

## Wake Up Call For Big Tobacco--E-Cigs Are The Wave Of The Future

- **Could E-Cig Consumption Surpass Traditional Cigs in 10 Years?** While difficult to predict, we think it is possible that consumption of e-cigarettes could outpace traditional cigarettes over the next decade, especially given the rapid pace of innovation and consumers' demand for reduced harm products. As e-cigs continue to evolve and offer an experience that is increasingly similar to smoking a traditional cigarette, we think consumer acceptance and conversion will accelerate. Furthermore, we can't help but continue to draw a parallel between e-cigs and the energy drink category; we think e-cigs are to tobacco what energy drinks are to the beverage industry. Therefore, we think **big tobacco needs to wake up** and recognize the potential opportunity of the e-cigarette category and not make the mistakes of the large beverage companies that overlooked the potential of the energy drink category when it was in its nascent stage. Bottom line--we believe e-cigs are more than just a fad and most of our industry trade contacts agree. Considering both LO and RAI have dipped their toes in the e-cig waters, **the next move is MO's** and we expect it to be big.
- **NJOY's Innovative New King E-Cig and Packaging Could Be A Game Changer** - We recently had the opportunity to meet with NJOY's senior management team, many of whom were successful tobacco industry executives prior to joining NJOY. One of the leading e-cigarette brands, NJOY has approximately 39% retail market share and distribution in nearly 30,000 retail outlets. NJOY will be releasing a "next generation" e-cigarette product (NJOY King) this fall that greatly improves upon current e-cigs in the market, offering a look, feel, flavor profile and packaging that more closely resembles a traditional smoking experience. Bottom line--we believe **NJOY is very well positioned** to compete with traditional tobacco and e-cigarettes, with its game-changing new King product, and should continue to drive growth in the e-cigarette category. According to one retailer, "They hit a home run with this new product." (See pages 3-7 for more retailer feedback on NJOY King and e-cig category).
- **Retailers Drawn to E-Cigs for Fat Margins and "Low Maintenance" Selling (No Controlling Contracts)** - Retailer feedback from our "Tobacco Talk" surveys has been positive around e-cigarettes, primarily due to their healthy margins (particularly given ongoing margin pressure in the traditional cigarette category for retailers) and the lack of strict contracts that the retailers perceive as controlling and stifle their ability to run their businesses as they see fit. Retailers can earn ~3x the gross profit (around 30-40% margin) on e-cigarettes as compared to traditional cigarettes.
- **Concerns Linger Around Potential Regulation and Driving Consumer Trial** - As the e-cigarette category is still in its nascency, we believe that FDA regulation will eventually find its way to e-cigarettes. As the timing and scope of such regulation is unknown, this uncertainty will likely continue to be an overhang on the e-cigarette category. Another challenge for the e-cig manufacturers is generating consumer awareness and trial. As e-cigarettes continue to evolve and better address the needs and wants of adult smokers, we expect the technology to keep improving and this should help to drive interest. Although e-cigarette companies may not have the marketing budget of a big tobacco company, they are somewhat less encumbered (for now) in communicating to consumers.

Tobacco

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## NJOY Best In Class E-Cigarette Company

We were very impressed with the quality of NJOY's management team. With at least several dozen e-cigarette brands out in the marketplace, fueled by easily available product made in China, NJOY stands out with its:

- deep bench of experienced industry executives (both in the tobacco and technology industries),
- entrenchment with both consumers and retailers, and
- thought leadership with its 2009 lawsuit against the FDA in which the FDA agreed to regulate e-cigarettes as tobacco products and set the groundwork for what the industry has become currently.

Overall, we believe NJOY has done a good job of harnessing talent from within the tobacco industry while possessing an innovative and entrepreneurial culture. In fact, this could be the key to the company's success or "secret sauce."

