

## 22nd Century Group, Inc. (NASDAQ: XXII)

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### Buy: Q3 Review.

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Q3 revenue was better than expected but gross margin was lower than forecast and operating expenses higher than modeled resulting in EBITDA below our estimates. We expect gross margins to improve with the commission of a new extraction facility and a greater contribution from high-margin VLN sales. VLN is now available in five states and will be offered in states comprising half the U.S. market over the next 12 to 18 months. The company has line of sight to 1% market share suggesting a multi-billion VLN franchise value. We reiterate our Buy recommendation and \$8.50 price target.

Q3 revenue was \$19.4 million, better than our \$17.9 million estimate, from better-than-expected tobacco revenue. Gross margin was much lower than forecast, primarily due to lower than forecast margin at GVB. The company is opening a new extraction facility this quarter which should result in better margins as should greater regulation of the market by the FDA and receipt of pharmaceutical-grade API certifications.

Tobacco revenue was \$11.5 million in the quarter, up from \$10.0 million in Q2 and a result of increased contract manufacturing. For 2023 we expect the current level of contract manufacturing to be sustained and \$5 million to \$10 million of VLN revenue as the company expands in the five states it currently serves and enters up to 13 more states that would allow the company to address about 50% of the U.S. tobacco market. There is line of sight to 1% market share suggesting a multi-billion VLN franchise value.

We estimate a 1% market share of the domestic combustible cigarette market could be worth over \$2 billion, or over \$10 per share. In 2021 Altria generated \$22.9 billion in sales (including excise taxes) from smokeable products. Using its estimated market share of 48.8% puts the domestic combustible market for manufacturers at almost \$47 billion. (The retail market is about \$80 billion). 1% share of this market equates to \$470 million in sales and using the 5x EV/Sales multiple Altria (and Philip Morris International) trade at suggests a value of 1% market share of \$2.4 billion.

For next year we expect revenue of \$91 million, about \$40 million from contract manufacturing, \$44 million from GVB and \$7 million from VLN. We have modeled margins to improve with the GVB extraction unit that is coming online in Q4. We expect FDA enforcement action to drive some of the weaker competitors out of the space and this should also benefit pricing and margins at GVB. As VLN scales, this too should improve margins, but we expect the more meaningful impact in 2024.

**Valuation:** Our \$8.50 price target is the sum of: An estimated \$4.58/share for the VLN asset, \$3.18/share for the low-nicotine mandate and \$0.74 for the hemp/cannabis franchise.

**Risks to Target include, among others:** Our price target assumes the company launches VLN pilots in test markets this year and this could take longer than estimated, and/or its partner could demand different terms than assumed. Our price target also assumes a nicotine mandate. The nicotine mandate may take longer to decide, and the transition period could be longer than estimated. See the Risks Analysis section for additional risks.

Current Price	\$1.13		
Price Target	\$8.50		
Estimates			
	F2021A	F2022E	F2023E
Revenues (\$M's)	\$ 30.9	\$ 63.4	\$ 90.9
1Q March	\$ 6.8	\$ 9.0	\$ 20.7
2Q June	\$ 8.4	\$ 14.5	\$ 21.3
3Q September	\$ 7.8	\$ 19.4	\$ 22.2
4Q December	\$ 8.0	\$ 20.5	\$ 26.7
	F2021A	F2022E	F2023E
EPS (diluted)	\$ (0.21)	\$ (0.24)	\$ (0.21)
1Q March	\$ (0.03)	\$ (0.05)	\$ (0.06)
2Q June	\$ (0.03)	\$ (0.06)	\$ (0.05)
3Q September	\$ (0.06)	\$ (0.06)	\$ (0.05)
4Q December	\$ (0.09)	\$ (0.06)	\$ (0.05)
EBITDA (\$Ms)			
	\$ (23.2)	\$ (32.9)	\$ (29.4)
EV/EBITDA (x)			
	-10.5x	-7.4x	-8.3x
Stock Data			
52-Week Range	\$0.85	-	\$3.52
Shares Outstanding (mil.)	215.3		
Market Capitalization (mil.)	\$243		
Enterprise Value (mil.)	\$243		
Debt to Capital	7%		
Cash (mil.)	\$43.7		
Cash/share	\$0.20		
Average Three Months Trading Volume (K)	2,572		
Insider Ownership	2.6%		
Institutional Ownership	19.8%		
Short interest (mil.)	7.0%		
Dividend / Yield	\$0.00/0.0%		



**Actual v Estimates**

Tobacco sales were \$11.5 million and Hemp/Cannabis (primarily GVB) \$7.9 million. Gross margin was weaker than expected, mostly at GVB with pricing weaker than expected. A new extraction facility in Oregon will help, as will FDA action to clamp down on the market, and pharmaceutical API certification. We have modeled gross margin to improve beginning Q4 as a result of these factors.

