

**22nd Century Group, Inc. (XXII - \$2.63)**

**COMPANY NOTE**

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**Sales and trading** 7 a.m. to 7 p.m. ET, (646) 465-9090

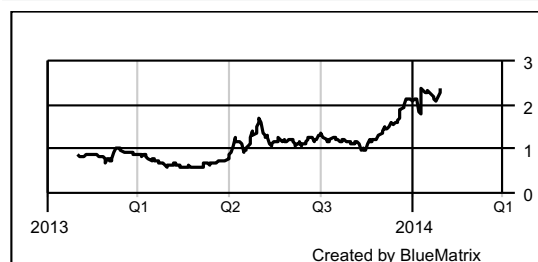
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Stock Data	01/31/14
Price	\$2.63
52 Week Range	(\$0.46 - \$2.70)
Price Target	\$9.00
Market Cap (mil)	\$153.21
Shares out (mil)	58.25
3-Mo Avg Vol	303,062
Cash per share	\$0.10
Total Debt (mil)	\$0.17

EPS (\$)					
Yr Dec	2013A	2014E		2015E	
	Actual	Curr	Prev	Curr	Prev
Mar	(0.07)	(0.03)	–	(0.02)	–
Jun	(0.01)	(0.04)	–	(0.02)	–
Sep	(0.32)	0.00	–	0.01	–
Dec	(0.15)	0.00	–	0.01	–
YEAR	(0.60)	(0.07)	–	(0.01)	–
P/E	(4.4)x	(37.6)x	–	(263.0)x	–

Revenues (\$ millions)					
Yr Dec	2013A	2014E		2015E	
	Actual	Curr	Prev	Curr	Prev
Mar	0.0	0.5	–	2.5	–
Jun	0.0	0.3	–	2.8	–
Sep	0.1	2.8	–	5.0	–
Dec	7.2	3.5	–	5.0	–
YEAR	7.3	7.0	–	15.3	–

**One year price history XXII**



**Q4 Operating Income and CF Exceed Estimates. Maintain Buy and \$9 Target.**

Q4 revenue, operating income and operating cash flow for 22nd Century were higher than our estimates. Revenue of \$7.2 million exceeded our \$6.8 million estimate; Operating income of \$5.9 million was higher than \$5.2 million estimate; Operating cash flow of \$6.3 million beat our \$5.5 million estimate. The net loss for the quarter was higher than we modeled, due to a higher than expected warrant charge. This was a non-cash item. Our estimates for 2014 and 2015 are unchanged and we continue to believe there are multiple near-term catalysts to drive the shares higher. We reiterate our Buy recommendation and \$9 target and the stock remains one of our Top Picks for the year.

The next catalyst we expect is NAAG consent for 22nd Century's membership in the Master Settlement Agreement (MSA). When this occurs, possibly in the next 30 to 60 days, 22nd Century will begin manufacturing REDSUN and MAGIC at its newly acquired Mocksville facility. We believe the company will enter into distribution agreements with high-end tobaccoists shortly after receiving MSA membership.

The 10K provided additional information on the company's license with British American Tobacco (BAT). If BAT enters into the worldwide license it will pay 22nd Century \$3 million in the first two years and \$100 per metric ton of licensed tobacco supplied to or grown and processed by BAT and \$200 per metric ton supplied or grown and processed to Reynolds American, Inc. The minimum and maximum due 22nd Century are \$3 and \$15 million respectively in years 3 through 5 and ramp to a minimum and maximum of \$5 million and \$25 million from year 6 through 2028. Our estimates for the license agreement remain unchanged.

Our \$9 price target uses a sum of the parts method, valuing the BAT license stream at \$1.67 per share, the commercial product revenue at \$4.34 per share and the combined modified risk/X-22 at \$3 per share. Risks to achieving this target include increased regulation, inability to obtain MSA membership, delays in finalizing distribution agreements and commercial license revenue lower than expectations.

**Investment Summary:**

We expect meaningful revenues to begin from a number of sources including a license agreement with British American Tobacco (BAT) and commercial product sales from the company's proprietary RED SUN and MAGIC brands. Over the longer-term 22<sup>nd</sup> Century will pursue the \$1 billion US smoking-cessation market with its proprietary X-22 cigarette, and will file with the FDA applications for modified risk cigarettes. We believe there are multiple near-term catalysts for the stock, including an up-listing, inclusion in the modified settlement agreement (MSA), beginning of production in North Carolina and a potential FDA award for research cigarettes. The stock has reacted favorably recently due to growing awareness of these catalyst as well as the recent warrant exchange which cleans up the capital structure and resulted in a cash balance of \$6 million.