Furthermore, we are encouraged by NJOY's "next generation" e-cigarette product (NJOY King) which it will be releasing this fall that greatly improves upon current e-cigs in the market, offering a look, feel, flavor profile and packaging that more closely resembles a traditional smoking experience. One retailer stated the **"new NJOY King comes closer to bridging the gap between current e-cigs and traditional cigarettes."**

NJOY King, is the same size as a traditional cigarette, is nearly as light weight and features a "Master Blended" flavor profile. The "filter" area on the King is squishy rather than metal (similar in feel to a traditional cigarette). King comes in a compact, clear, hard plastic flip case that makes it easy to carry for men and women and replicates the tactile sensation of flipping a package open. This new package should also enable the NJOY brand to be much more visible with a critical branding opportunity as most e-cigarettes on the market today are packaged in a long plastic tube that is not easily carried around in a pocket and thus is usually discarded. Further, this case has space for two combustible cigs (as most of NJOY's "vapers" are dual-users) and this will effectively result in those cigs being externally "branded" NJOY, which we believe is a brilliant marketing move as NJOY seeks to grow brand awareness. Importantly, this new packaging will be more conducive to retail display and the retail display tower much more visible at the counter compared to e-cigarette displays today, which usually consist of a small box display that is easy to miss.

Bottom line - we believe **NJOY is very well positioned** to compete with traditional tobacco and e-cigarettes, with its game-changing new King product, and should continue to drive growth in the e-cigarette category.



Source: Sottera, Inc.

## Vape "Em If You Got 'Em - E-cigarette Fast Facts

1.) The industry size is thought to be ~\$300 million in revenue currently at retail (according to LO CEO Kessler at a recent conference), and it is estimated that this could grow to \$1 billion in the next few years with attractive margins (gross margins likely comparable to cigarettes); 2.) There are 2.5 million e-cigarette users according to industry group Tobacco Vapor Electronic Cigarette Association; 3.) Top brands include NJOY, blu (which LO believes has around 25% share) and 21<sup>st</sup> Century; the market appears to be fragmented with dozens of brands in the marketplace, which we believe will eventually consolidate; 4.) e-cigarettes fall under the purview of the FDA as they are regulated as "tobacco products", although regulation is currently very light, we expect regulation of this category to increase; and 5.) there are no federal or state excise taxes imposed on e-cigarettes (yet), helping to make them generally cheaper than conventional cigs.

## Retailer Feedback on NJOY King and the E-Cig Category

| What Do You Think of NJOY King E-Cigarette?  |
|--|
| I think it is innovative and will bring new users. Improved usability, better flavor profile and novelty appeal.   |
| Best packaging so far. They thought of the consumer placing regular cigarettes in it. Also the attributes of a pack of cigs are built into the case.   |
| I think it's attractive and will sell more product.  |
| A solid improvement over current packaging. Having the "pack" to carry the product is a great move.  |
| I like it. Packaging is compact and they've created a case that can be used with both their e-cigarette as well as regular cigarettes. The spinner display rack also does a nice job of showcasing the product. The actual item feels more like a regular cigarette as well.   |
| NJOY King really moves the needle in terms of replicating the traditional smoking experience. Ironically enough, I think it will put a serious dent in the demand for ONE-JOY—the leading disposable sku they've spent months building.  |
| The product is much better than anything I have seen thus far. It is much closer to the feel of a real cigarette. They have surely raised the bar for the category as a whole. Other manufacturers will struggle for a while trying to make their products lighter and feel similar to this. The packaging is slick, but I still think they should have made it wide enough to fit an actual cigarette spring load. There is a natural progression for this category to be supplemental/incremental to existing cigarette sales, and ultimately merchandising the product near or with cigarettes would be ideal. Merchandising solutions from manufacturers continue to plague this category. Whoever can find a way to properly display this category so it coincides with regular cigarette sales will win. |
| These people have hit a home run with this product.  |
| I like the product and especially like the packaging.  |
| It's a huge improvement to their current disposable. Their new, very high levels of nicotine could prove to be attractive to smokers... The packaging is addictive.  |
| In my opinion the packaging will appeal to the tobacco consumer that is going to want to have their craving for nicotine satisfied in situations where lighting up is not possible.  |
| I like the product's weight, size, feel, and flavor profile. I also like the packaging which is more traditional, and similar to cigarette branding.   |
| <ul style="list-style-type: none"> <li>a. Great product – feels more like a real cigarette (soft and not a rod) &amp; an improved taste profile vs. other e-cigs</li> <li>b. Great package – small, discrete package to carry e-cig product and two traditional king cigarettes</li> <li>c. First innovation in the e-cig category since the product introduction</li> <li>d. Next step is to get this type of product in a rechargeable version</li> </ul>  |
| I believe it will be a winner.   |
| I thought the packaging was unique and would strongly appeal to the cigarette consumer. The product is by far the closest looking/feeling to a cigarette on the market. Also, I think you will see most of the other e-cig manufacturers try and copy the technology.  |

