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

September 6, 2023

Buy: Exploring Strategic Options for Tobacco Business.

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22nd Century announced it has begun a process to consider strategic alternatives for its tobacco business including “business combinations, asset sales, licensing agreements, [and] alternate financing strategies”.

The company’s tobacco business generated about \$38 million, or 45% of total company sales, over the past 12 months, but most of this from contract manufacturing. Over the coming quarters, we have modeled a reduction in contract manufacturing, displaced by production of the company’s VLN cigarettes. But that transition has taken longer than expected as indicated by the change in company leadership in July, followed by the cost-cutting program and reduced revenue guidance. We think it is early yet to monetize the tobacco business, given the company is still in the initial stages of rolling out VLN, but a combination, asset sale, licensing agreement or joint venture has always been an option we considered possible.

Before its cost-cutting program, the company estimated it could achieve positive cash-flow for its tobacco business at annual VLN volumes of 1.2 million cartons, or \$72 million in revenue, at \$60 per carton. We believe the company will need to generate close to this amount or demonstrate it is on a path to doing so if it wants to monetize the tobacco business at industry multiples of 3x-5x sales.

Relative to the size of the market, 1.2 million cartons is modest. Annual volumes in the U.S. is almost 900 million cartons and 22nd Century is now addressing about 55% to 60% of the total market. If we assume the cost-cutting program focuses the company on half of where it is currently distributing product, achieving sales of 1.2 million cartons implies a market share of less than 0.5% in the markets it would be actively addressing.

The challenge for the company is how much time, and money, it will take to achieve this market share and exploring strategic options could address one or both of the factors, but we expect it would come at the cost of a lower valuation or reduced participation in future revenue and cash flow.

Should the company exit the tobacco business, the remaining sales, about \$45 million in the past twelve months, would come from the CBD business, which is expected to show substantial margin improvement as distillate and isolate capacity come on-line in the remaining months of this year. However, multiples of sales in the CBD business are much lower than in the tobacco business, less than 1x versus ~4x, due to the lower margin profile of the business.

Valuation: Our \$7.50 price is based on a multiple of sales of about 1.5x our 2024 revenue estimate of \$148 million and assumes a 32 million share count, after the warrant exercise. The multiple range is consistent with other companies in the space, but as margins and cash flow improve, we expect the multiple can increase.

Risks to Target: Our price target assumes success in VLN launches this year and this could take longer than estimated, and/or its partner could demand different terms than assumed. We assume significant margin expansion in both the tobacco and hemp segments which will be driven partly by capacity utilization. Our forecasted growth in the company’s hemp segment this year could be impacted by price pressures

Estimates	F2022A	F2023E	F2024E
Current Price			\$1.54
Price Target			\$7.50
Revenues (\$M's)	\$ 62.1	\$ 85.9	\$ 148.5
1Q March	\$ 9.0	\$ 22.0	\$ 26.0
2Q June	\$ 14.5	\$ 23.4	\$ 32.5
3Q September	\$ 19.4	\$ 19.5	\$ 40.0
4Q December	\$ 19.2	\$ 21.0	\$ 50.0
EBITDA (\$M's)	\$ (39.2)	\$ (50.8)	\$ (2.6)
1Q March	\$ (6.5)	\$ (14.6)	\$ (4.9)
2Q June	\$ (6.9)	\$ (16.1)	\$ (2.8)
3Q September	\$ (11.0)	\$ (10.9)	\$ 0.0
4Q December	\$ (14.8)	\$ (8.0)	\$ 5.0
EBITDA (\$Ms)	\$ (39.2)	\$ (50.8)	\$ (2.6)
EV/Sales	0.7x	0.5x	0.3x
Stock Data			
52-Week Range	\$1.22	-	\$21.75
Shares Outstanding (mil.)			21.1
Market Capitalization (mil.)			\$32
Enterprise Value (mil.)			\$41
Debt to Capital			24%
Cash (mil.)			\$17.8
Cash/share			\$0.85
Average Three Months Trading Volume (K)			61
Insider Ownership			2.3%
Institutional Ownership			9.1%
Short interest (mil.)			6.0%
Dividend / Yield			\$0.00/0.0%



Valuation is compelling. The shares trade at 0.4x our 2024 revenue estimate, far below the comp group of hemp/cannabis and tobacco stocks. We expect significant improvement in gross margin as volume in both segments grows, distillate and isolate capacity comes online and VLN sales ramp. Also, a \$15 million annual expense reduction program is underway and is a key component of our positive EBITDA estimate by mid-year 2024.

Gross margin in the hemp/cannabis segment has been negatively impacted by the Grass Valley fire and the subsequent lack of distillate and isolate manufacturing capacity forced the company to purchase product on the open market to satisfy customer demand. Distillate capacity comes online this quarter and isolate capacity in Q4, which will drive gross margin higher.