22nd Century owns or exclusively controls 113 issued patents and 37 patent applications which gives it exclusive worldwide rights to all uses for certain genes that control nicotine content in tobacco plants. The company's proprietary technology enables the control of nicotine levels in tobacco plants by controlling the genes responsible for nicotine production in tobacco plants.

The value of this technology was validated by BAT in October of 2013 when it signed a worldwide research license agreement with 22nd Century. The company received a \$7 million payment in Q4 of 2013 and we expect \$3 million of license revenue from BAT in 2014 and an additional \$4 million in 2015. BAT has the option to turn this research license into a royalty-bearing commercial license at any time.

22nd Century announced the purchase of NASCO, a member of the Master Settlement Agreement (MSA) in September of last year and the deal's closing will take place following the consent of the National Association of Attorneys General (NAAG). NAAG approval sets off a chain of events, including distribution agreements that will result in commercial sales this year.

**Valuation:**

We approached valuation from a sum-of-the-parts perspective to arrive at our \$9.00 price target. We discounted the projected BAT license revenue at 10% and in the low case assumed the license terminated in 2028, while in the high case we assumed the license was extended by an additional 15 years.

For the commercial products we assume RED SUN can achieve \$142 million in sales by 2023 and MAGIC \$55 million by the same year. Our EV/Sales valuation ranges are comparable to the 3.6x to 5.2x EV/Sales multiples awarded to Altira, British American Tobacco, Lorillard, Reynolds American and Philip Morris International.

Our modified risk/X-22 valuation of \$2 to \$4 per share is derived in a number of ways. E-cigarette makers, Victory Electronic Cigarettes and Vapor Corp., proxies for modified risk valuations, have enterprise values of \$499 million and \$141 million respectively. This equates to \$2.42 per share using the lower EV as a bogie. X-22 valuation using a modest market share of the smoking cessation market and EV/Sales of 2x to 3x also yields per share valuation to 22<sup>nd</sup> Century of over \$2 per share. We have heavily discounted these assumptions due to the longer-term nature of development of these lines of business as well as the additional capital required for them.

**Risks to achievement of target price:**

Risks to achieving our price target: NAAG approval of the NASCO purchase is critical and assumed to occur this quarter. Lacking that approval we believe it will be difficult for the company to achieve our domestic RED SUN estimates. We have also assumed the commercial product growth trajectory will be similar to American Spirit, but changes in the industry can hinder 22<sup>nd</sup> Century from achieving our estimates. We have also assumed the BAT license will change from a research license to a commercial royalty-bearing license, but that too is not assured. The industry is subject to significant regulatory constraints, litigation, societal views on smoking and changing legislation. Any one of these could have a deleterious impact on our assumptions.

**Company description:**

22<sup>nd</sup> Century owns or exclusively controls 113 issued patents and 37 patent applications which gives it exclusive worldwide rights to all uses for certain genes that control nicotine content in tobacco plants. The company's proprietary technology enables the control of nicotine levels in tobacco plants by controlling the genes responsible for nicotine production in tobacco plants. This can be accomplished with or without genetic engineering.

