

22nd Century Group, Inc. (NYSE AM: XXII)

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Buy: Building to Launch VLN Worldwide

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22nd Century is taking initial steps to launch its very-low-nicotine cigarette, VLN, in international markets with the signing of an agreement with a tobacco exporter, adding staff at its manufacturing facility and making investments to lower costs and increase productivity. Gross margin has improved substantially since 2019, and, we expect, will move higher with volume and the investments in productivity. We have not included a VLN launch in international markets in our price target, and success in those markets could be additive to our existing target.

Contract manufacturing began in 2015 and grew from \$7 million in annual revenue, with negative gross margin, to \$28 million in 2019 with 5.1% gross margin. Gross margin improved in the second half of 2020 and almost reached 10% in Q1. The improvement has been based on higher volumes, better pricing, and cost reductions. We expect these factors to continue with the agreement and actions announced yesterday.

Our price target includes \$3.08 per share for VLN assuming 22nd Century achieves a 3% market share of smokers attempting to quit, about 1.5% of the total market, based on CDC data (Source: CDC. Tobacco Product Use and Cessation Indicators Among Adults — United States, 2018). It does not include anything for sales of VLN in international markets.

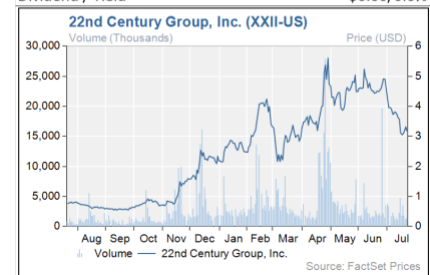
The company is now looking to leverage the investments it has made in VLN and will make the product available globally. In addition to the signed agreement cited above, 22nd Century is in advanced negotiations with two other partners that could expand distribution domestically and internationally.

Our estimates assume a steady state of contract manufacturing, but the recently signed cigar contract manufacturing deal could be a boost to our estimates and the addition of international sales would be additive as well. Regarding timing, the company continues to wait for approval of MRTP, which we think will occur this year.

Valuation: Our \$7 price target is the sum of: \$3.08/share for the VLN asset, \$3.18/share for the low-nicotine mandate and \$0.74 for the hemp/cannabis franchise.

Risks to Target: Our price target assumes approval of the company's MRTP application and a nicotine mandate, which could be delayed or may not be approved. Finding a partner for the VLN business could take longer than estimated and/or on different terms than assumed. The nicotine mandate may take longer to decide, and the transition period could be longer than estimated. There is no guarantee the industry will use 22nd Century's solution and it may opt to focus on other nicotine delivery systems as regulation of the combustible cigarette market increases. This could affect our assumptions on the royalty rate and market share.

Current Price	\$3.18		
Price Target	\$7.00		
Estimates	F2020A	F2021E	F2022E
Revenues (\$000s)	\$ 28,111	\$ 29,806 E	\$ 32,000
1Q March	\$ 7,058	\$ 6,806 A	\$ 9,500
2Q June	\$ 6,435	\$ 7,000 E	\$ 7,500
3Q September	\$ 7,310	\$ 7,000 E	\$ 7,500
4Q December	\$ 7,308	\$ 9,000 E	\$ 7,500
	F2020A	F2021E	F2022E
EPS (diluted)	\$ (0.14)	\$ (0.11)E	\$ (0.10)
1Q March	\$ (0.03)	\$ (0.03)A	\$ (0.02)
2Q June	\$ (0.04)	\$ (0.03)E	\$ (0.03)
3Q September	\$ (0.03)	\$ (0.03)E	\$ (0.03)
4Q December	\$ (0.05)	\$ (0.02)E	\$ (0.03)
EBITDA (\$Ms)	\$ (16.0)	\$ (15.5)	\$ (15.7)
EV/EBITDA (x)	-28.0x	-28.9x	-28.5x
Stock Data			
52-Week Range	\$0.55	-	\$6.07
Shares Outstanding (mil.)			162.6
Market Capitalization (mil.)			\$517
Enterprise Value (mil.)			\$448
Debt to Capital			1%
Book Value/Share			\$0.34
Price/Book			9.2x
Average Three Months Trading Volume (K)			8,476
Insider Ownership			2.4%
Institutional Ownership			28.2%
Short interest (mil.)			8.1%
Dividend / Yield			\$0.00/0.0%



