

Tobacco Talk Survey--E-Cigarettes A Promising Opportunity

- **Tobacco Talk Survey Says ... E-Cigs Are More than Just a Fad** - We recently conducted a survey of tobacco retailers and wholesalers, representing around 30,000 retail locations, to learn more about e-cigarettes and take the pulse of how the trade views this opportunity. As we have highlighted in our past "**Tobacco Talk**" surveys, the trade has generally been pretty positive on e-cigarettes and this trend has continued. The majority of our respondents indicated that they believe e-cigarettes are not just a passing trend but that they are here to stay, with several noting LO's purchase of blu ecigs lending credibility and legitimacy to the entire category. We continue to believe LO's e-cig acquisition is very positive and expect RAI to be the next mover into this growing category most likely organically, but we wouldn't rule out a potential acquisition.
- **"Vape" 'Em If You Got 'Em - E-Cigs 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 21st 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.
- **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**). We think it's possible that MO and RAI have been held up on the e-cigarette front due to IP issues. Regardless, 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.
- **We Expect Industry Regulation, Taxation and Consolidation In Time** - As the e-cigarette category is still in its nascency, federal regulation is minimal and regulation thus far has mostly taken place at the state/local levels. A handful of states have passed laws restricting the sale of e-cigarettes to minors and a few municipalities have enacted e-cigarette public smoking bans. **We think e-cigs are to tobacco what energy drinks are to beverages.** In other words, similar to energy drinks, e-cigs are profitable, growing quickly, gaining shelf space and consumer acceptance; therefore e-cigarettes are an important new niche category for retailers.

Tobacco

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Key Takeaways from E-Cigarette Survey

We recently reached out to several of our industry trade contacts to get a better sense of current dynamics in the e-cigarette category. Below are some of the key takeaways from this survey including direct quotes from a number of tobacco retail trade contacts, representing thousands of retail locations across the country. Also, please see page 11 for a brief history and overview of the e-cigarette landscape in the U.S.

- **Majority of Our Trade Contacts Think E-cigarettes Are Here to Stay**

We think e-cigarettes are more than just a fad; however, we expect increased regulatory scrutiny and taxation of the products in time.

- **NJOY and blu Appear to Be Emerging As Early Market Leaders**

The category is in its nascency and is highly fragmented with dozens of brands in the marketplace. NJOY and LO-owned blu appear to be emerging as early category leaders and we expect the category will consolidate over time.

- **C-stores Counters Reign Supreme in e-cig Distribution**

Similar to traditional cigs, c-stores are a popular distribution point for e-cigarettes; however, we feel the convenience and broad choice offered by the online channel will prove to be meaningful as well.

- **E-cigarettes Not Meaningfully Taking Shelf Space From Cigs and Smokeless (Yet)**

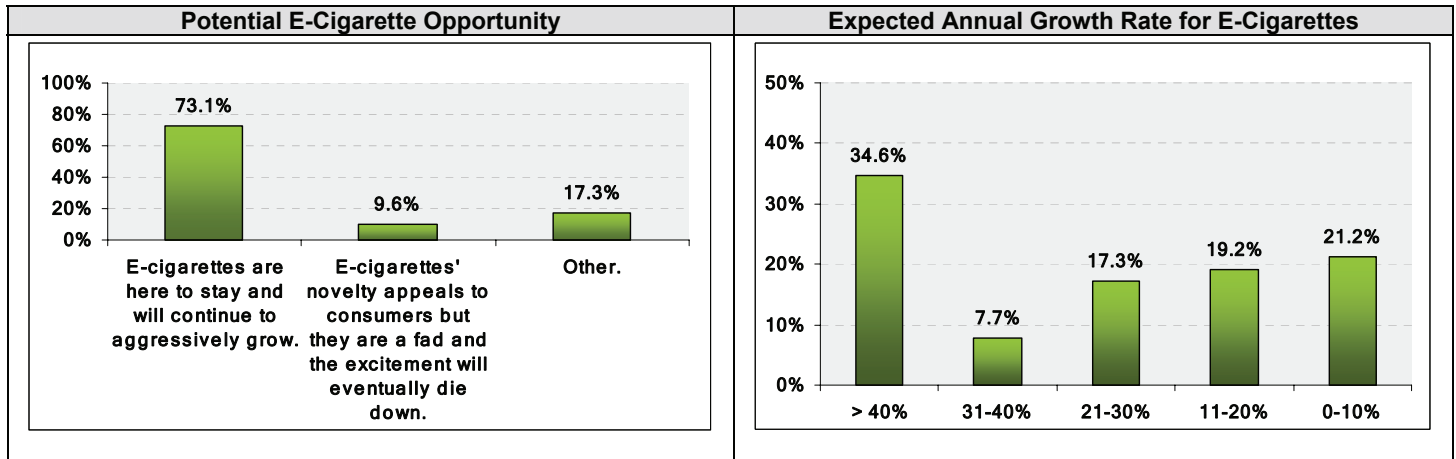
E-Cigarettes are not yet taking much shelf space from cigarettes but this could change as sales continue to rapidly grow.