VLN sales remain modest but will grow over time as customer education and awareness improves. The company has a large footprint, and a consequence of the expense reduction will be a focus on the higher-volume, densely populated markets. As VLN sales grow, margins will improve, as we expect 50% gross margins at reasonable volumes.

The change in company leadership, the cost reduction program, and the need to expand margins have caused a change in how the company is addressing the VLN market. The company will focus on customer education and awareness in fewer markets in order to more efficiently deploy its capital. This will result in lower revenue than we previously forecast but the size of the available market is unchanged.

Tobacco stocks trade at EV/Sales multiple of 3x to 5x, and as the company's tobacco sales increase, we believe the multiple can as well. Currently the shares trade at 0.7x 2023 estimated sales and about 40% of 2024 estimated sales.

The depressed multiple of sales, we believe, is a reflection of low gross margin in both the hemp and tobacco segments as well as an uncertain path to positive operational cash flow and the cash needed to get there. We expect gross margin to show noticeable improvement in the coming quarters from both the hemp and tobacco units and the \$15 million annualized cost-cutting program should result in sharply improved cash flow and positive operational cash flow by mid-year 2024.

Exhibit 1. Income Statement

<i>(\$ in 000's except per-share data)</i>	2020	2021	2022	Q1 23 A	Q2 23 A	Q3 23 E	Q4 23 E	2023 E	2024 E
Revenue	\$ 28,111	\$ 30,948	\$ 62,111	\$ 21,962	\$ 23,427	\$ 19,500	\$ 21,000	\$ 85,889	\$ 148,500
Cost Of Goods Sold	26,673	28,879	60,937	23,139	25,772	18,860	19,355	87,126	117,750
Gross Profit	1,438	2,069	1,174	(1,177)	(2,345)	640	1,645	(1,237)	30,750
	5.1%	6.7%	1.9%	-5.4%	-10.0%	3.3%	7.8%	-1.4%	20.7%
SG&A	14,971	25,881	44,517	14,231	14,540	12,665	10,790	52,226	38,637
R&D	4,128	3,274	6,561	1,517	1,793	1,793	1,793	6,896	6,400
Other	176	78	7,202	898	675	0	0	1,573	0
Depreciation & Amort.	1,346	1,248	0	0	0	0	0	0	0
Opex	20,621	30,481	58,280	16,646	17,008	14,458	12,583	60,695	45,037
Operating Income	\$ (19,183)	\$ (28,412)	\$ (57,106)	\$ (17,823)	\$ (19,353)	\$ (13,818)	\$ (10,938)	\$ (61,932)	\$ (14,287)
Interest and other, net	(490)	(4,183)	(3,129)	(359)	(1,140)	(1,080)	(1,080)	(3,659)	(4,320)
Pretax Income	(19,673)	(32,595)	(60,235)	(18,182)	(20,493)	(14,898)	(12,018)	(65,591)	(18,607)
Income Tax Expense	38	14	(434)	0	0	0	0	0	0
Net to Common	\$ (19,711)	\$ (32,609)	\$ (59,801)	\$ (18,182)	\$ (20,493)	\$ (14,898)	\$ (12,018)	\$ (65,591)	\$ (18,607)
Shares (000)	9,254	10,414	12,856	14,386	14,900	18,503	21,079	17,217	30,680
EPS	(\$2.13)	(\$3.13)	(\$4.65)	(\$1.26)	(\$1.38)	(\$0.81)	(\$0.57)	(\$3.81)	(\$0.61)
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D&A	1,346	1,536	3,306	1,175	1,442	1,442	1,442	5,501	5,768
Stock Comp	1,654	3,983	5,489	1,175	1,486	1,486	1,486	5,633	5,944
Other	176	0	9,065	898	336	0	0	0	0
EBITDA	\$ (16,007)	\$ (22,893)	\$ (39,246)	\$ (14,575)	\$ (16,089)	\$ (10,890)	\$ (8,010)	\$ (50,798)	\$ (2,575)

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

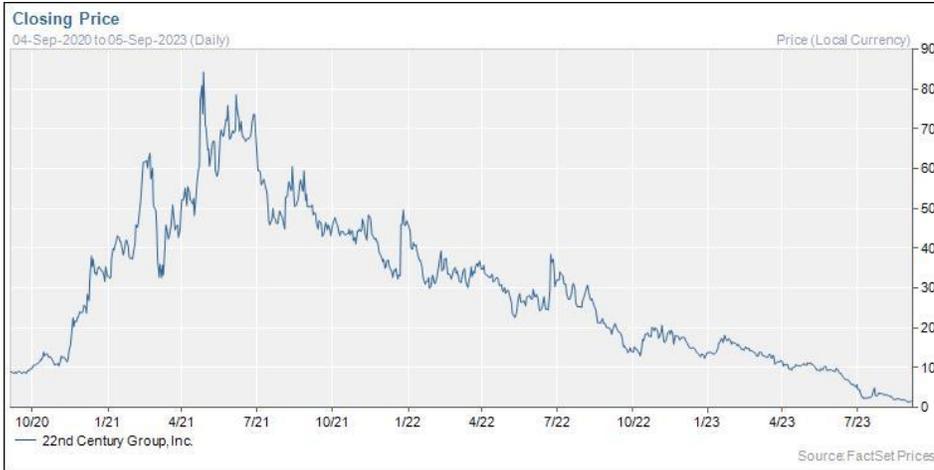
Exhibit 2. Balance Sheet and Cash Flow Statement