Approval of the company's MRTP by the FDA is still the mostly likely near-term catalyst, in our view. Since the company's MRTP fits into the FDA's strategy of reducing tobacco consumption, we continue to believe approval of the MRTP will occur. We think it is likely, based on the FDA's long-standing goal of reducing cigarette consumption, that the FDA will reintroduce a low-nicotine mandate, although the timing is uncertain and could follow nomination and confirmation of an FDA commissioner. We believe it is reasonable to assume a new mandate would broadly follow the 2018 ANPRM since none of the studies supporting the efficacy of a low-nicotine mandate have been invalidated and, in our opinion, technical achievability of a mandate has been demonstrated by 22nd Century.

The company has ample financial resources to execute its plan. It recently raised \$40 million in gross proceeds, \$38.2 million net, from the sale of 10 million shares to one investor, bringing pro forma cash to almost \$70 million, or over 5 years of cash at recent burn rates. However, we believe the burn rate can decline with successful monetization of the company's tobacco IP and initiatives in hemp and cannabis. The stronger balance sheet will, in our view, provide greater negotiating leverage to the company in the case where a low-nicotine mandate is implemented, provide greater resources to roll out a VLN cigarette if and when the MRTP is approved, build out the hemp/cannabis franchise and acquire additional IP in the existing or new franchises.

Our price target of \$7 comprises three components: We attribute about \$3.08/share for the VLN asset. The non-addictive nicotine mandate is valued at \$3.18 per share. The remainder of the price target, or \$0.74 per share, equals about \$112 million and encompasses its investment in Panacea, the Anandia licenses and the potential from its relationship with KeyGene. We have assumed a long gestation period for the hemp/cannabis business because it is in the early stages. However, the Aurora announcement and the restructuring of the Panacea investment could be catalysts to more rapid development of the market and 22nd Century's monetization efforts.

Price Target. Our \$7 price target is the sum of the estimated values of the VLN, non-addictive nicotine and hemp franchises. We attribute about \$3.08/share for the VLN asset. The non-addictive nicotine mandate is valued at \$3.18 per share. The remainder of the price target comprises the investment in the hemp business and the relationship with KeyGene.

Risk Analysis

The tobacco industry is highly regulated, and our price target depends on approval of the company's MRTP application and a nicotine mandate, which could be delayed or may not be approved. Our price target assumes the company will find a partner for the VLN business and this could take longer than estimated and/or the partner could demand different terms than assumed. The nicotine mandate may take longer to decide, and the transition period could be longer than estimated. There will likely be other paths attempted by the industry to comply or the industry may opt to focus on other nicotine delivery systems as regulation of the combustible cigarette market increases. This could affect our assumptions on the royalty rate as well as market share.

Exhibit 1. Income Statement

(\$ in 000s, except per-share data)

