

22nd Century Group, Inc. (XXII - \$0.76 - Buy)

COMPANY NOTE

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

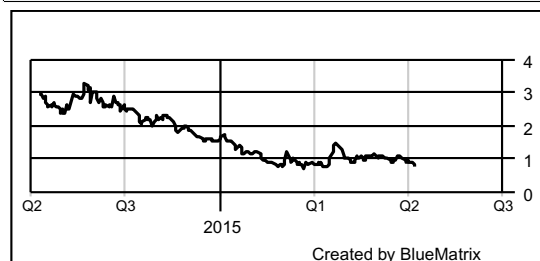
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Stock Data		07/10/15
Price		\$0.76
52 Week Range		(\$0.65 - \$3.35)
Price Target		\$9.00
Market Cap (mil)		\$49.19
Shares out (mil)		64.73
3-Mo Avg Vol		557,141
Cash per share		\$0.21
Total Debt (mil)		\$1.10

EPS (\$)						
Yr Dec	2014A		2015E		2016E	
	Actual	Curr	Prev	Curr	Prev	
Mar	(0.09)	(0.06)A	–	(0.02)	–	
Jun	(0.03)	(0.02)	–	(0.02)	–	
Sep	(0.05)	(0.03)	–	(0.02)	–	
Dec	(0.09)	(0.03)	–	(0.01)	–	
YEAR	(0.26)	(0.15)	–	(0.07)	–	
P/E	(2.9)x	(5.1)x	–	(10.9)x	–	

Revenues (\$ millions)						
Yr Dec	2014A		2015E		2016E	
	Actual	Curr	Prev	Curr	Prev	
Mar	0.4	0.6A	–	2.4	–	
Jun	0.0	1.3	–	3.0	–	
Sep	0.1	1.3	–	3.8	–	
Dec	0.0	1.6	–	4.5	–	
YEAR	0.5	4.7	–	13.6	–	

One year price history XXII



Remain Positive on Company Progress

We believe 22nd Century is likely to exceed its \$1.5 million revenue guidance for Q2 as well as the \$5 million it has guided for the year. Since early May the company has added distribution in the US, expanded the number of retail outlets it is serving, received approval to distribute in all 50 states and the District of Columbia, has been granted both a Cigarette Stamping Agent license and a Wholesale Cigarette Dealer license in the important New York state market, initiated a brand ambassador program to drive acceptance at the end-user level, launched MAGIC in the UK, and bolstered the balance sheet with a \$6 million offering.

The catalysts for the shares this year remain the roll-out of RED SUN in the US, MAGIC in Europe and contract manufacturing. Other pivot points for the stock include 22nd Century's pursuit of multiple JVs in Asia (China, Japan, and South Korea) and it intends on consummating at least one of them this year. In addition, the company is hoping to close a deal to fund a phase 3 study for X-22. We have not built the latter two events into our estimates.

In the US, there are over 280 REDSUN retail outlets listed on the company's website but that only captures a subset of the total retailers selling the product. At the middle of May there were 170 stores listed on the company's website. The goal was 500 stores by the end of the Q2, which we believe was achieved. More will come as the year progresses and distributors expand into existing markets. Beginning June 1st, Rich & Rhine, a Portland-based distributor, doubled RED SUN's retail base, adding 200 independently owned retail stores.

22nd Century has deployed about a dozen "brand ambassadors" in key markets focusing on about 340 events during the remainder of the year to increase consumer awareness of the product.

MAGIC is also proceeding well. At launch the company had pre-orders from 900 stores in Spain, and currently has orders from 1,100 outlets and expects 2,500 by year-end. Late in in May the company launched MAGIC 0.0 in the UK. By year-end 22nd Century also hopes to have MAGIC available in four more countries including Belgium, Italy and France.

The take-up rate, is still an unknown. To date sales have been made to distributors but the real success of the product depends on end-user demand. Early indications probably won't be available until the end of Q3. At that point, re-orders by retailers, to distributors, will indicate how successful the company has been in the initial launch phase. It will take time to build demand and for that reason we have modeled modest growth this year for both RED SUN and MAGIC.