Operating expenses were higher than modeled. About half of the \$3.5 million delta was non-cash acceleration of stock compensation expense and about half from strategic consulting expenses for IP protection. Stock comp should drop back to normal levels in Q4, while elevated strategic consulting expenses will remain for a few quarters.

<b>Q3 22</b>			
<i>\$ in 000's, except per-share data</i>	Actual	Estimates	
Revenue	\$ 19,383	\$ 17,870	8.5%
Cost Of Goods Sold	18,764	14,070	33.4%
Gross Profit	619	3,800	-83.7%
	3.2%	21.3%	
R&D	1,318	1,897	-30.5%
G&A	14,569	10,471	39.1%
Opex	15,887	12,368	28.5%
Operating Income	\$ (15,268)	\$ (8,568)	-78.2%
Other Income (Expense)	(415)	(1,020)	
Pretax Income	(15,683)	(9,588)	
Income Tax Expense	(2,581)	0	
Net to Common	\$ (13,102)	\$ (9,588)	
Shares (000)	210,131	206,223	
EPS	\$ (0.06)	\$ (0.05)	
D&A	1,068	503	
Stock Comp	2,247	1,106	
EBITDA	(10,975)	(6,959)	

Source: 22<sup>nd</sup> Century Group, Inc. and Dawson James Securities estimates

We have increased our revenue estimates but lowered our EPS and EBITDA estimates to reflect the Q3 results, improved outlook for VLN and contract manufacturing and margin pressure at GVB.

	2022E		2023E	
	Old	New	Old	New
Revenue (\$M)	\$ 61.5	\$ 63.4	\$ 88.0	\$ 90.9
EPS	\$ (0.20)	\$ (0.25)	\$ (0.16)	\$ (0.21)
EBITDA (\$M)	\$ (26.7)	\$ (32.9)	\$ (23.9)	\$ (29.4)

Source: Dawson James Securities estimates

**Valuation.** Our price target of \$8.50 comprises three components: We attribute about \$4.58/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 the company's investment in Exactus, 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/Exactus investment could be catalysts to more rapid development of the market and 22nd Century's monetization efforts.

#### **Risk Analysis**

Our price target assumes the company launches VLN pilots in test markets this year, and this could take longer than estimated and/or its launch partner could demand different terms than assumed. Our price target also assumes a nicotine mandate. 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**

<i>(\$ in 000's except per-share data)</i>	2019	2020	2021	Q1 22 A	Q2 22 A	Q3 22 A	Q4 22 E	2022 E	2023 E
Revenue	\$ 25,833	\$ 28,111	\$ 30,948	\$ 9,045	\$ 14,477	\$ 19,383	\$ 20,500	\$ 63,405	\$ 90,913
Cost Of Goods Sold	25,818	26,673	28,879	8,585	13,585	18,764	17,950	58,884	75,868
Gross Profit	14	1,438	2,069	460	892	619	2,550	4,521	15,045
	0.1%	5.1%	6.7%	5.1%	6.2%	3.2%	12.4%	7.1%	16.5%
R&D	8,057	4,128	3,274	972	1,897	1,318	1,318	5,505	5,272
G&A	12,956	14,971	25,881	7,305	9,471	14,569	12,869	44,214	52,441
Impairment Charge	1,142	176	78	0	0	0	0	0	0
Depreciation & Amort.	1,425	1,346	1,248	329	0	0	0	329	0
Opex	23,581	20,621	30,481	8,606	11,368	15,887	14,187	50,048	57,713
Operating Income	\$ (23,566)	\$ (19,183)	\$ (28,412)	\$ (8,146)	\$ (10,476)	\$ (15,268)	\$ (11,637)	\$ (45,527)	\$ (42,668)
Interest and other, net	(2,992)	(490)	(4,183)	(772)	(1,022)	(415)	(478)	(2,687)	(1,912)
Pretax Income	(26,559)	(19,673)	(32,595)	(8,918)	(11,498)	(15,683)	(12,115)	(48,214)	(44,580)
Income Tax Expense	0	38	14	0	0	(2,581)	0	0	0
Net to Common	\$ (26,559)	\$ (19,711)	\$ (32,609)	\$ (8,918)	\$ (11,498)	\$ (13,102)	\$ (12,115)	\$ (48,214)	\$ (44,580)
Shares (000)	125,883	138,813	156,208	163,157	182,044	210,131	215,302	192,658	215,689
EPS	(\$0.21)	(\$0.14)	(\$0.21)	(\$0.05)	(\$0.06)	(\$0.06)	(\$0.06)	(\$0.25)	(\$0.21)
D&A	1,425	1,346	1,248	421	503	1,068	1,068	3,060	4,272
Stock Comp	3,540	1,654	3,983	1,213	1,106	2,247	2,247	6,813	8,988
Other	1,142	176	0	0	1,765	978	0	2,743	0
EBITDA	\$ (17,459)	\$ (16,007)	\$ (23,181)	\$ (6,512)	\$ (7,102)	\$ (10,975)	\$ (8,322)	\$ (32,911)	\$ (29,408)