	2018	2019	2020	Q1 21 A	Q2 21 E	Q3 21 E	Q4 21 E	2021 E	2022 E
Revenue	\$ 26,426	\$ 25,833	\$ 28,111	\$ 6,806	\$ 7,000	\$ 7,000	\$ 9,000	\$ 29,806	\$ 32,000
Cost Of Goods Sold	25,527	25,818	26,673	6,159	6,159	6,159	6,159	24,636	26,000
Gross Profit	899	14	1,438	647	841	841	2,841	5,170	6,000
			5.1%	9.5%					
R&D	14,990	8,057	4,128	701	701	701	701	2,804	2,944
G&A	7,658	12,956	14,971	4,829	4,829	4,829	5,418	19,905	20,900
Impairment Charge	0	1,142	176	0	0	0	0	0	0
Sales & marketing	927	0	0	0	0	0	0	0	0
Depreciation & Amort.	1,342	1,425	1,346	288	288	288	288	1,152	1,152
Opex	24,918	23,581	20,621	5,818	5,818	5,818	6,407	23,861	24,996
Operating Income	\$ (24,019)	\$ (23,566)	\$ (19,183)	\$ (5,171)	\$ (4,977)	\$ (4,977)	\$ (3,566)	\$ (18,691)	\$ (18,996)
Other	14,945	(4,002)	(428)	36	36	36	36	144	144
Impairment Charge	49	0	(1,741)	0	0	0	0	0	0
Interest Income	1,069	1,066	1,751	112	309	652	617	1,691	2,218
Interest Expense	(11)	(56)	(72)	(7)	(7)	(7)	(7)	(28)	(28)
Pretax Income	(7,967)	(26,559)	(19,673)	(5,030)	(4,639)	(4,296)	(2,920)	(16,884)	(16,662)
Income Tax Expense	0	0	38	0	0	0	0	0	0
Net to Common	\$ (7,967)	\$ (26,559)	\$ (19,711)	\$ (5,030)	\$ (4,639)	\$ (4,296)	\$ (2,920)	\$ (16,884)	\$ (16,662)
Shares (000)	124,299	125,883	138,813	144,258	157,421	162,694	163,194	156,892	164,007
EPS	(\$0.06)	(\$0.21)	(\$0.14)	(\$0.03)	(\$0.03)	(\$0.03)	(\$0.02)	(\$0.11)	(\$0.10)
D&A	1,200	1,425	1,346	288	288	288	288	1,152	1,152
Stock Comp	3,187	3,540	1,654	507	507	507	507	2,028	2,129
Other	0	1,142	176	0	0	0	0	0	0
EBITDA	\$ (19,632)	\$ (17,459)	\$ (16,007)	\$ (4,376)	\$ (4,182)	\$ (4,182)	\$ (2,771)	\$ (15,511)	\$ (15,715)

 Source: 22nd Century Group, Inc. and Dawson James Securities estimates

Exhibit 2. Balance Sheet and Cash Flow Statement

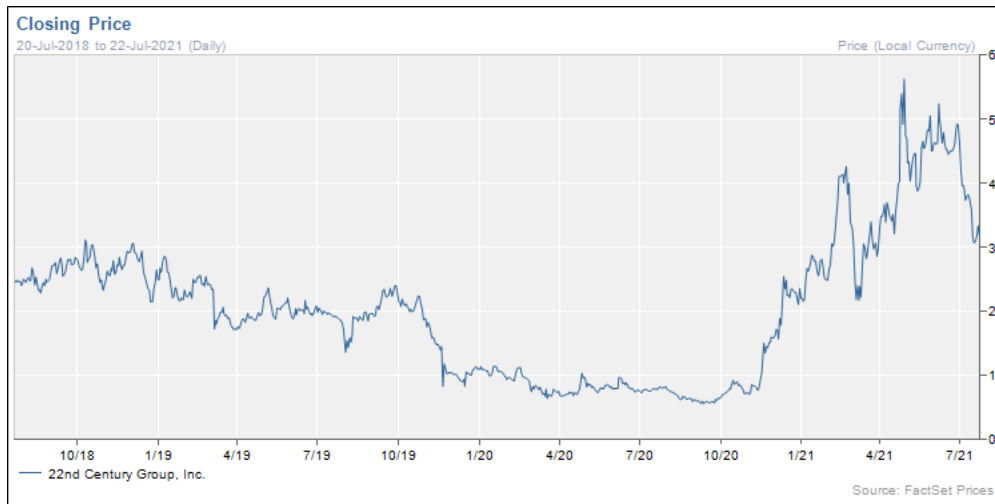
(\$ in 000s)