22nd Century Group, Inc  
Income Statement \$ in 000s

	2012	2013	Q1 14 E	Q2 14 E	Q3 14 E	Q4 14 E	2014 E	Q1 15 E	Q2 15 E	Q3 15 E	Q4 15 E	2015 E
Revenue	19	7,278	450	250	2,750	3,500	6,950	2,500	2,750	5,000	5,000	15,250
Cost Of Goods Sold	68	462	225	125	625	1,000	1,975	1,250	1,375	1,500	1,500	5,625
Gross Profit	(49)	6,817	225	125	2,125	2,500	4,975	1,250	1,375	3,500	3,500	9,625
R&D	729	744	250	400	400	400	1,450	450	450	450	450	1,800
G&A	2,205	4,107	1,500	1,500	1,500	1,500	6,000	1,650	1,650	1,650	1,650	6,600
Sales & marketing	62	9	150	250	250	250	900	350	350	350	350	1,400
Depreciation & Amort.	198	144	125	125	125	125	500	150	150	150	150	600
Opex	3,195	5,004	2,025	2,275	2,275	2,275	8,850	2,600	2,600	2,600	2,600	10,400
Operating Income	(3,244)	1,812	(1,800)	(2,150)	(150)	225	(3,875)	(1,350)	(1,225)	900	900	(775)
Interest Expense	(1,495)	(749)	(2)	(2)	(2)	(2)	(8)	(2)	(2)	(2)	(2)	(8)
Other	0	122	0	0	0	0	0	0	0	0	0	0
Warrant Charge	(1,998)	(27,339)	0	0	0	0	0	0	0	0	0	0
Pretax Income	(6,737)	(26,153)	(1,802)	(2,152)	(152)	223	(3,883)	(1,352)	(1,227)	898	898	(783)
Income Tax Expense	0	0	0	0	0	0	0	0	0	0	0	0
Net before Minority Interest	(6,737)	(26,153)	(1,802)	(2,152)	(152)	223	(3,883)	(1,352)	(1,227)	898	898	(783)
Minority Interest	1	0	0	0	0	0	0	0	0	0	0	0
Net to Common	(6,735)	(26,153)	(1,802)	(2,152)	(152)	223	(3,883)	(1,352)	(1,227)	898	898	(783)
Shares	30,420	43,635	57,000	57,500	58,000	58,500	57,750	59,000	59,500	60,000	60,500	59,750
EPS	(\$0.22)	(\$0.60)	(\$0.03)	(\$0.04)	(\$0.00)	\$0.00	(\$0.07)	(\$0.02)	(\$0.02)	\$0.01	\$0.01	(\$0.01)

22nd Century Group, Inc  
Income Statement \$ in 000s

	2012	2013	2014 E	2015 E	2016 E	2017 E	2018 E	2019 E	2020 E	2021 E
Revenue	19	7,278	6,950	15,250	20,361	31,542	47,813	71,220	105,330	137,318
Cost Of Goods Sold	68	462	1,975	5,625	9,181	14,271	21,407	32,110	48,165	63,159
Gross Profit	(49)	6,817	4,975	9,625	11,181	17,271	26,407	39,110	57,165	74,159
R&D	729	744	1,450	1,800	2,000	2,300	2,645	3,042	3,498	4,023
G&A	2,205	4,107	6,000	6,600	7,260	7,986	8,785	9,663	10,629	11,692
Sales & marketing	62	9	900	1,400	2,000	3,000	4,500	5,625	6,469	7,116
Depreciation & Amort.	198	144	500	600	700	770	847	932	1,025	1,127
Opex	3,195	5,004	8,850	10,400	11,960	14,056	16,777	19,262	21,621	23,958
Operating Income	(3,244)	1,812	(3,875)	(775)	(779)	3,215	9,630	19,848	35,544	50,201
Interest Expense	(1,495)	(749)	(8)	(8)	(8)	(8)	(8)	(8)	(8)	(8)
Other	0	122	0	0	0	0	0	0	0	0
Warrant Charge	(1,998)	(27,339)	0	0	0	0	0	0	0	0
Pretax Income	(6,737)	(26,153)	(3,883)	(783)	(787)	3,207	9,622	19,840	35,536	50,193
Income Tax Expense	0	0	0	0	(276)	1,122	3,368	6,944	12,438	17,568
Net before Minority Interest	(6,737)	(26,153)	(3,883)	(783)	(512)	2,085	6,254	12,896	23,098	32,626
Minority Interest	1	0	0	0	0	0	0	0	0	0
Net to Common	(6,735)	(26,153)	(3,883)	(783)	(512)	2,085	6,254	12,896	23,098	32,626
Shares	30,420	43,635	57,750	59,750	61,750	63,750	65,750	67,750	69,750	71,750
EPS	(\$0.22)	(\$0.60)	(\$0.07)	(\$0.01)	(\$0.01)	\$0.03	\$0.10	\$0.19	\$0.33	\$0.45

