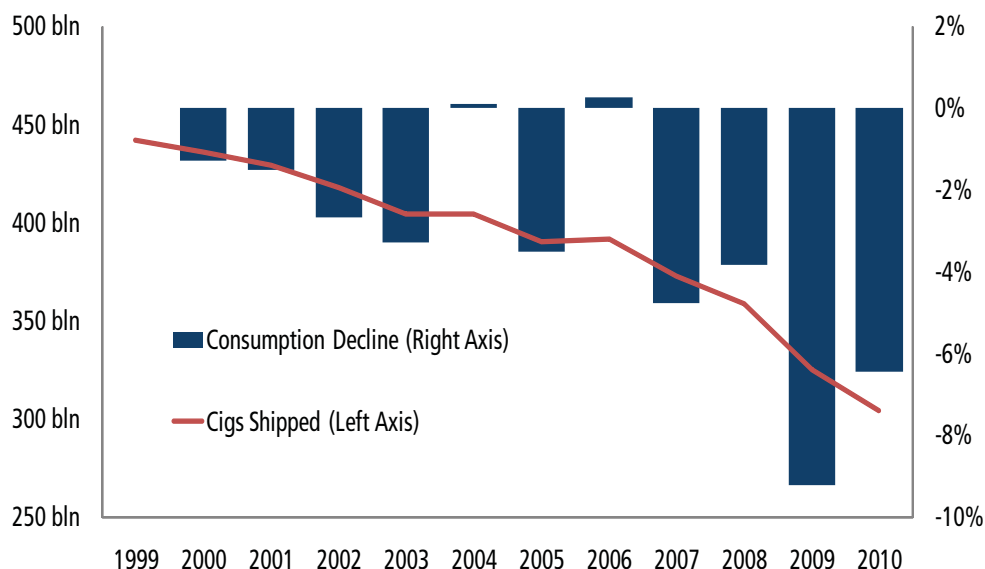
In general we believe that consumption declines will settle into the 4% annual range. A December report from Morgan Stanley projected declines of 3.5% to 4% in the near future. Modeling assumptions noted in a May Moody's report have a mean consumption decline of 4%. The significant diminishment of demand due to dramatic tax increases, particularly at the federal level, and statewide smoking restrictions will likely be less impactful in the future. According to the Center for Disease Control, as of December 2010, twenty five states and DC have comprehensive smoke free laws, while another eigh-

1 The District of Columbia, Puerto Rico and several territories are also signatories to the agreement. Florida, Minnesota, Mississippi and Texas settled their cases separately.

2 OPMs are now three due to merger of R J Reynolds and Brown & Williamson

Potential NPM adjustments going back to 2003, exceed \$7.0 billion, with \$3.1 billion now held in a disputed payments escrow account.

Consumption Declines Have Far Outpaced Forecasts in Recent Years



Source: Janney Fixed Income Strategy, NAAG

One of the most unusual aspects of the MSA settlement is that it has no termination date – payments continue perpetually.

teen have some statewide restrictions. Only seven states, mostly southern (where most US tobacco is grown) have no statewide restrictions. The point is that further demand declines from restrictive laws will likely be minimal, although the FDA’s recently announced requirement of graphic warning labels (a corpse, rotting teeth etc.) on packaging, beginning in 2012, exemplifies the continuing effort to reduce smoking.

It’s important to note that past predictions of future cigarette consumption have been woefully inadequate. Global Insight, formerly DRI•WEFA, employed sophisticated econometric models to provide assumptions underlying most outstanding tobacco bond issues. Although Global Insight’s 35 page analysis, included in many Official Statements, explored a variety of scenarios, the base case projected average consumption declines of 1.81% from 2004 through 2047.

THE GIFT THAT KEEPS ON GIVING

One of the most unusual aspects of the MSA settlement is that it has no termination date – payments continue perpetually. Adjustments to payment amounts include not only consumption and NPM, as noted, but also an inflation factor, increasing payments by the percentage increase in the CPI, with a floor of 3% annually. Unlike most municipal bonds, these asset backed bonds are for the most part pure cash flow securities. The “asset” is the payment stream pledged to secure the bonds, and subject to various adjustments as noted. The payment stream continues to perpetuity. TSRs pledged to secure bonds will continue until the bonds are totally retired, even if this extends principal payments beyond maturity. Interest payments continue beyond maturity as long as bonds remain outstanding.

Although specific structures and provisions may differ, most issues have cash flow schemes whereby after payment of a minimal “capped” amount of authority or trust operating expense, pledged MSA payments “owned” by the authority or trust along with interest earnings are applied (1) to pay interest on outstanding senior bonds, (2) to pay maturity and sinking fund payments on senior bonds, (3) to replenish any previous draws against the liquidity reserve accounts and finally after paying operating expenses above the cap and certain enforcement expense (4) to redeeming outstanding bonds, usually in maturity order. Larger payments from tobacco companies and resultant faster cash flows increase the pace of redemptions, and may lead to bonds being retired well before maturity. Decreases in payments and cash flows can lead to slower than anticipated amortization and even missed interest or maturity payments. Unlike traditional municipal bonds, a missed sinking fund payment, for most tobacco issues is not an event of default.