At the end of Q1 the company had \$3.8 million in cash but was set to receive \$1 million through August in settlement of a legal dispute. In addition, a \$6 million registered direct offering in late May added to

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the company's cash.

Other catalysts for the shares include an application for modified risk cigarettes, X-22 and the China JV. 22nd Century is seeking a pharmaceutical partner to fund a phase 3 study of its Brand A very-low nicotine cigarette. A handful of studies can be presented to the FDA, supplemented with a consumer perception study, reducing the time and expense required to get modified risk designation from the FDA. The company is also seeking a pharmaceutical partner to fund a phase 3 study for X-22. The China JV remains the biggest upside to our estimates since its contribution could quickly dwarf contributions from RED SUN, MAGIC and contract manufacturing.

We remain positive on the shares given near-term revenue generation for multiple sources but clearly the story has taken longer to develop than we expected. We believe there is a good chance the company will exceed our revenue estimates and there is significant upside possible from its Asian joint venture. Our \$9 price target is driven by a sum-of-the-parts methodology comprised of the discounted present value of the projected BAT license revenue, the discounted value of commercial product sales, RED SUN and MAGIC, and a value for the company's modified risk and X-22 initiatives.

Investment Summary:

We expect meaningful revenues to begin from product sales of the company's proprietary RED SUN and MAGIC brands. Over the longer-term 22nd 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.

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. BAT has the option to turn this research license into a royalty-bearing commercial license at any time.

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 and MAGIC can achieve \$150 to \$200 million in sales by 2023. 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 bogey. 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 22nd 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: We have assumed the commercial product growth trajectory will be similar to American Spirit, but changes in the industry can hinder 22nd 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:

22nd Century owns or exclusively controls 128 issued patents, 53 pending patent applications and has co-exclusive rights to another 2 patents and 16 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.

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

	2012	2013	2014	Q1 15	Q2 15 E	Q3 15 E	Q4 15 E	2015 E	2016 E
Revenue	19	7,278	529	616	1,250	1,250	1,550	4,666	13,625
Cost Of Goods Sold	68	462	498	633	1,065	1,065	1,215	3,978	9,813
Gross Profit	(49)	6,817	31	(16)	185	185	335	689	3,813
R&D	729	744	1,249	183	400	400	400	1,383	2,000
G&A	2,205	4,107	8,793	3,644	1,644	1,644	1,644	8,576	7,380
Pre-Mfg. Facility Costs	0	0	1,177	0	0	0	0	0	0
Sales & marketing	62	9	86	115	250	250	250	865	1,400
Depreciation & Amort.	198	144	463	161	150	150	150	611	700
Opex	3,195	5,004	11,768	4,103	2,444	2,444	2,444	11,435	11,480
Operating Income	(3,244)	1,812	(11,737)	(4,119)	(2,259)	(2,259)	(2,109)	(10,746)	(7,668)
Interest Expense	(1,495)	(749)	(7)	(6)	(2)	(2)	(2)	(12)	(8)
Other	0	122	(30)	(51)	1,000	0	0	949	0
Warrant Charge	(1,998)	(27,339)	(3,821)	59	0	0	0	59	0
Pretax Income	(6,737)	(26,153)	(15,595)	(4,117)	(1,261)	(2,261)	(2,111)	(9,750)	(7,676)
Income Tax Expense	0	0	0	0	0	0	0	0	(2,686)
Net before Minority Interest	(6,737)	(26,153)	(15,595)	(4,117)	(1,261)	(2,261)	(2,111)	(9,750)	(4,989)
Minority Interest	1	0	0	0	0	0	0	0	0
Net to Common	(6,735)	(26,153)	(15,595)	(4,117)	(1,261)	(2,261)	(2,111)	(9,750)	(4,989)
Shares	30,420	43,635	59,993	64,188	64,688	65,188	65,688	64,938	76,688
EPS	(\$0.22)	(\$0.60)	(\$0.26)	(\$0.06)	(\$0.02)	(\$0.03)	(\$0.03)	(\$0.15)	(\$0.07)