22nd Century Group, Inc  
Balance Sheet and Cash Flow Statement \$ in 000s

	2012	2013	Q1 14 E	Q2 14 E	Q3 14 E	Q4 14 E	2014 E	2015 E	2016 E
Cash	0	5,831	4,364	3,591	2,345	2,043	2,043	3,641	3,241
Due from related party and officers	41	50	50	50	50	0	0	0	0
A/R	0	0	370	205	1,027	1,644	1,644	2,466	4,418
Inventory	1,231	1,406	1,185	1,103	1,513	1,821	1,821	2,232	3,207
Prepaid Exp.	10	458	458	254	1,271	2,034	2,034	3,051	5,467
<b>Total Current Assets</b>	<b>1,281</b>	<b>7,744</b>	<b>6,426</b>	<b>5,203</b>	<b>6,206</b>	<b>7,543</b>	<b>7,543</b>	<b>11,390</b>	<b>16,333</b>
Patent and Trademark costs	1,353	1,545	1,484	1,422	1,361	1,300	1,300	1,055	810
PP&E	6	2,998	3,172	3,142	3,107	3,068	3,068	2,867	2,595
Deferred Costs	4	0	0	0	0	0	0	0	0
<b>Total Assets</b>	<b>\$ 2,645</b>	<b>\$ 12,287</b>	<b>\$ 11,081</b>	<b>\$ 9,768</b>	<b>\$ 10,675</b>	<b>\$ 11,911</b>	<b>\$ 11,911</b>	<b>\$ 15,312</b>	<b>\$ 19,737</b>
Bank Loans and N/P	2,686	175	175	175	175	175	175	175	175
A/P	1,411	55	46	43	59	71	71	87	125
Accrued Interest	4	0	0	0	0	0	0	0	0
Accrued Expenses	503	576	485	451	620	746	746	914	1,313
Deferred Revenue	0	179	0	0	0	0	0	0	0
<b>Total Current Liabilities</b>	<b>4,603</b>	<b>984</b>	<b>706</b>	<b>669</b>	<b>853</b>	<b>991</b>	<b>991</b>	<b>1,175</b>	<b>1,613</b>
Warrant Liability	4,173	3,780	3,780	3,780	3,780	3,780	3,780	3,780	3,780
Shareholder's Equity	(6,131)	7,523	6,596	5,319	6,042	7,140	7,140	10,357	14,345
<b>Total Liabilities And Equity</b>	<b>\$ 2,645</b>	<b>\$ 12,287</b>	<b>\$ 11,081</b>	<b>\$ 9,768</b>	<b>\$ 10,675</b>	<b>\$ 11,911</b>	<b>\$ 11,911</b>	<b>\$ 15,312</b>	<b>\$ 19,737</b>

	2012	2013	Q1 14 E	Q2 14 E	Q3 14 E	Q4 14 E	2014 E	2015 E	2016 E
Net Income	(6,737)	(26,153)	(1,802)	(2,152)	(152)	223	(3,883)	(783)	(512)
Depreciation & Amort.	198	144	212	216	221	225	875	946	1,018
Stock Comp	808	980	375	375	375	375	1,500	2,000	2,500
Other	3,866	29,386	0	0	0	0	0	0	0
Working Capital	100	(501)	(427)	413	(2,066)	(1,500)	(3,579)	(2,066)	(4,906)
Operating Cash Flow	(1,764)	3,856	(1,642)	(1,147)	(1,622)	(676)	(5,087)	97	(1,900)
Acquisition of Patents and trademarks	(163)	(290)	0	0	0	0	0	0	0
Capx	0	(3,452)	(325)	(125)	(125)	(125)	(700)	(500)	(500)
Investing Activities	(163)	(3,743)	(325)	(125)	(125)	(125)	(700)	(500)	(500)
Debt	225	(1,810)	0	0	0	0	0	0	0
Equity	1,468	7,536	500	500	500	500	2,000	2,000	2,000
Other	(17)	(9)	0	0	0	0	0	0	0
Financing Activities	1,675	5,717	500	500	500	500	2,000	2,000	2,000
Change in Cash	<b>(\$252)</b>	<b>\$ 5,830</b>	<b>(\$1,467)</b>	<b>(\$772)</b>	<b>(\$1,247)</b>	<b>(\$301)</b>	<b>(\$3,787)</b>	<b>\$ 1,597</b>	<b>(\$400)</b>

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Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [BUY]	29	78.38	7	24.14
HOLD [NEUTRAL]	8	21.62	2	25.00
SELL [SELL]	0	0.00	0	0.00
NOT RATED [NR]	0	0.00	0	0.00

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