

# TOBACCO BONDS

## JANNEY FIXED INCOME STRATEGY

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Many tobacco issues were downgraded as cigarette consumption and MSA revenues declined, but a new issue from Illinois offers much stronger security.

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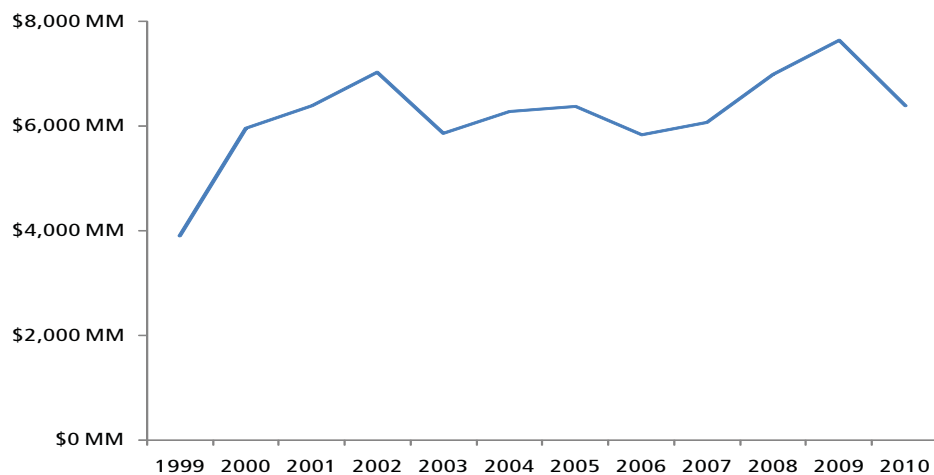
### SUMMARY

- Tobacco bonds are secured by payments from cigarette manufacturers to states based on a 1998 Master Settlement Agreement.
- In the eleven years from 2000 to 2010 payments averaged \$6.4 billion per year.
- A steeper than anticipated decline in cigarette consumption led to downgrades of issues and maturities.
- Illinois Railsplitter, a November 2010 issue, set a new standard for tobacco issue structuring, garnering the first A rating S&P has placed on a tobacco settlement backed issue in nine years.

### THE MASTER SETTLEMENT AGREEMENT

In 1998, a Master Settlement Agreement (MSA) was reached between attorneys general of 46 states, DC and several territories on the one hand and the four major cigarette manufacturers on the other hand as settlement of litigation over medical expenses incurred by states for tobacco and smoking related illnesses. The MSA provided for annual payments from cigarette manufacturers to the states and territories beginning in 1999. The target annual payments ranged from about \$7 billion per year in 2000 to \$9 billion annually in 2008 and thereafter in perpetuity. Annual payments are adjusted based on a variety of factors, the two major ones being inflation increases (3% minimum) and U S cigarette shipment volumes. These adjustments led to actual payments ranging between \$5.8 billion and \$7.6 billion since 2000. The \$6.4 billion 2010 payment reflected a sharp drop in consumption in 2009, a result of varying types of smoking bans in at least forty states as well as increases in tobacco taxes at both the state and federal level. Particularly impactful was the April 2009 increase of the federal excise tax from \$0.40 to \$1.00 per pack.