Source: Wells Fargo Securities, LLC

| Do you think NJOY King Will Encourage more Smokers to Make the Switch and try E-cigarettes?   |
|---|
| Yes, the key improvements of this new item overcome existing hurdles and are meaningful satisfiers for consumers.   |
| Word of mouth may help as the nicotine content is higher, smell, different packaging...how do you get the rest of the smoking world to try ???  |
| Unsure at this point. It will likely add more credibility to the product though as it looks less like a novelty and more like a traditional cigarette product. The game changer for switching to e-cigs, in my opinion, would be statements around risk continuum.  |
| That remains to be seen but I certainly hope so.  |
| It's a game changer; once competitors get their hands on this, there will be a mad dash to replicate the technology. What I hear most from users that have tried e-cigarettes is that they enjoy the flavor, but the feel and weight of current offerings usually drives them back to traditional smokes. |
| This product is much closer to bridging the gap, and will get more trial. They will not switch entirely to e-cigs yet...We have found most customers use them in between times they can smoke regular cigarettes.   |
| It will be because it is closer to the size of a normal cigarette   |

Tobacco

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| NO I do not. I am an x smoker. I chose to quit and lucky me I was successful, an E-Cig is not to stop smoking. It is to help satisfy your fix in NON-Smoking situation. After you smoke a E-Cig you still want the real thing.   |
| I'm not sure it will encourage anyone to switch from cigs to e-cigs, but <b>it might create some trial users.</b>  |
| <b>I think packaging will help attract consumers, but the big players will dominate.</b>   |
| I think its familiarity to a Marlboro label may draw additional attention.   |
| I do think that the product will <b>appeal to an untapped consumer</b> , based on the new weight, size, feel, and flavor profile.  |
| More cigarette smokers will definitely embrace the product.  |
| I believe they will. However I don't think smokers will stop using regular cigarettes.   |
| <b>I am confident this will be more appealing to the broader cigarette consumer audience (on look/feel alone).</b> The test will be if the product taste is consistent from unit to unit (and if it is similar to their favorite Marlboro/Newport, etc) so that consumers who make the switch stick with NJOY Kings. <b>The taste will be as big of a factor as the look/feel.</b> |

Source: Wells Fargo Securities, LLC

| Will you Carry NJOY King?   |
|---|
| Yes will carry and introduce on first available date.   |
| We will, but <b>merchandising remains a challenge.</b> King will slot well into a permanent back-bar position, but OneJOY and its odd packaging design doesn't necessarily lend itself to creating a brand billboard. |
| No, will not carry this product due to more cigarette companies carrying E-Cig's that offer payment and rebates.  |
| Yes, if they can find a merchandising solution that is reasonable.  |
| Yes, we are going to carry this product and are currently selling the full line at this time  |
| NO we will not carry this item, as we have a similar item now.  |
| Probably.   |
| No plans to at this point.  |
| That price point will appeal to most smokers in high tax states.  |
| Yes more then likely.   |
| We will carry this product.   |
| Our chain will carry the product as soon as it is available.  |
| Yes we plan to bring the product into all of our stores as soon as it is available. 425 stores in 8 states.   |
| We carry 21st Century now and have no plans to change.  |

