



Fitch Takes Various Actions on Tobacco Settlement ABS

Fitch Ratings-New York-3 February 2016: Fitch Ratings has concluded its comprehensive review of all non-New York tobacco settlement asset-backed securities (ABS) transactions announced on Nov. 30, 2015. The rating actions described below consider: Fitch's new U.S. Tobacco Settlement ABS Criteria dated Oct. 5, 2015, a deviation from that criteria, updated and clarified data, model refinements, and enhancements to Fitch's rating analysis, particularly as they relate to the treatment of operating expenses and reinvestment rates for reserve fund balances.

Fitch currently maintains ratings on 39 tobacco ABS transactions with 252 discrete bonds. The concluded review covers 23 transactions (148 bonds), of which 18 (116 bonds) are summarized in this commentary and five transactions (32 bonds) are summarized in a new Fitch rating action commentary titled *"Fitch Takes Rtg Actions on Kern, Cal. Statewide, Children's Trust Tobacco ABS; Errors Corrected,"* (dated Feb. 3, 2016).

Of the 116 bonds subject to this commentary, 60 have been affirmed and 56 have been downgraded. Rating Watches are being resolved for 57 bonds. Despite updates and clarifications to data which affected bond break-even rates throughout the portfolio, the downgrades pertaining to these transactions were directly attributable to the application of Fitch's revised U.S. Tobacco Settlement ABS criteria (49 bonds) or the application of a criteria modification (7 bonds) in connection with the review. As discussed below, 15 transactions (83 bonds) involving the securitizations of MSA payments received by the State of New York were not subject to the cumulative portfolio review. Additionally, one transaction (21 bonds) issued by the Tobacco Settlement Financing Corporation (Rhode Island) was excluded because this transaction was newly issued in 2015.

A detailed listing of all the rating actions is included in the file titled *"Fitch Takes Various Actions on Tobacco Settlement ABS"* published simultaneously with this commentary.

COMPREHENSIVE PORTFOLIO REVIEW

Fitch's comprehensive portfolio review focused on verifying several inputs, both key and minor, used in the determination of tobacco settlement ABS credit ratings. These inputs include, inter alia, the issuer's allocable share of the April 2015 payment received by states under the Master Settlement Agreement (MSA), each state's and trust's allocation percentage of annual and strategic contribution fund payments, reserve fund balances, outstanding bond balances, bond coupon rates, bond maturity dates, operating expense caps and reinvestment rates on reserve fund balances.

Fitch verified all inputs, when reasonably possible, by one or more sources, including offering memoranda and other issuer disclosure documents, data published by the National Association of Attorneys General (NAAG), transaction reports, bank account statements, ad hoc information requests and discussions with representative of the issuer and/or state offices of the Attorney General.

KEY RATING DRIVERS

The key rating drivers of tobacco settlement ABS transactions are identified in Fitch's U.S. Tobacco Settlement ABS Criteria, dated Oct. 5, 2015 and include MSA payments, the financial strength of U.S. tobacco manufacturers, liquidity risk, and the legal structure of the transaction. In addition, a key rating driver for California transactions is the population adjustment provisions of the MSA, which can impact cash flow to the transaction based upon updated U.S. Census information.

CRITERIA DEVIATION

As part of this review, Fitch applied a criteria deviation that eliminated the two-year migration period for a rating to reach its model-indicated grade (MIG), as produced by Fitch's break-even cash flow model. Fitch applied this generally more conservative approach to eliminate any potential lagging effects of overall rating movements given the complexity of the review.

RATING OUTLOOKS

Bonds with a MIG of 'a-' or higher have two positive attributes: they are able to withstand fairly significant and sustained annual declines before experiencing a projected loss, and they exhibit a buffer to ratings volatility given that their MIGs are higher than the rating cap of 'BBB+sf' that Fitch applies in this sector. Fitch will typically assign Stable Rating Outlooks to bonds exhibiting these MIGs.

Bonds with a MIG between 'bbb+' and 'b+' exhibit an overall ability to sustain declining cash flows into the future, albeit at different rates. Given that these bonds do not exhibit the same buffer as those with a higher MIG (as explained in the preceding paragraph), the bonds' ratings are more prone to potential rating volatility and can be directly influenced by their location within the break-even ranges set forth in the table included on page 2 of Fitch's U.S. Tobacco Settlement ABS Criteria. For example, a bond with a break-even percentage (BE %) near the higher end of its break-even range should be able to withstand a slightly higher, or longer, stress before being downgraded versus a bond with a BE % at the lower end of its range. As a result, for these bonds Fitch will typically assign Rating Outlooks depending on where a bond resides in its BE % band - a Stable Outlook will typically be applied to those bonds in the higher half of the range while a Negative Outlook will typically be applied to those in the lower half.

Bonds with 'b' and 'b-' MIGs need to sustain positive cash flow growth in order to avoid losses, and, thus, are more risky. Given the current tobacco ABS payment environment, Fitch will typically assign Negative Outlooks for these bonds, subject to particular deal characteristics.

Finally, bonds with MIGs below 'b-' will not typically be assigned Rating Outlooks. Instead, a Recovery Estimate of 'NC' (not calculated) will typically be assigned, as described below.

RECOVERY ESTIMATES

Fitch will assign a Recovery Estimate of 'NC' to tobacco ABS bonds in distressed rating categories. Fitch believes that it is less meaningful to apply Recovery Estimates to tobacco ABS as opposed to other types of ABS transactions. Recovery Estimates are most useful when calculated with a stable denominator. However, many tobacco ABS transactions are structured with capital appreciation bonds (CABs) which accrete principal and build significant, exponential value over time; thus never having a stable denominator with which to calculate a Recovery Estimate. Failure to acknowledge this concept could cause widely fluctuating, less relevant and possibly misleading results.

The fact that no final recovery mechanism other than the potential continuation of cash flow into the future exists further complicates the application of Recovery Estimates for tobacco ABS bonds. To calculate a recovery estimate at legal final maturity while not giving value to this future cash flow could potentially overlook the largest component of its value, lessening its importance, or at worst, be misleading.

NEW YORK TRANSACTIONS

As stated above, the rating actions announced here and in the accompanying rating action commentary titled "Fitch Takes Rtg Actions on Kern, Cal. Statewide, Children's Trust Tobacco ABS; Errors Corrected" conclude Fitch's comprehensive tobacco settlement ABS portfolio review for all transactions not backed by the MSA share allocable to New York (the NYS Transactions), as well as one backed by the MSA share allocable to Rhode Island. Fitch requires additional information to complete its review of the NYS Transactions in order to resolve the current Rating Watch status. If Fitch does not obtain satisfactory verification for key rating inputs related to these transactions, we may consider rating withdrawals.

RATING SENSITIVITIES

Fitch runs different declines in MSA payment scenarios when evaluating the rating sensitivity for tobacco settlement ABS in transactions issued in the last two years. For further discussion of Fitch's sensitivity analysis, please see the related presale or new issue report for the respective transaction. In the absence of sensitivity analysis for transactions which are older, model inputs that would impact the analysis include the issuer's allocable share of the April 2015 MSA payment received by states under the MSA, the state's and trust's allocation percentage of annual and strategic contribution fund payments, reserve account balance, outstanding bond balances, bond coupon rates bond maturity dates, operating caps and reinvestment rates on reserve fund balances.

DUE DILIGENCE USAGE

No third-party due diligence was provided or reviewed in relation to the rating actions announced by this rating action commentary.

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