(\$ in 000's)	2020	2021	2022	2023 E	2024 E
Cash & ST Investments	22,342	48,736	21,213	2,080	7,801
A/R	2,159	585	5,641	7,831	18,645
Inventory	2,034	2,881	10,008	10,753	20,278
Insurance Recovery	0	0	5,000	0	0
Prepaid Exp.	1,806	2,183	2,743	6,388	6,388
Total Current Assets	\$ 28,341	\$ 54,385	\$ 44,605	\$ 27,052	\$ 53,112
PP&E	2,483	5,841	13,093	14,877	15,829
Operating Lease	247	1,723	2,675	6,955	6,955
Goodwill	0	0	33,160	33,360	33,360
Patent, Trademark, other intangibles	8,211	7,919	16,853	20,334	17,950
Equity Investment	6,536	2,345	682	682	682
Restricted Cash				7,500	7,500
Other Assets	5,876	3,741	3,583	3,681	3,681
Total Assets	\$ 51,694	\$ 75,954	\$ 114,651	\$ 114,441	\$ 139,069
Bank Loans and N/P	539	596	908	1,988	1,988
LTD-Current	0	0	0	1,960	1,960
Operating Lease	247	308	681	1,082	1,082
A/P	1,116	2,173	4,168	4,843	9,133
Accrued Expenses & Payroll	4,830	5,014	4,627	6,960	13,126
Accrued excise taxes and fees	0	0	1,423	2,704	2,704
Deferred Income	272	119	831	214	214
Other	339	217	380	1,438	1,438
Total Current Liabilities	\$ 7,343	\$ 8,427	\$ 13,018	\$ 21,190	\$ 31,645
Notes and loans payable	0	0	0	185	185
Operating Lease	0	1,432	2,141	6,118	6,118
Long-Term Debt	0	0	3,001	15,326	15,326
Other	241	21	516	5,656	5,656
Shareholders' Equity	44,110	66,074	95,975	65,966	80,139
Total Liabilities And Equity	\$ 51,694	\$ 75,954	\$ 114,651	\$ 114,441	\$ 139,069
Net Income	(19,711)	(32,609)	(59,801)	(65,637)	(18,607)
Depreciation & Amort.	1,345	1,536	3,591	5,501	5,768
Stock Comp	1,654	3,983	5,489	5,633	5,944
Other	2,722	4,984	10,577	6,399	0
Working Capital	(1,631)	(733)	(11,570)	(2,731)	(9,883)
Operating Cash Flow	\$ (15,621)	\$ (22,839)	\$ (51,714)	\$ (50,835)	\$ (16,778)
Acquisition of Patents and trademarks	(468)	(326)	(772)	(648)	(500)
CapEx	(54)	(745)	(3,657)	(4,759)	(4,000)
Other	16,991	(26,658)	27,007	22,080	0
Investing Activities	\$ 16,469	\$ (27,729)	\$ 22,578	\$ 16,673	\$ (4,500)
Debt	(354)	49	(3,822)	14,312	0
Equity	50	50,826	32,335	26,410	27,000
Other	0	0	2,307	0	0
Financing Activities	\$ (304)	\$ 50,875	\$ 30,820	\$ 40,722	\$ 27,000
Change in Cash	\$ 544	\$ 307	\$ 1,684	\$ 6,560	\$ 5,722

 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
- 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
- Update – Buy – November 22, 2022 – Price Target \$8.50
- Update – Buy – February 1, 2023 – Price Target \$8.50

Update – Buy – March 6, 2023 – Price Target \$8.50
Update – Buy – March 10, 2023 – Price Target \$8.50
Price Target Change – Buy – May 10, 2023 – Price Target changed from \$8.50 to \$4.50
Price Target Change – Buy – July 3, 2023 – Price Target changed from \$4.50 to \$1.00
1-15 Stock split July 5, 2023
Price Target Change – Buy – July 25, 2023 – Price Target changed from \$15.00 to \$10.00
Price Target Change – Buy – August 15, 2023 – Price Target changed from \$10.00 to \$7.50
Price Target Change – Buy – September 6, 2023 – Price Target \$7.50

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Current as of 22-Aug-23

	Company Coverage		Investment Banking	
Ratings Distribution	# of Companies	% of Total	# of Companies	% of Totals
Market Outperform (Buy)	23	65.70%	3	8.60%
Market Perform (Neutral)	12	34.30%	3	8.60%
Market Underperform (Sell)	0	0%	0	0.00%
Total	35	100%	6	17.20%

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