Source: Wells Fargo Securities, LLC

| Do you Think the \$7.99 Retail Price Point is Attractive?   |
|---|
| <b>Price point is right in line...</b>  |
| I wouldn't call it attractive...more along the lines of "reasonable".   |
| Yes – when compared to the price of two regular packs.  |
| Not for the introduction phase, but long-term, I think it sells the brand and experience a little short, relative to some of the other "junk" that is on the market for similar cost. We'd like to see 40 margins and to get there, you really need \$9.99. Lorillard and BLU are very proud of their line, which is the highest price in the marketplace; even with full retail coverage from Lorillard it is hard to justify a \$10.99 price point for their items. |
| \$7.99 - great retail price.  |
| Depends on how many "Puffs" it has. The price is ok, not great not bad.   |
| <b>\$7.99 is quickly becoming the "hot price point"</b> . Everyone is aiming at \$7.99 these days. I would hope we continue to see innovation like this and keep the price point up. <b>The margin spin off in the category is helping offset margin we are giving away on our regular cigarette sales.</b> I would hate to see the margin/price point continue to erode beyond \$7.99.   |
| Yes, most of the tobacco smoke shops are at \$9.99 regardless of brand and cost.  |
| Retail is great. But MN chose to add the tax to the E-Cig. so 7.99 retail does not work in MN for most E-Cigs   |

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| I think that is the key point (besides the packaging) that will help this product.   |
| Not sure. It would be a <b>good price point for a "Disposable"</b> .   |
| I think their margins are too low, and will probably charge more than \$7.99   |
| Being new technology, and at price parity with their other One Joy products, the product would drive more trial with a lower price point, or promotional price.  |
| <b>\$7.99 is a great introductory retail.</b>  |
| Equivalent to 2 packs of cigarettes in most areas.   |
| Yes. I think the \$7.99 retail is an attractive offer for the cigarette consumer who is unsure if they will like the product. \$19.99 or higher tends to scare the consumer away (for an unknown product) in our store locations. Most consumers are willing to try something for this retail price. |
| Yes - good retail price point.   |

Source: Wells Fargo Securities, LLC

| <b>What are Your Concerns with this New Product and/or the E-cigarette Category Overall?</b>  |
|---|
| Awareness and understanding of the product, <b>experience still not quite as good as a traditional cigarette.</b>   |
| No concerns with the new product other than the old OneJoy line...what happens to that velocity and residual inventory? <b>Biggest concern is PM and RJRT introductions.</b>  |
| Overall, the biggest issue with this category is <b>where to merchandise product.</b>   |
| <b>FDA needs to move quicker and with more transparency.</b>  |
| I'm concerned that it will cannibalize the disposable NJOY.   |
| Merchandising remains the biggest hurdle; on the one hand, we want to carve out a permanent home for the leading brands and really convey the fact that we are in the business; on the other hand, we recognize that we are also speaking to non-smokers (friends and relatives of smokers), <b>so transaction counter placement remains a must. Lorillard's approach, which is anchored by a billboard of BLU on the back-bar and incents retailers with a cigarette-like monthly payment, suggests they believe that back-bar placement is the most logical home for the category.</b>  |
| Category continues to grow. Any new or different product will sell.   |
| Just one more item in a sea of way too many brands.   |
| Wonder about battery life due to the smaller size. Overall concern.... too many companies   |
| Obviously tax pressure and regulation from state or federal governments. <b>The million dollar question is if FDA could certify any of these as safe alternatives. If that ever happened the category would be a gold mine for everyone.</b>  |
| I believe education to the end user must be passed on to the retailer who is going to have to sell this product to be effective. Just a Retailer purchasing products and hoping they will sell requires more efforts from a cashier at the point of sale to educate, communicate, and sell effectively.   |
| I personally think the E-Cig is a good item. Any of them.   |
| <b>My biggest concern is the government (that's my biggest concern with everything).</b> I am still waiting for the feds to do something to kill the whole category.  |
| I'm reluctant to bring in many brands, until all of the major players get in the game.  |
| The nicotine levels are more than double compared to their previous disposable item. Also, the squishy end makes it easy to accidentally squeeze out the liquid inside. Both of these items are a concern to me.  |
| Pending legislation and the application of taxes both state and federal.  |
| My concern with the e-cigarette category is that there are so many suppliers, so it makes it difficult to identify a brand leader.  |
| My biggest concern in the total e-cig category is the over abundance of manufacturers in for the short-term profit  |
| No concerns but the number of e cigarettes and knock off seem to grow every day.  |
| <b>We continue to believe strongly in the e-cigarette category overall. We think multiple brands have a place in the category (3 - 4) in the long haul.</b> We like that the category brings additional sales dollars/margin enhancement, etc. that have eroded from the cigarette category the last few years. My biggest concern is space and merchandising. We believe it needs to be on the front counter so the consumer can touch/feel/explore the product to understand how it works and will more likely switch. With multiple brands, space is very, very limited. I am concerned that Lorillard (Blu), Swisher, etc. are trying to carve out space within the OTP space. <b>This should be treated as a separate unique category.</b> The mass market of cigarette consumers don't understand the differences between NJOY Kings, Blu, Logic, etc. based on the packaging, so placing it on the backbar makes for a difficult sale. |
| None-Category continues to grow.  |