Source: 22<sup>nd</sup> Century Group, Inc. and Dawson James Securities estimates

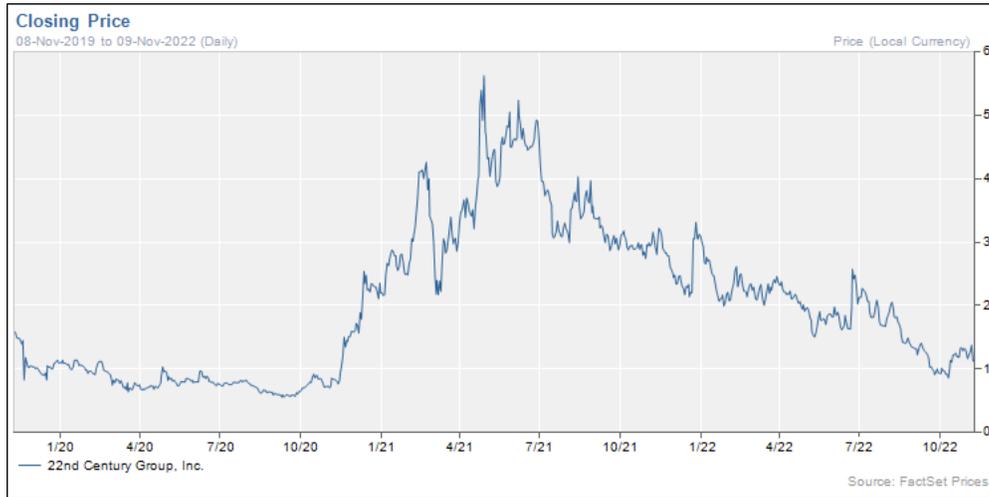
**Exhibit 2. Balance Sheet and Cash Flow Statement**