	2018	2019	2020	2021 E	2022 E
Cash	605	485	1,029	1,272	1,272
Short-Term Investments	55,749	38,477	21,313	58,252	44,671
A/R	871	867	2,159	2,023	2,023
Inventory	3,044	2,266	2,034	2,137	2,137
Prepaid Exp.	928	648	1,806	1,280	1,280
Total Current Assets	\$ 61,198	\$ 42,743	\$ 28,341	\$ 64,964	\$ 51,383
PP&E	3,261	3,120	2,483	2,148	1,696
Operating Lease	0	602	247	182	182
Patent, Trademark, other intangibles	9,752	8,494	8,211	8,035	7,935
Equity Investment	3,092	8,403	6,536	6,643	6,643
Convertible Note Receivable	0	5,589	5,876	5,876	5,876
Total Assets	\$ 77,302	\$ 68,951	\$ 51,694	\$ 87,848	\$ 73,715
Bank Loans and N/P	689	581	539	295	295
Operating Lease	0	220	247	182	182
A/P	2,575	1,998	1,116	1,572	1,572
Accrued Expenses	1,826	2,619	4,830	4,681	4,681
Accrued Severance	0	359	339	274	274
Deferred Income	83	5	272	0	0
Total Current Liabilities	\$ 5,174	\$ 5,780	\$ 7,343	\$ 7,004	\$ 7,004
Long-Term Debt	848	292	0	0	0
Operating Lease	0	382	0	0	0
Accrued Severance	0	446	241	187	187
Shareholders' Equity	71,280	62,051	44,110	80,657	66,524
Total Liabilities And Equity	\$ 77,302	\$ 68,951	\$ 51,694	\$ 87,848	\$ 73,715
	2018	2019	2020	2021 E	2022 E
Net Income	(7,967)	(26,559)	(19,711)	(16,884)	(16,662)
Depreciation & Amort.	1,200	1,425	1,345	1,152	1,152
Stock Comp	3,187	3,540	1,654	2,028	2,129
Other	(14,618)	7,249	2,722	(10)	0
Working Capital	354	(242)	(1,631)	334	0
Operating Cash Flow	\$ (17,844)	\$ (14,587)	\$ (15,621)	\$ (13,380)	\$ (13,381)
Acquisition of Patents and trademarks	(657)	(515)	(468)	(395)	(500)
CapEx	(449)	(527)	(54)	(175)	(100)
Other	16,251	5,595	16,991	(8,415)	0
Investing Activities	\$ 15,145	\$ 4,552	\$ 16,469	\$ (8,985)	\$ (600)
Debt	(800)	(700)	(354)	(246)	0
Equity	445	10,616	50	51,435	400
Other	0	0	0	0	0
Financing Activities	\$ (355)	\$ 9,916	\$ (304)	\$ 51,189	\$ 400
Change in Cash	(\$3,055)	(\$120)	\$ 544	\$ 28,824	(\$13,581)

 Source: 22nd Century Group, Inc. and Dawson James Securities estimates

Important Disclosures:

Price Chart:



Price target and ratings changes over the past three years:

Initiated – Buy – April 13, 2021 – Price Target \$7.00
 Update – Buy – April 15, 2021 – Price Target \$7.00
 Update – Buy – April 19, 2021 – Price Target \$7.00
 Update – Buy – May 7, 2021 – Price Target \$7.00
 Update – Buy – June 1, 2021 – Price Target \$7.00
 Update – Buy – June 11, 2021 – Price Target \$7.00
 Update – Buy – July 2, 2021 – Price Target \$7.00
 Update – Buy – July 23, 2021 – Price Target \$7.00

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- 1) **Buy:** The analyst believes the price of the stock will appreciate and produce a total return of at least 20% over the next 12-18 months.
- 2) **Neutral:** The analyst believes the price of the stock is fairly valued for the next 12-18 months.
- 3) **Sell:** The analyst believes the price of the stock will decline by at least 20% over the next 12-18 months and should be sold.

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As of: 30-Jun-21

Ratings Distribution	Company Coverage		Investment Banking	
	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	24	71%	4	17%
Market Perform (Neutral)	10	29%	0	0%
Market Underperform (Sell)	0	0%	0	0%
Total	34	100%	4	12%

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