Source: Wells Fargo Securities, LLC

| Do you Think E-cigarettes (Especially NJOY's new Technology) will Become the New Way to Smoke?  |
|---|
| I think there is strong potential. Continued improvements in future generations and brand development will all make an impact.  |
| E cig companies are getting closer to real product through innovation and may become new way to smoke. Getting people to try is the biggest obstacle.   |
| I think E Cigs will continue to grow, and the products that most closely mirror the real smoking experience will be the most the most successful.   |
| It's an evolutionary transformation as opposed to revolutionary. I would not go so far to say it will be the new way to smoke, but will it be a viable nicotine delivery model for nicotine consumers? Absolutely.  |
| The segment is here to stay unless the FDA somehow manages to kill it...so yes.   |
| Eventually (3-5 years from now), I can see e-cigs representing between 10 and 20% of the total cigarette category. It's going to require a lot of effort, however, on the part of industry leaders and manufacturers because acceptance among regulators and municipalities is still low. There is clearly a stigma that needs to be overcome, and ultimately, I think the larger tobacco players getting into the game will serve to solidify some of the confusion and voids in communication.  |
| Yes, e-cigs are the new era of smoking.   |
| I think it will continue to grow but it may start to slow down, it will be interesting to see what if any FDA regulations come to be and if they start to get taxed. I think they are here to stay now unless government gets in the way.   |
| New yes, but preferred no.  |
| People will always smoke cigarettes...I think this e-cig category is just a way to help people cut back on the amount they normally smoke regular cigarettes. E-cigs are no longer a fad in my mind.  |
| Yes, and will have a strong impact on the cigarette category which continues decline.   |
| NO I do not think they will be come they way to smoke. Like I said, it is to help cravings in NON Smoking situations. It does not satisfy your craving like a real cigarette at all.  |
| No, I think it is an additional way to smoke, but I don't think it will ever replace the traditional method.  |
| It's catching on. I saw people using it on a sitcom last night (2 Broke Girls), so it's getting exposure.   |
| E-cigs are here to stay.  |
| It certainly appears to be the most obvious replacement thus far in the ever changing cigarette and tobacco business.   |
| Not anytime soon. I think that electronic cigarettes are a long ways away from replacing cigarettes, but as cigarettes decline in volume, e-cigarettes, with new technology like this, will help pick up volume.  |
| Ways to Smoke: a. E-cigs currently are a fill-in and a way to get nicotine when you can't smoke<br>b. Eventually, the government will rule on relative risk of each tobacco alternative and then more smokers will convert to e-cigs  |
| My feeling is that it will eventually be the way to smoke since many areas are banning smoking in public areas.   |
| This is tough to say. We have had carried NJOY (OneJoy and mini-rechargeables) since early May 2012. In the first 14 weeks of introduction we experienced more sales dollar (and margin) success than the previous 52 weeks of other e-cig brands (Krave, Smoke 51 and Cig Electric -- tested in various stores combined). During the initial introduction we used large signage on front windows and counters and that made a huge impact; now the signs have come down due to new promotions, sales have dropped off but not to the level of prior (before NJOY). This tells me as more and more consumers understand/see the product, they want and are willing to try it. The new technology will only help with this. People do not see Snus as an alternative. They want something that meets the habitual needs that cigarette smoking offers. I believe the e-Cigs will be able to do this. |
| Not sure but it's off to a good start.  |