MSA Payments to States - 1999 to 2010



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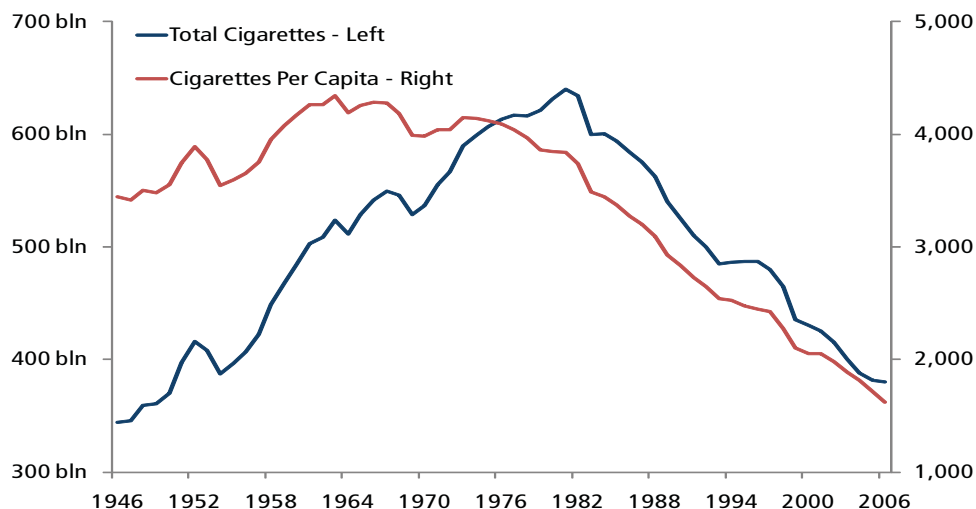
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Source: National Association of Attorneys General



Tobacco Settlement Revenues (TSRs) are allocated among states and other signatories of MSA in predefined portions. Distribution ranges from large states such as New York and California, which each receive about 12.75% of the total payments to smaller states such as Vermont and Delaware whose payments are around 0.4% of the total. Eighteen states and their political subdivisions (including NY and CA counties) as well as the District of Columbia, Puerto Rico, Guam and the Virgin Islands have securitized some or all of their TSRs through the issuance of tobacco bonds. For example in 2007 Ohio exchanged an estimated forty years worth of annual payments (\$305 million in 2007) for about \$5 billion up front, by issuing bonds through the Buckeye Tobacco Settlement Financing Authority.

Cigarette Consumption Has Been Falling for Thirty Years



Source: USDA - Economic Research Service

TOBACCO BOND RISKS

Bonds secured by the MSA carry a series of unique risks which investors must consider. Variables associated with litigation and the rate of U S cigarette consumption pose particular issues. Official Statements for these issues typically include many pages identifying and explaining potential risks and some of the more noteworthy include:

**Cigarette Consumption** – Reacting to higher taxes, smoking bans and anti-smoking education efforts, smokers’ rate of cigarette consumption in the United States has been on the decline for the past thirty years. Since the underlying revenue stream comprising the assets securing tobacco bonds can vary with the rate of U S cigarette smoking, future legislation, tax increases or other events can have a negative impact on consumption and revenues. It is somewhat ironic that most of the states and communities that benefit from the MSA have taken measures to reduce smoking including partial or complete bans on smoking in public places and work places. Many states and communities have increased per pack and other tobacco related taxes – a pack of cigarettes in New York City costs around \$11. Educational initiatives to reduce smoking are ongoing, in many cases financed by proceeds from the MSA. If everyone in the country stops smoking, the MSA payment stream and the future of tobacco bonds goes up in smoke. Of course this won’t happen, given the addictive nature of nicotine.

Risks for tobacco sector credit quality include declining cigarette consumption and litigation.



The majority of tobacco settlement secured issues have no guarantee or other backing from the issuing state or municipality.

**The Manufacturers** - MSA payments are based on tobacco companies' ability to meet MSA payment requirements. The three major manufacturers are Altria (Baa1/BBB/BBB+), parent of Philip Morris, Reynolds American (Baa3/BBB/BBB-), and Lorillard (Baa2/BBB-/BBB-) with combined market share of about 83%. Approximately 50 smaller manufacturers are subsequent parties to the MSA and they account for about 10% of the market, while a group known as non participating manufacturers (NPMs), who are not signatories to the MSA, comprise the remaining market share. States are actively working on corralling the NPMs into the agreement with their market share falling from 8% in 2004 to about 6% in 2009. The MSA includes provisions whereby if a manufacturer files for bankruptcy and ceases payments, promises of the states not to sue will become null and void, opening the door for lawsuits by the states to recover expenses related to illnesses from tobacco usage.