THREE ISSUERS DRAW ON LIQUIDITY RESERVE ACCOUNT

With this year's MSA distribution being the lowest since 2006, three issuers, all of 2007 vintage, received too little TSRs to meet all interest and maturity obligations in FY2011, and so have disclosed that, if no further tobacco revenues are received, they will draw on their Liquidity Reserve Funds to make December 2011 interest payments. Issuers typically fund a Liquidity Reserve Account from the proceeds of issuance, as an added security feature. As noted earlier, reserve deficiencies are replenished from pledged TSRs after required interest and principal payments are made. If MSA payments were to continue in the \$6 billion range of 2011, not only would future draws be needed, but scheduled amortization under sinking fund schedules would fall behind. On the other hand, if revenues pick up to the pre-2009 pace, a likelihood if NPM adjustments are resolved in favor of states and consumption declines fall back to the 4% range, liquidity reserves would be replenished and amortization and the pace of redemptions would quicken.

The most stressed issues tend to be those of 2006 and 2007 vintage, most of which were structured based on breakeven consumption declines in the 4% range. Pre-2006 loans and particularly December's Illinois Railsplitter deal, were structured with more conservative assumptions. Other 2007 issues such as New Jersey and TSASC (New York City) received sufficient TSRs this year to not only make interest payments, but to redeem bonds, although far fewer were called than last year.

If the reported NPM settlement is finalized, it's possible that \$1.1 billion, now held in escrow, could be released to the states, perhaps eliminating the necessity to draw against reserve funds as announced. Nevertheless, these three issuers, along with others of the 2006-2007 timeframe, remain stressed, with lower declines in consumption needed for cash flows to match originally projected amortization.

An issue related to Liquidity Reserve Accounts is lack of interest earnings. In addition to pledged TSRs, most structures add earnings on the Liquidity Reserve Fund to amounts available for debt service. Ohio's Tobacco bond issuer, Buckeye Tobacco Settlement Financing Authority, has a Liquidity Reserve Account totaling about \$389 million. In fiscal years ending 6-30-08 and 6-30-09, the Reserve Fund earned \$14.9 million and \$12.3 million respectively. As short term interest rates plunged and reserve fund investments matured, interest earned on the new investments generated only \$735,000 in FY2010, a huge decrease in moneys available to support debt service.

Three Tobacco Issuers Will Tap Reserves in 2011

	VA - 2007	OH - 2007	CA - 2007
Total Reserve Fund	\$85.4 mln	\$389.2 mln	\$252 mln
Draw - 2011	\$3.6 mln	\$6 to \$8 mln	\$7.7 mln
Bonds Outstanding	\$1 bln	\$5.2 bln	\$4.3 bln
Ratings	Baa3/BB-/NR	Baa3/BB-/BBB-	Baa3/BB+/BBB-

Source: Janney Fixed Income Strategy, State Disclosure Documents

RATINGS

Most tobacco bonds carry ratings from one or more of the three rating agencies. Fitch and S&P performed extensive reviews of the sector, culminating in a series of downgrades last year. More recently Moody's announced that it was placing maturities from nine issues on watch for upgrade (including short serial maturities of Ohio-Buckeye) and maturities from five issues on watch for downgrade. Rating considerations for issues backed by MSA payments differ greatly from those of traditional municipal bonds. In many cases, longer maturities have lower ratings than short maturities, since cash flow assumptions as they relate to specific issue structures, are more predictable and certain in shorter time frames.

CONCLUSION

The sector of bonds secured by tobacco settlement revenues is generally a high risk and high yield area, with uncertainty about future payments overhanging. We retain our cautious outlook for the sector, but believe that the worst is behind, and expect consumption declines leveling out in the 4% range along with resolution of the NPM disputes to provide more consistent cash flows in the future. Investors must weigh the relatively high yields against the known and unknown risks impacting future TSR cash flows. Varying in structure and structuring assumptions, the longer maturities of these issues have recently traded at yields ranging between 6% and 9%. Our next report will focus more on specific issuers and structures.

Three issuers received too little TSRs to meet all interest and maturity obligations and so have disclosed that they will draw on their Liquidity Reserve Funds to make December 2011 interest payments.

ANALYST CERTIFICATION

I, Alan Schankel, the Primarily Responsible Analyst for this report, hereby certify that all of the views expressed in this report accurately reflect my personal views about any and all of the subject sectors, industries, securities, and issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

DISCLAIMER

Janney or its affiliates may from time to time have a proprietary position in the various debt obligations of the issuers mentioned in this publication.

Unless otherwise noted, market data is from Bloomberg, Barclays, and Janney Fixed Income Strategy & Research (Janney FIS).

This report is the intellectual property of Janney Montgomery Scott LLC (Janney) and may not be reproduced, distributed, or published by any person for any purpose without Janney's express prior written consent.

This report has been prepared by Janney and is to be used for informational purposes only. In no event should it be construed as a solicitation or offer to purchase or sell a security. The information presented herein is taken from sources believed to be reliable, but is not guaranteed by Janney as to accuracy or completeness. Any issue named or rates mentioned are used for illustrative purposes only, and may not represent the specific features or securities available at a given time. Preliminary Official Statements, Final Official Statements, or Prospectuses for any new issues mentioned herein are available upon request. The value of and income from investments may vary because of changes in interest rates, foreign exchange rates, securities prices, market indexes, as well as operational or financial conditions of issuers or other factors. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. We have no obligation to tell you when opinions or information contained in Janney FIS publications change.

Janney Fixed Income Strategy does not provide individually tailored investment advice and this document has been prepared without regard to the circumstances and objectives of those who receive it. The appropriateness of an investment or strategy will depend on an investor's circumstances and objectives. For investment advice specific to your individual situation, or for additional information on this or other topics, please contact your Janney Financial Consultant and/or your tax or legal advisor.