Source: Wells Fargo Securities, LLC

## Patent and Intellectual Property (IP) Issues Remain Murky

China-based company Ruyan (also known as Dragonite International Ltd.), the inventor of the modern-day e-cigarette, holds patents in over 50 countries including the U.S. Over the past few years, Ruyan has brought patent infringement lawsuits against e-cigarette manufacturers, including blu. Prior to its purchase by LO, blu had settled with Ruyan to use its technology for an undisclosed settlement sum (and surprisingly **no royalties**). On June 22, 2012, Ruyan filed ten new patent infringement complaints against several companies including; Finiti, Logic, Vapor and Sottera, Inc the makers of NJOY. This begs the question of what other manufacturers may be infringing upon Ruyan's e-cigarette patents and, if so, how aggressively Ruyan may defend these patents in court. This could potentially expose manufacturers, retailers and distributors of e-cigarettes to patent infringement liability. Of course, companies could develop their own IP that would leave them less exposed to patent infringement issues. We will monitor this issue as we think this could have a key impact on shaping the future of the e-cigarette category.

## **E-cigarette History – 10,000 Foot Overview**

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The modern e-cigarette was invented in 2003 in China by pharmacist Hon Lik. The company Lik co-founded, China-based Ruyan (now also known as Dragonite), has since registered patents in more than 50 countries (including the U.S.). Currently in the U.S., there are dozens of brands of e-cigarettes as the category is still new, quickly growing, and highly fragmented. The basic components of most e-cigarettes include a power source (usually a battery or a wired USB adapter), a heating element or “atomizer”, and a liquid reservoir which also serves as the mouthpiece. Some models have a disposable integrated atomizer and liquid reservoir component known as a “cartomizer” which can be a more cost-effective option given a typical atomizer lasts around 2-3 months before “burning out”. E-cigarettes are typically powered via a rechargeable lithium-ion battery that lasts for around 100-300 charges. Many models operate such that the power is activated by puffing or drawing on the e-cig, while others have manual batteries that offer greater control over vapor thickness. The liquid used in e-cigarettes is typically a propylene glycol or vegetable-based glycerin solution containing varying concentrations of nicotine as well as flavors. The vapor created by the heated propylene glycol reportedly contains far fewer chemicals than the several thousands found in traditional cigarette smoke, some of which are known carcinogens. Unlike traditional cigarettes, hundreds of different flavors are available for e-cigarettes. Some closely resemble traditional cigarettes with flavors such as regular tobacco and menthol and claim to mimic popular brands such as Marlboro and Camel, while other flavors are food- or spice-inspired and run the gamut from watermelon and grape to cinnamon and vanilla.

## **Regulation of E-cigarettes**

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E-cigarettes are currently considered “tobacco products” and, as such, are regulated by the FDA due to its authority under the Family Smoking and Tobacco Control Act of 2009 which gave it the authority to regulate tobacco products. From 2008 – 2010, the FDA had originally determined that e-cigarettes were drug delivery devices. This was challenged in court by Sottera, Inc. (manufacturer of the NJOY brand of e-cigarettes) where it was ruled that e-cigarettes can be regulated as “tobacco products” rather than “drugs” or “devices”. In April 2011, the FDA issued a statement indicating the government would not “seek further review” of this decision and it “will comply with the jurisdictional lines” established by the case. The FDA’s letter also noted it intended to “propose a regulation” to ensure that the Agency’s authority would be extended to “other” tobacco products (any “tobacco product” other than in areas such as registration, product listing, ingredient listing, good manufacturing practice requirements and pre-market review requirements. However, this proposal has not yet occurred and, as such, e-cigarettes remain currently very lightly regulated. Similar to other OTP segments of the market, we expect further study is needed to assess long-term health implications of e-cigarettes. In terms of airlines, we checked with several major airlines and the use of e-cigarettes on board is not allowed, although they may be placed in checked or carry-on luggage.