**Litigation** - Litigation is an ongoing challenge for both the cigarette manufacturers and the Master Settlement Agreement. As has been the case for many years, tobacco companies face ongoing litigation seeking compensation for illnesses related to tobacco consumption. A large adverse verdict could have a negative impact on manufacturers' income and profitability which could in turn impact MSA payments. There have been several lawsuits instituted challenging the constitutionality of the MSA. Other lawsuits claim challenges based on federal antitrust laws, civil rights laws, consumer protection laws and unfair competition laws.

**No State Backing** - Although proceeds of tobacco issues go to the issuing state or community, most issues have no direct or indirect backing from the state or local government. An exception is a Golden State issue (California) (2005A) which has the state's moral obligation backing. By securitizing annual payment streams, issuers of tobacco bonds transferred the risks of MSA payment variability to bondholders, and to the extent that these revenues are insufficient to meet debt service obligations, it is highly unlikely that the states, counties and territories which benefitted from these tobacco issues, will come to the rescue of bond investors in the event of a default.

**Disputes** - Calculation of MSA payments is frequently disputed by various signatories of the MSA, and such disagreements can be raised up to four years after payment due date. Many of these disputes are related to an MSA provision whereby participating manufacturers may receive an adjustment of payment if their market share declines due to cigarette sales by non participating manufacturers. Underlying this provision is a requirement that states enact and enforce statutes penalizing cigarette manufacturers which have not agreed to participate in the MSA, preventing NPMs from gaining competitive advantage over MSA participants. These disputes are settled through an arbitration process which can last for several years. These give rise to potential reduction of future MSA payments.

**BOND STRUCTURING AND CONSUMPTION ASSUMPTIONS**

Tobacco bonds differ from most municipal bonds in that they are asset backed securities, the assets being the stream of TSRs which are owned by the trust underlying the bonds. In some cases, states or subdivisions pledged 100% of each year's payment to supporting the bonds, while in other cases only a portion was committed to securing bonds. Some issues (including the Illinois Railsplitter issue noted later in this report) were marketed with traditional municipal bond amortization and redemption structures. TSRs are used to pay debt service with excess or residual amounts flowing to the state or other issuer. The majority of outstanding issues, however, utilized a "turbo" structure whereby TSRs flow first to pay interest, next to pay scheduled maturities and finally to retire bonds prior to maturity. The amounts of annual TSR payments determine how quickly bonds are redeemed, so depending on cash flow, principal payments can be variable.

At the time of issuance, it was anticipated that most tobacco bonds with turbo structures would be retired well before maturity and ahead of the planned amortization schedules. Official Statements included sections titled "structuring assumptions" with a variety of scenarios applying various assumptions related to declines in cigarette consumption. The 2007 Ohio Buckeye issue, for example, used information from consulting firm Global Insight. Couched with the expected disclaimers about many unforeseeable variables, Global Insight projected a "base case" decline in consumption after 2006 of below 2% per year. Under this scenario all bonds, with maturities as long as 2052, would be retired by 2032, via turbo and sinking fund redemptions.



The Illinois Railsplitter issue is structured to have debt service covered if cigarette consumption declines by as much as 10% per year after 2010.

The worst case scenario listed in the Buckeye Official Statement, which assumed a 4% annual consumption decline, had all senior bonds retired by the scheduled maturity of 2047, although subordinate zero coupon bonds due in 2047 and 2052 would not have been retired on time. As it turned out, consumption fell an average of 6.25% per year 2007 through 2009, exceeding estimates. No doubt S&P considered this when they dropped the rating on most Buckeye maturities to BB-, junk territory. It's important to note that the average consumption decline of recent years was skewed from the 10% decline of 2009, which was largely a result of the sharp increase in the federal excise tax. We believe that declines in consumption will be more moderate going forward.

### RAILSPLITTER – A NEW APPROACH

A dramatic drop in cigarette consumption in 2009 followed by many rating downgrades - some to below investment grade - cast a pall over bonds secured by MSA payments, in many cases moving trading yields higher. Illinois, a state faced with significant financial challenges, chose to securitize its MSA payment stream by issuing \$1.5 billion of Railsplitter Tobacco Settlement Authority bonds in November 2010, the first new tobacco bond issue in two years. Adopting a more traditional structure, Railsplitter bonds have no turbo feature. Each year, after certain limited operating expenses of the authority are paid, scheduled debt service payments are made and any reserve deficiencies are remedied, residual revenues revert to the state.