(\$ in 000's)	2019	2020	2021	2022 E	2023 E
Cash	485	1,029	1,336	2,364	2,364
Short-Term Investments	38,477	21,313	47,400	34,547	2,387
A/R	867	2,159	585	3,370	7,315
Inventory	2,266	2,034	2,881	11,732	8,127
Prepaid Exp.	648	1,806	2,183	3,463	3,463
<b>Total Current Assets</b>	<b>\$ 42,743</b>	<b>\$ 28,341</b>	<b>\$ 54,385</b>	<b>\$ 55,476</b>	<b>\$ 23,656</b>
PP&E	3,120	2,483	5,841	17,489	14,329
Operating Lease	602	247	1,723	2,429	2,429
Goodwill		0	0	33,748	33,748
Patent, Trademark, other intangibles	8,494	8,211	7,919	18,283	18,071
Equity Investment	8,403	6,536	2,345	981	981
Other Assets	5,589	5,876	3,741	4,002	4,002
<b>Total Assets</b>	<b>\$ 68,951</b>	<b>\$ 51,694</b>	<b>\$ 75,954</b>	<b>\$ 132,408</b>	<b>\$ 97,216</b>
Bank Loans and N/P	581	539	596	5,825	5,825
Operating Lease	220	247	308	927	927
A/P	1,998	1,116	2,173	5,787	5,787
Accrued Expenses & Payroll	2,619	4,830	5,014	3,511	3,511
Accrued excise taxes and fees		0	0	1,525	1,525
Deferred Income	5	272	119	693	693
Accrued Severance	359	339	217	397	397
<b>Total Current Liabilities</b>	<b>\$ 5,780</b>	<b>\$ 7,343</b>	<b>\$ 8,427</b>	<b>\$ 18,665</b>	<b>\$ 18,665</b>
Long-Term Debt	292	0	0	220	220
Operating Lease	382	0	1,432	1,592	1,592
Accrued Severance	446	241	21	0	0
Shareholders' Equity	62,051	44,110	66,074	111,320	76,128
<b>Total Liabilities And Equity</b>	<b>\$ 68,951</b>	<b>\$ 51,694</b>	<b>\$ 75,954</b>	<b>\$ 132,408</b>	<b>\$ 97,216</b>
	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022 E</b>	<b>2023 E</b>
Net Income	(26,559)	(19,711)	(32,609)	(45,633)	(44,580)
Depreciation & Amort.	1,425	1,345	1,248	3,060	4,272
Stock Comp	3,540	1,654	3,983	6,813	8,988
Other	7,249	2,722	5,272	3,844	0
Working Capital	(242)	(1,631)	(733)	(7,417)	(340)
<b>Operating Cash Flow</b>	<b>\$ (14,587)</b>	<b>\$ (15,621)</b>	<b>\$ (22,839)</b>	<b>\$ (39,333)</b>	<b>\$ (31,660)</b>
Acquisition of Patents and trademarks	(515)	(468)	(326)	(519)	(500)
CapEx	(527)	(54)	(745)	(2,601)	(400)
Other	5,595	16,991	(26,658)	3,275	0
<b>Investing Activities</b>	<b>\$ 4,552</b>	<b>\$ 16,469</b>	<b>\$ (27,729)</b>	<b>\$ 155</b>	<b>\$ (900)</b>
Debt	(700)	(354)	49	638	0
Equity	10,616	50	50,826	32,758	400
Other	0	0	0	0	0
<b>Financing Activities</b>	<b>\$ 9,916</b>	<b>\$ (304)</b>	<b>\$ 50,875</b>	<b>\$ 33,396</b>	<b>\$ 400</b>
Change in Cash	<b>(\$120)</b>	<b>\$ 544</b>	<b>\$ 307</b>	<b>(\$5,782)</b>	<b>(\$32,160)</b>

 Source: 22<sup>nd</sup> 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
- Update – Buy – August 6, 2021 – Price Target \$7.00
- Update – Buy – August 31, 2021 – Price Target \$7.00
- Update – Buy – October 18, 2021 – Price Target \$7.00
- Update – Buy – November 5, 2021 – Price Target \$7.00
- Update – Buy – November 22, 2021 – Price Target \$7.00
- Update – Buy – December 9, 2021 – Price Target \$7.00
- Update – Buy – December 23, 2021 – Price Target \$7.00
- Price Target Change – Buy – January 6, 2022 – Price Target changed from \$7.00 to \$8.50
- Update – Buy – January 24, 2022 – Price Target \$8.50
- Update – Buy – February 16, 2022 – Price Target \$8.50
- Update – Buy – February 24, 2022 – Price Target \$8.50
- Update – Buy – March 4, 2022 – Price Target \$8.50
- Update – Buy – May 2, 2022 – Price Target \$8.50
- Update – Buy – May 6, 2022 – Price Target \$8.50
- Update – Buy – May 16, 2022 – Price Target \$8.50
- Update – Buy – June 13, 2022 – Price Target \$8.50
- Update – Buy – June 22, 2022 – Price Target \$8.50
- Update – Buy – July 1, 2022 – Price Target \$8.50
- Update – Buy – July 26, 2022 – Price Target \$8.50
- Update – Buy – August 10, 2022 – Price Target \$8.50
- Update – Buy – September 21, 2022 – Price Target \$8.50
- Update – Buy – October 20, 2022 – Price Target \$8.50
- Update – Buy – October 27, 2022 – Price Target \$8.50
- Update – Buy – November 9, 2022 – Price Target \$8.50

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- 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.

The following chart reflects the range of current research report ratings for all companies, followed by the analysts of the Firm. The chart also reflects the research report ratings relating to those companies for which the Firm has performed investment banking services.

Current as of 28-Oct-22

	Company Coverage		Investment Banking	
<b>Ratings Distribution</b>	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	24	80%	3	13%
Market Perform (Neutral)	5	17%	1	20%
Market Underperform (Sell)	1	3%	0	0%
Total	30	100%	4	13%

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