## **State and Local Regulation**

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Several states, including New York, California, Hawaii and Idaho have started to regulate e-cigarettes, particularly in restricting e-cigarettes’ sale to minors. New Jersey has banned e-cigarettes in enclosed public places and workplaces, while Boston banned e-cigarettes in “workplaces”. Hawaii tried to pass legislation that would tax e-cigarettes at the 70% OTP rate but was not successful. Generally speaking, e-cigarettes remain under very loose, if any, regulation at any level (federal, state or local).

## **Financials**

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A recent article in the WSJ estimated the e-cigarette category size as \$200-500 million and LO’s estimate provided at a recent conference was ~\$300 million at retail. Feedback from our e-cigarette survey suggests the category continues to grow at a fast clip and that margins tend to be attractive. The Tobacco Vapor Electronic Cigarette Association (TVECA) numbers e-cig users as 2.5 million, compared to the CDC’s estimate of ~42 million daily traditional cigarette smokers in the U.S.

## **Key Players**

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According to one of our recent “Tobacco Talk” surveys, leading brands include NJOY, blu, 21<sup>st</sup> Century, Krave and Logic. Other popular brands are V2, Green Smoke, The Safe Cig, Pure Cigs, White Cloud, Smoketip, South Beach Smoke, Eversmoke, Eluma and Zerocig. Obviously the e-cigarette category is in a nascent form and is very fragmented but we expect it will consolidate over time.

## **Distribution**

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The c-store channel is the most popular, according to our survey respondents (more on that below). E-cigarettes are also widely available online which offers greater convenience for repeat, regular purchasers. There may also be favorable sales tax treatment of e-cigarettes purchased online. E-cigarettes also tend to be available at tobacco shops.

## **Pricing**

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E-cigarettes are sold in a “starter kit”, the most basic of which typically includes two batteries, several cartridges, and wall and USB chargers. While some starter packs were priced as low as \$29.99, most of the ones we saw were in the \$50-80 range. One regular cartridge lasts as long as around one to two packs of cigarettes, depending on the brand, nicotine level and individual preferences/use. A 5-pack of cartridges (~5-10 packs) typically costs around \$12-20, or ~\$2-4 per “pack”, much cheaper than “analog” cigarettes, which is not surprising given e-cigarettes do not incur federal or state excise taxes, except in the state of Minnesota, where e-cigarettes are taxed. There are also disposable varieties of e-cigarettes, which usually cost under \$10 for one (or less per unit if purchased in a bundled pack). One disposable e-cigarette can equate to 1.5-2 packs, similar to rechargeable e-cigarettes. It appears that disposable e-cigarettes are quite popular, most likely due to the attractive price point which encourages trial.

## **Taxation**

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There are currently no federal or state excise taxes imposed on e-cigarettes except for an OTP tax in Minnesota. However, states have started to explore the taxation of e-cigarettes but none have elected (yet) to tax e-cigarettes similarly to tobacco. We think it is very likely taxes will ultimately be imposed on e-cigarettes, especially as they encroach on the turf of traditional cigarettes and start to meaningfully detract from federal and state tax revenue. Most notably in Hawaii, a bill to tax e-cigarettes at the 70% tobacco tax rate failed. However, legislation has been successfully passed in imposing age limitations that restrict the sale of e-cigarettes to minors; states that have passed such legislation include Minnesota, New Hampshire, Hawaii and Utah.

## **Required Disclosures**

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### STOCK RATING

**1=Outperform:** The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY

**2=Market Perform:** The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD

**3=Underperform:** The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

### SECTOR RATING

**O=Overweight:** Industry expected to outperform the relevant broad market benchmark over the next 12 months.

**M=Market Weight:** Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

**U=Underweight:** Industry expected to underperform the relevant broad market benchmark over the next 12 months.

### VOLATILITY RATING

**V** = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

### As of: August 7, 2012

48% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Outperform.

Wells Fargo Securities, LLC has provided investment banking services for 40% of its Equity Research Outperform-rated companies.

50% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Market Perform.

Wells Fargo Securities, LLC has provided investment banking services for 30% of its Equity Research Market Perform-rated companies.

2% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Underperform.

Wells Fargo Securities, LLC has provided investment banking services for 11% of its Equity Research Underperform-rated companies.

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