

NEW JERSEY TOBACCO

JANNEY FIXED INCOME STRATEGY

DEC 9 2009

> Higher federal tobacco taxes are expected to drive cigarette consumption and MSA payments lower, a key factor which could pressure the credit of outstanding New Jersey tobacco bonds.

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Issuer: Tobacco Settlement Financing Corporation, New Jersey

TOBACCO SETTLEMENT ASSET-BACKED BONDS**SENIOR UNDERLYING RATINGS**

MOODY'S: BAA3 (DEVELOPING)
S&P: BBB (NEGATIVE)
FITC: NO RATING

FIRST SUBORDINATE UNDERLYING RATINGS

MOODY'S: NO RATING
S&P: BB (NEGATIVE)
FITC: NO RATING

BONDS OUTSTANDING: There are approximately \$3.2 billion of senior and \$185 million of subordinated bonds currently outstanding.

SECURITY: The New Jersey tobacco bonds are payable from a portion of NJ's share of Master Settlement Agreement ("MSA") payments. NJ tobacco bonds are not guaranteed by the state.

ISSUER DESCRIPTION: The State of New Jersey created the New Jersey Tobacco Settlement Financing Corporation to issue bonds that are securitized by the MSA payments NJ is scheduled to receive. The state used the 2002 and 2003 bond proceeds to fund budget deficits and the Series 2007 bonds were refunding bonds.

CREDIT STRENGTHS:

- + FDA regulation may allow larger tobacco companies to maintain market-share.
- + A \$214 million non-declining liquidity reserve account is pledged to pay senior serial and turbo term bonds.

CREDIT WEAKNESSES

- We expect MSA payments to trend downward as a result of lower cigarette consumption.
- The majority of MSA payments are paid by the largest tobacco companies which are rated in the triple B range and are experiencing declining credit quality. S&P also recently downgraded most of their rated tobacco bonds to the triple B range, with a negative outlook.
- Minimal amount of available disclosure about MSA payment history, legal proceedings and bond redemptions do not allow for a thorough analysis of events or litigation affecting the bonds.

DISCUSSION:

NJ tobacco bonds offer an opportunity to pick up additional yield, compared to most municipal bonds. There is less exposure to declines in MSA payments in the shorter maturities but there are some significant factors that will continue to stress medium and long term NJ tobacco bond payments. MSA payments made by participating manufacturers have been lower than initially projected, cigarette consumption is expected to further decline and rating trends have not been favorable for tobacco bonds specifically and tobacco companies in general.

The Master Settlement Agreement

The variability of the annual payments NJ receives under the Master Settlement Agreement ("MSA") is a key factor to consider with regard to the NJ tobacco bonds. The MSA is an agreement executed in November 1998 between the attorneys general from 46 states and Participating Manufacturers ("PMs".) The MSA resolved tobacco related litigation between the states and the tobacco companies and the contract protects the companies from any future claims from states. In return, the tobacco companies agreed to make ongoing annual and Strategic Contribution Fund (a fund which is expected to contribute approximately \$850 million a year, subject to adjustments, to total MSA payments until 2017) payments to the states.

MSA payments were intended to reimburse states for the treatment of tobacco related illnesses, but over the recent past some state governments securitized the projected future stream of MSA payments with bond issues. Oftentimes, bond proceeds funded budget shortfalls, but an argument can also be made from the states' perspective that it made sense to securitize the MSA payments, take an up-front payment in the form of bond proceeds and pass on the MSA payment risk to bondholders. Under the MSA, New Jersey is entitled to receive 3.8669963% of the total annual payments and 2.8469526% of the Strategic Contribution Fund payments made by the PMs. New Jersey then pledged 76.26% of the State's Tobacco Settlement Revenues ("TSR") as security for the NJ tobacco bonds.

Who Makes the MSA Payments?

Altria (Phillip Morris), Reynolds America and Lorillard are the largest companies party to the MSA. They account for almost 90% of the tobacco industry market-share and thus a majority of MSA payments. Another 45 smaller tobacco companies are also party to the MSA. These companies also make annual and Strategic Contribution Fund payments. Annual payments are calculated from a base amount that is adjusted for each PM according to factors such as:

- Domestic tobacco consumption
- Companies' market share
- Certain other adjustments (inflation, non-participating manufacturer) according to the MSA

Trends in the Tobacco Industry after the MSA

A key trend affecting MSA payments is falling cigarette consumption and the expectation that cigarette consumption will decline further. The recent drop is a result of increases in tobacco taxes, government funded education programs to decrease tobacco consumption and cultural pressures against smoking. At the time of the initial MSA agreement Global Insight forecast cigarette consumption would decline by 1.7% a year. Cigarette consumption actually fell at an approximate 4.5% annual rate from 2003-2008, according to the Bureau of Tax and Trade. This trend is illustrated in the lower actual annual MSA payments NJ received from 2004-2006 in the below table. Further declines are expected as the federal tax on cigarettes was increased in the beginning of 2009 by 62 cents a pack to \$1.01. This amounts to a 15% increase per pack on average. Industry studies show that consumption can decline as much as .5% for every 1% of price increase.