The structuring assumptions underlying the Railsplitter issue are more conservative than previous tobacco issues. For one thing there are no estimates about future consumption from a consultant such as the aforementioned Global Insight. Instead the Official Statement lists several scenarios for consumption declines ranging from 3% per year after 2010 to a "breakeven" 10%. In other words if cigarette consumption in the United States declined at a 10% annual rate through the 2028 final maturity of the Railsplitter issue, revenues are anticipated to be sufficient (barely) to cover debt service. Another key point is the relatively short maturity structure. Railsplitter's longest maturity is 2028, well short of the forty year maturities of many earlier issues.

### TOBACCO BOND RATINGS

Most tobacco issues are rated by Moody's, S&P and/or Fitch. Both Standard and Poor's and Fitch recently reviewed bonds they rated, Fitch in early 2010, and S&P more recently. S&P lowered its ratings on 51 of the 122 tranches or maturities it reviewed, affirming 71. Generally ratings are limited to the BBB categories and below, based on the underlying ratings of the major tobacco companies. If ratings differ within an issue, they are typically lower for the longer maturities. The New Jersey issue offers a good example with ratings ranging from BBB on the serials and shorter term maturities to B- on very long maturity subordinated zeros. (See table on page 5 for ratings information on several issuers including New Jersey and Buckeye).

In its rating report for Railsplitter Tobacco Settlement Corp., Fitch rates all of the bonds with maturities from 2012 to 2028 BBB+, but they also list a delinked rating which they define as an indication of "the level of stress the bonds could withstand without linkage to the tobacco industry rating." The delinked ratings range from AAA for the serial bonds in 2012 and 2013, to A for the longest maturities 2020 and beyond.

In its rating report on Railsplitter, S&P rated bonds in maturities from 2012 to 2021 as A and the term bonds maturing in 20023, 2024 and 2028 as A- noting that this was the first A rating category they've assigned a tobacco settlement secured bond since an Alabama issue in 2001.

### U S Cigarette Shipments

Year	Sticks Shipped	YOY Decline
1999	409 bln	
2000	403 bln	-1.6%
2001	384 bln	-4.6%
2002	365 bln	-4.9%
2003	345 bln	-5.6%
2004	339 bln	-1.6%
2005	332 bln	-2.1%
2006	327 bln	-1.5%
2007	312 bln	-4.5%
2008	300 bln	-3.9%
2009	269 bln	-10.3%