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

	2012	2013	2014	Q1 15	Q2 15 E	Q3 15 E	Q4 15 E	2015 E	2016 E
Cash	0	5,831	6,403	3,844	8,731	7,434	5,994	5,994	12,899
Due from related party and officers	41	50	46	46	46	46	46	46	46
A/R	0	0	0	209	329	329	575	575	2,055
Inventory	1,231	1,406	2,065	2,563	1,875	1,875	1,998	1,998	3,587
Prepaid Consulting Fees	0	0	1,979	0	0	0	0	0	0
Prepaid Exp.	10	458	214	458	335	335	357	357	641
Total Current Assets	\$ 1,281	\$ 7,744	\$ 10,707	\$ 7,120	\$ 11,315	\$ 10,019	\$ 8,971	\$ 8,971	\$ 19,228
Patent and Trademark costs	1,353	1,545	7,078	7,166	7,104	7,043	6,982	6,982	6,737
PP&E	6	2,998	2,851	2,794	2,826	2,854	2,878	2,878	2,928
Equity Investment	0	0	1,318	1,267	1,592	1,592	1,592	1,592	1,592
Total Assets	\$ 2,645	\$ 12,287	\$ 21,954	\$ 18,347	\$ 22,838	\$ 21,509	\$ 20,423	\$ 20,423	\$ 30,485
Bank Loans and N/P	2,686	175	495	495	495	495	495	495	495
A/P	1,411	55	884	1,414	1,034	1,034	1,102	1,102	1,978
Accrued Expenses	503	576	1,294	537	393	393	419	419	752
Deferred Revenue	0	179	0	0	0	0	0	0	0
Total Current Liabilities	\$ 4,603	\$ 984	\$ 2,673	\$ 2,446	\$ 1,922	\$ 1,922	\$ 2,016	\$ 2,016	\$ 3,225
Long-Term Debt	0	0	605	605	605	605	605	605	605
Accrued Severance	0	0	412	364	295	227	158	158	0
Warrant Liability & Other	4,173	3,780	3,043	2,984	2,984	2,984	2,984	2,984	2,984
Shareholder's Equity	(6,131)	7,523	15,220	11,948	17,032	15,771	14,660	14,660	23,671
Total Liabilities And Equity	\$ 2,645	\$ 12,287	\$ 21,954	\$ 18,347	\$ 22,838	\$ 21,509	\$ 20,423	\$ 20,423	\$ 30,485
Net Income	(6,737)	(26,153)	(15,595)	(4,117)	(1,261)	(2,261)	(2,111)	(9,750)	(4,989)
Depreciation & Amort.	198	144	463	185	154	158	163	660	695
Stock Comp	808	980	2,293	2,441	500	500	500	3,941	2,500
Other	3,866	29,386	6,740	52	(69)	(69)	(69)	(154)	(158)
Working Capital	100	(501)	(483)	(1,082)	168	0	(298)	(1,212)	(2,143)
Operating Cash Flow	(1,764)	3,856	(6,583)	(2,521)	(508)	(1,671)	(1,815)	(6,515)	(4,095)
Acquisition of Patents and trademarks	(163)	(290)	(727)	0	0	0	0	0	0
Capx	0	(3,452)	(212)	(4)	(125)	(125)	(125)	(379)	(500)
Other	0	0	(1,769)	0	0	0	0	0	0
Investing Activities	(163)	(3,743)	(2,708)	(4)	(125)	(125)	(125)	(379)	(500)
Debt	225	(1,810)	(4)	0	0	0	0	0	0
Equity	1,468	7,536	9,859	(35)	5,520	500	500	6,486	11,500
Other	(17)	(9)	7	0	0	0	0	0	0
Financing Activities	1,675	5,717	9,863	(35)	5,520	500	500	6,486	11,500
Change in Cash	(\$252)	\$ 5,830	\$ 572	(\$2,559)	\$ 4,887	(\$1,296)	(\$1,440)	(\$408)	\$ 6,905

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