- **“Typical” E-cigarette Consumer is Drawn to Convenience, Health Benefits, and Cheaper Cost of E-cigarettes vs. Traditional Cigarettes**

E-Cigarettes’ appeal stems from a variety of perceived advantages over traditional cigarettes, most commonly the perceptions that e-cigarettes are healthier, cheaper, and can be used almost anywhere.

Majority of Our Trade Contacts Think E-cigarettes Are Here to Stay

Nearly ¾ of our survey respondents (retailer and wholesaler trade contacts) think that e-cigarettes are a lasting “trend” and not merely a fad. As a relatively new category, e-cigarettes are rapidly growing albeit off a small base. ~35% of our respondents think the annual growth rate is 40% or more. We believe there are many perceived or real benefits of e-cigarettes vs. “analog” cigs – including less exposure to harmful chemicals, cheaper cost and less disturbance to others (i.e. no secondhand smoke). However, we do note the relative lack of regulation of e-cigarette products, concerns about health and safety due to unknown short or long-term effects on individuals or “public health”, and the risk posed particularly by products manufactured outside the U.S. **Bottom Line – We think e-cigarettes are more than just a fad; however, we expect increased regulatory scrutiny and taxation of the products in time.**



Retailer Comments on E-Cigarette Opportunity and Expected Growth Rate

- “They are a **real opportunity**, but not quite up to the hype.”
- “I think **if the US goes dark on cigs, these will go even better.**”
- “I think they are **here to stay** however **growth will be moderate.**”
- “I see too many people **buy them for a few months** and then **go back to the Brand they enjoy.**”
- “E cigs are typically used on Friday and Saturday nights when one goes 'out' and their place of leisure does not allow smoking. I understand that few work places are accepting the practice so... **let's wait and see.**”
- “Government regulation will soon slow this category down !!”
- “E-cigarettes are currently **unregulated** to a degree not known by the public. Being manufactured with unknown ingredients in China where there is absolutely no regulation that would be seen in a food or even tobacco product, this product has **extreme liability risk.**”
- “I believe that the prices will continue to decline and **unit sales will be up** but the dollars will be flat.”
- “I believe that E cigarettes are a **viable category and will continue to grow** with the major brands rising to the top. With Lorillard purchasing Blu, some validity has been added to the category.”
- “It will have **its market niche.**”
- “There is an **appeal to a relatively small percentage of the smoking population...**I wouldn't predict continued "aggressive" growth but I do think **e-cigarettes are here to stay**”
- “There are a **large variety of brands in the market place and it may mature** and the total amount of varieties may change depending on how much of a foothold a particular brand gets with their share of the market place before any regulations kick in and take hold. We get calls everyday on new or different companies that want to sell us their particular E-cigarettes and it is hard to know which brand to partner up with and stock. I don't feel that we want to try and develop 20 different brands at retail.”
- “I think this is a **legitimate category.** The only unknown is **what the FDA chooses to do long-term.**”
- “It all **depends on legislation.** Currently there are 19 cities & towns in Mass. that ban them in public areas.”
- “I think the **category will grow but aggressively.**”
- “The **current growth rate is still part of the initial retailer acceptance.**”
- “I think they're growing at that strong rate now, but **building from nothing, tends to inflate growth numbers.**”
- “New products. New technology. Better consumer knowledge. Anticipated reduced retails. All these points should **fuel**”