Source: National Assoc. of Attorneys General



Ratings on Select Tobacco Issues - Includes November S&P Changes

Issues	S&P		Fitch	Moody's
	Was	Now		
<b>Buckeye Tobacco Settlement Corp (Ohio) (2007) - Majority downgraded</b>				
Serials 2011 through 2017	BBB	BBB	BBB+	Baa3
Turbo Terms 2024, 2030, 2034, 2042, 2047	BBB	BB-	BBB-	Baa3
Cvt Turbo Terms 2037	BBB	BB-	BBB-	Baa3
1st and 2nd Sub CABs due 2047 and 2052	NR	NR	BB	NR
<b>Children's Trust (Puerto Rico) (2002) - No downgrades</b>				
Serials 2011 through 2014	BBB	BBB	BBB+	Baa3
Turbo Terms 2033, 2039, 2043	BBB	BBB	BBB+	Baa3
1st Sub CABS 2050	NR	NR	BBB	NR
2nd Sub CABS 2055	NR	NR	BBB	NR
Sub CABS 2057	NR	NR	B+	NR
<b>Golden State Tobacco Securitization Corp (California) (2007) - All were downgraded</b>				
Serials 2011 through 2017	BBB	BBB-	BBB+	Baa3
Turbo Terms 2027	BBB	BBB-	BBB	Baa3
Turbo Terms 2033 and 2047	BBB	BB+	BBB-	Baa3
Cvt Turbo Terms 2037	BBB	BB+	BBB-	Baa3
1st Sub CABs 2047	BB	B	NR	NR
2nd Sub CABs 2047	BB-	B-	NR	NR
<b>Tobacco Settlement Financing Corp (New Jersey) (2007-1)- Majority downgraded</b>				
Serials 2011 through 2019	BBB	BBB	NR	Baa3
Turbo Terms 2023 and 2026,	BBB	BBB	NR	Baa3
Turbo Terms 2029	BBB	BBB-	NR	Baa3
Turbo Terms 2034	BBB	BB+	NR	Baa3
Turbo Terms 2041	BBB	BB-	NR	Baa3
1st Sub CABs 2041	BB	B	NR	NR
2nd Sub CABs 2041	BB-	B-	NR	NR
<b>TSASC Inc. (New York City) (2006-1) - Most unchanged - 2042 downgraded</b>				
Turbo Terms 2022	BBB	BBB	BBB+	NR
Turbo Terms 2026	BBB	BBB	BBB+	NR
Turbo Terms 2034	BBB	BBB	BBB	NR
Turbo Terms 2042	BBB	BBB-	BBB	NR
<b>Tobacco Settlement Financing Corp (Rhode Island) (2007) - Most unchanged - Subs downgraded</b>				
Turbo Terms 2023	BBB	BBB	BBB+	Baa3
Turbo Terms 2032 and 2042	BBB	BBB	BBB+	Baa3
1st Sub CABs 2052	BB	B	NR	NR
2nd Sub CABs 2052	BB-	B-	NR	NR
3rd Sub CABs 2052	NR	NR	NR	NR
<b>Tobacco Settlement Financing Corp (Virginia) (2007) - Most bonds downgraded</b>				
Taxable 2046	BBB	BB	NR	Baa3
Turbo Terms 2047	BBB	BB-	NR	Baa3
Cvt Turbo Terms 2046	BBB	BB-	NR	Baa3
1st Sub CABs 2047	BB	B+	NR	NR
2nd Sub CABs 2047	BB-	B-	NR	NR

S&P reviewed ratings of 122 maturities from 31 tobacco issues beginning in August. 71 were affirmed while 51 were downgraded in November.

Source: Fitch, Moody's and S&P



CONCLUSION

Over the past eleven years, state and local authorities from eighteen states, DC and three U S territories raised money by securitizing some or all of the revenue stream generated under the Master Settlement Agreement of 1998 into tobacco bonds. In a time of tight state and local government finances, it is likely we will see more issues as states and other localities struggle to close budget gaps. The landscape has changed since the early issues, with the decline in cigarette smoking exceeding earlier expectations, leading to many downgrades, often to junk rating categories. The 10% consumption decline in 2009, was a particularly potent wakeup call on the variability of MSA payments and the risk associated with the tobacco bond sector.

Public health issues and tight state and local budgets have generated significant headwinds to smoking in the form of smoking bans and higher excise taxes, and will continue to drive declines in consumption. However, as evidenced by structuring of the recent Illinois Railsplitter issue, assumptions about revenue streams have become more realistic. Although legal challenges are still abundant, and there is no assurance of outcomes, the MSA has held up well in the twelve years of its existence.

In the aftermath of S&P's November rating downgrade, the longest maturity Ohio Buckeye issue, 5.875% maturing in 2047, traded at yields as high as 9.5%, with prices fluctuating by as much as 13 points over three weeks. This is indicative of the sharp valuation declines seen in tobacco bonds, the volatile market for these issues and the perceived risk reward proposition. By contrast the 2028 maturity of the recent Illinois Railsplitter issue has traded at yields around 6%, as investors found comfort with the more conservative structure and underlying assumptions. Investors seeking yields above typical or benchmark tax free yields, who have a tolerance for additional inherent risk, should consider tobacco bonds as part of a diversified tax free portfolio. Individual issues and maturities within these issues have differing structures and ratings, so each must be considered on its specific structure and merits.

Tobacco bonds offer both higher yields and heightened risk.

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