> *NJ tobacco's Series 2007 June 1, 2023 turbo term bonds have paid down 23% less than expected.*

Projected vs. Actual Annual MSA Payments to New Jersey (\$ in millions)

	2004	2005	2006	Total
Projected MSA Annual Payments to NJ(1)	\$245	\$248	\$253	\$746
Actual MSA Annual Payments to NJ(2)	240	243	223	706
Difference	(\$5)	(\$5)	(\$30)	(\$40)

Source: (1) NJ Tobacco Series 2002 OS page 64. (2) NJ Tobacco Series 2007 OS page 55.

Current MSA payment levels, which have been lower than expected, should provide enough revenue to cover debt service in the short term but bonds with medium or longer maturities will come under stress. This trend is currently affecting the pay-down of the structured turbo bonds by extending the average lives. For example, NJ tobacco's Series 2007 June 1, 2023 turbo term bonds have paid down 23% less than expected as shown in the below table. This is a telling statistic because the issuer has the ability to redeem the turbo bonds early in order to reduce interest costs but has not received enough revenue to do so.

Projected vs. Actual Annual Turbo June 1, 2023 Redemptions

	Projected Turbo Redemptions	Actual Turbo Redemptions	Difference
June 1, 2009	\$188,140,000	\$144,870,000	\$43,270,000

Source: Official Statement and disclosure.



> NJ tobacco bonds offer an opportunity to pick up additional yield, but decreased MSA payments are expected, litigation event risk is high and rating trends have not been favorable.

Another key trend that is always inherent with regard to the tobacco industry is litigation event risk which may affect the tobacco companies. In the near term we do not expect any adverse legal judgments to impair or significantly decrease MSA payments. Notable in the recent past, is the expectation that new class action suits may occur based on findings from the United States versus Phillip Morris case. Any legal action will likely take time to materialize.

Tobacco Companies and Tobacco Bond Ratings Deterioration

The three largest tobacco companies, Altria, Reynolds and Lorillard, possess market share of almost 90% of the tobacco industry and these companies fund the majority of MSA payments. These companies' credit ratings are currently in the low triple B range and have been deteriorating over the recent past as most were in the A rating category as early as 2003.

Current Ratings of Largest Tobacco Companies

	Moody's		S&P		Fitch	
	Rating	Outlook	Rating	Outlook	Rating	Outlook
Altria Group	Baa1	Negative	BBB	Stable	BBB+	Stable
Reynolds America	Baa3	Stable	BBB-	Stable	BBB	Stable
Lorillard	Baa3	Stable	BBB	Negative	BBB	Stable

Source: Moody's, S&P and Fitch.

In addition, Standard and Poor's lowered their ratings and assigned negative outlooks to their rated municipal tobacco debt in September 2009. This rating action included NJ tobacco bonds, which were downgraded to BBB with a negative outlook. The factors contributing to the stress in the industry cited by S&P included: declining industry fundamentals, litigation event risks and an inability to withstand stress tests, the rating agency reported.

CONCLUSION:

Although NJ tobacco bonds offer an opportunity to pick-up additional yield compared to most municipal bonds, decreased MSA payments are expected, litigation event risk is always high and rating trends have not been favorable for tobacco bonds specifically and tobacco companies in general.

ANALYST CERTIFICATION

I, Tom Kozlik, 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 our compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

DEFINITION OF OUTLOOKS

Positive: Janney FIS believes there are apparent factors which point towards improving issuer credit quality issuer which may result in potential credit ratings upgrades

Stable: Janney FIS believes there are factors which point towards stable issuer credit quality which are unlikely to result in either potential credit ratings upgrades or downgrades.

Cautious: Janney FIS believes there are factors which introduce the potential for declines in issuer credit quality that may result in potential credit ratings downgrades.

Negative: Janney FIS believes there are factors which point towards weakening in issuer credit quality that will likely result in credit ratings downgrades.

DEFINITION OF RATINGS

Overweight: Janney FIS expects the target asset class or sector to outperform the comparable benchmark (below) in its asset class in terms of total return

Marketweight: Janney FIS expects the target asset class or sector to perform in line with the comparable benchmark (below) in its asset class in terms of total return

Underweight: Janney FIS expects the target asset class or sector to underperform the comparable benchmark (below) in its asset class in terms of total return

BENCHMARKS

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Agencies: Janney FIS ratings employ the "Barclay's U.S. Agency Index" as a benchmark.

Mortgages: Janney FIS ratings employ the "Barclay's U.S. MBS Index" as a benchmark.

Investment Grade Credit: Janney FIS ratings employ the "Barclay's U.S. Credit Index" as a benchmark.

High Yield Credit: Janney FIS ratings for employ the "Barclay's U.S. Corporate High Yield Index" as a benchmark.

Municipals: Janney FIS ratings employ the "Barclay's Municipal Bond Index" as a benchmark.

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