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the growth.”
“Anything can grow in high percentages when the base is low or zero.”
“Just as with energy shots, e-cigarettes will continue to grow the next few years and then level out.”
“Small base and lots of trial going on...do not have repeat purchase data.”
“But from a very small base, so this can be misleading.”
“We recently launched a new electronic cigarette program in our stores (NJOY). From week 1 to Week 2 we had an increase of 193%. In the first two weeks of the program we have sold 20% of what we sold in the entire previous 52 weeks combined with another brand/program.”
“Based on spotty Nielsen data on certain brands, Q1 2012 volume is up 50% over Q4 2011.”
“Obviously starting from near zero.....growth rate will slow with maturity.”

Source: Wells Fargo Securities, LLC

NJOY and blu Appear to Be Emerging As Early Market Leaders

We asked our industry trade contacts what brands they felt were the top three e-cigarette brands and what brands have the potential to become market leaders. NJOY and blu were almost equal in responses to the “top brand” question while Logic was a distant third. NJOY’s parent company, Scottsdale, AZ-based Sottera, Inc., made headlines when it successfully challenged the FDA in 2010 that e-cigarettes should be regulated as tobacco products rather than drug/delivery devices, unless marketed for therapeutic purposes. Following this decision, the FDA released a statement on April 25, 2011, stating that it would not “seek further review” and that it would “comply with the jurisdictional lines established” in the Sottera case. Therefore, as it stands today, e-cigarettes are currently regulated by the FDA as tobacco products. It was also recently announced that Sottera/NJOY received a \$20 million investment from Catterton Growth Partners L.P., a consumer-focused private equity firm, to accelerate its growth. Other brands that were commonly mentioned include 21st Century, Krave and Logic. A few mentions were also given to XHale, Finiti Brands (FIN), Metro, Mystic and Fuma.

In terms of drivers behind what is making brands successful, broad distribution, a national presence, and “consumer-centric” branding/packaging and marketing were frequently cited. In the case of blu, several respondents said LO’s purchase of the company gives it “credibility” and “legitimacy,” not to mention the “backing of a major tobacco sales force.” There is speculation that MO and RAI may also enter the category and those potential brands would likely be successful. As such, we believe RAI will be the next manufacturer to make a move into e-cigarettes either via an acquisition or more likely organically. One contact noted NJOY’s distribution partnership with McLane as giving it an edge over other brands.

Bottom Line – the category is in its nascency and is highly fragmented with dozens of brands in the marketplace. NJOY and LO-owned blu appear to be emerging as early category leaders and we expect the category will consolidate over time.

Retailer Comments on Top Brands, Potential Market Leader(s) and What Drives These Brands’ Success
“NJOY, because they seem to have figured out the customs issues that hold up a lot of other brands.”
“Blu. Lorillard support.”
“NJOY and Blu. Marketing spend and Lorillard purchasing Blu.”
“Blu. First to be taken on by a major cigarette manufacture. Not sure about the consumer, maybe it appears to be hip?”
“21st Century Smoke has good potential due to availability and price point but the same could be said about NJOY as well. Blu may become more of a factor especially with its recent sale to a major tobacco company.”
“Fin or Blu; The Finiti team is focused on creating separation through true grass-roots marketing, alternative channels of distribution (beer distributors for bars, clubs, restaurants), unique packaging, and very consumer-centric branding / advertising campaigns. Others are simply competing on price, and with many of the brands coming from the same few Chinese factories, there will come a point where there is even less distinction between products, meaning the brands with the most consumer equity are likely to stick. With the support of Lorillard, particularly as it relates to merchandising, Blu will have an advantage over rivals, including the credibility factor. Ultimately, I see Lorillard pushing for a permanent home on tobacco back-bars, which will lend credence to the category long-term.”
“Blu because Lorillard is behind it now.”
“Blu (Lorillard credibility), NJOY”
“Metro”
“I will probably change to the Blu that Lorillard just bought at some point.”

