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# TOBACCO BONDS: DANGEROUS FOR YOUR FINANCIAL HEALTH?

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What first seemed simple has become one of the most complex types of tax-free bonds. In 1998, 48 states and 4 territories made a deal to get paid billions of dollars annually from tobacco manufacturers, in return for states dropping expensive lawsuits. Starting in 1999, states and cities decided to take the cash up front, instead of over 40 or more years, like choosing the “cash option” in a lottery. Starting at $6 billion a year and growing to $9 billion, there were 3 main factors that would increase or decrease those billions:

1. Changes in domestic cigarette sales;
2. Inflation (which would increase payments by no less than 3% annually);
3. A “sneaky” adjustment called the “NPM adjustment”

When first issued from 1999 through 2008, payment projections assumed only 2% annual declines of sales, which would result in increasing payments. What happened instead was sales declined by twice that much (greater than -4%), resulting in decreasing payments. Then, in 2005, bombs started dropping. Tobacco companies began holding back as much as $1.1 billion a year under the NPM adjustment. The tobacco companies have exerted that adjustment every year since 2005, and only one year’s challenge has been settled. Bonds that were expected to be paid early are now going to see insufficient revenue as early as the late 2020’s. This experience will result in long maturity “zero coupon” bonds never getting paid in full.

This phenomenon is not expected to end or be settled anytime soon. My advice if you are looking into these bonds is to keep maturities short, before payments run short of what’s needed to repay all tobacco bondholders.

## About the Author

### *RICHARD P. LARKIN, Stoever Glass & Co., Inc.*

*Richard Larkin, a recognized 40 year industry veteran, has joined SG & Co. as Director of Municipal Credit Analysis. Mr. Larkin began his career in credit rating analysis at Standard & Poor's in 1975. After rising through the ranks in various analytical and management positions, Dick left S&P as its Chief Municipal Rating Officer, responsible for municipal rating policy, practices, governance and criteria. In 1998, Mr. Larkin joined Fitch Ratings as Chairman of its Public Finance Criteria Committee. He ultimately left to take leading roles in municipal hi-yield analysis at firms JB Hanauer & HJ Sims.*

*"Dick will be a unique resource to Stoever Glass' municipal clients. His knowledge in specific issues and areas of the municipal bond industry will aid our representatives and their clients in making educated decisions, in a sector where this type of research is unique," said Roland Stoever of Stoever Glass.*