<p>"We carry only one brand, NJOY. Similar to energy drinks 5-10 years ago (and even continuing today but to a lesser extent) there is a ton of new products trying to get shelf space."</p>
<p>"Logic. Great flavor, great product, great margin. Customers like the flavor & the designer look/feel."</p>
<p>"I think 21 at this time but with Lorillard taking over Blu, I bet on them."</p>
<p>"Logic - Packaging, price, quality"</p>
<p>"I believe that Blu will be the market leader in the electronic cigarette category because Lorillard has now purchased the brand. With a major cigarette company in the game, they will be able to ensure that all FDA requirements are being met and they will put a lot of marketing into the product in order to get the brand recognition by customers."</p>
<p>"Blu - High quality manufacturing leaves the customer with a experience as close to smoking as actually smoking a regular cig"</p>
<p>"Ruyan and Blue. Ruyan owns the primary patents on the technology in e-cigarettes and would be the only brand grandfathered in under future FDA regulations due to their early entry to the market. If other products had to go through a lengthy and expensive FDA compliance program, Ruyan could be the only player in the market for roughly 2 years at a critical market development phase. Blu now has the backing of a major tobacco company with legal experience. If Lorillard were so inclined, they could leverage their Newport brand into a line extension and bring the first recognized/reputable brand to the marketplace. I do not believe that any current brands have a particular consumer following today."</p>
<p>"Blu, because it has recently been purchased by Lorillard, which is the first electronic cigarette investment made by one of the big three tobacco companies."</p>
<p>"NJOY. I see their ads the most."</p>
<p>"Logic is clearly the market leader in New Jersey, but I think the real market leader will be whomever RJR and or PM end up buying!"</p>
<p>"NJOY, it has the proper displays and is very visible with their POP etc."</p>
<p>"NJOY - great packaging, marketing and a commitment to be the leader in the segment."</p>
<p>"Metro - Seems to last longer per use than many of the other brands."</p>
<p>"I believe Blu will be the leader in the short term as Lorillard will be able to add more stability to the brand. Within a couple of years, other leaders could evolve as Altria and RJR potentially get into the e-cig business."</p>
<p>"NJOY. Best packaging, management has extensive tobacco background."</p>
<p>"I'd have to go with NJOY. They have distribution via McLane Company which gives them a competitive advantage."</p>
<p>"Fuma - Great product, great customer service, wholesale only, no internet sales, great margin."</p>
<p>"Blu because of the association with Lorillard. Any other brand that establishes a strong foothold has a better chance and those that can comply with any upcoming FDA rules. We have a few remaining disposable e-cigarettes from a company that I believe has gone out of business, which is smokers one choice brand and I'm not sure how many other brands have come and gone or are on the verge of going away."</p>
<p>"Blu - Lorillard Purchase"</p>
<p>"NJOY because they have strong packaging, marketing plans and wide distribution. Blu because they now have the backing of a major tobacco sales force. At this time, I do not think there is a true market leader because most consumers I have spoken to do not know what brand they are using."</p>
<p>"Logic as it is a better tasting product."</p>
<p>"NJOY and Blu are the two that come to mind first. Both have a national presence. Blu has been advertising nationally in the USA Today and now with the support of Lorillard I am confident they will continue to grow. NJOY seems to be doing things the right way with retailers and wholesale. They have a more unique product than a lot of the others who seem to have the exact same product/packaging only with a different label/brand name. I don't think consumers understand the category and/or differences in brands. I think they are still trying to learn how to use the product, what they like and find a taste that meets their needs."</p>
<p>"NJOY. Senior management and sales force of all ex PM employees. They understand the business from cigarette consumer focus."</p>
<p>"Blu due to Lorillard resources, Krave due to superior display"</p>
<p>"NJOY - They seem to have all the i's dotted & t's crossed based on SKU selection, insurance certificates & market exposure."</p>
<p>"NJOY - I believe they have the right business model and financing."</p>
<p>"Blu now as they have a major tobacco company behind it and eventually their sales force will be selling it. It depends on what other major tobacco companies do in this arena."</p>
<p>"NJOY...Merchandising and presentation, Blu... Lorillard"</p>
<p>"Blu - due to the acquisition by Lorillard"</p>

Tobacco

“21st Century and N-Joy. Both are doing it right with packaging and innovation. Both have solid brand distribution, good quality and reliability and their packaging help draw attention to the products.”

“I think it is still wide open and the opportunity for someone to take charge potentially is still undetermined. It will be interesting to see the impact that Lorillard has on the business since acquiring Blu.”

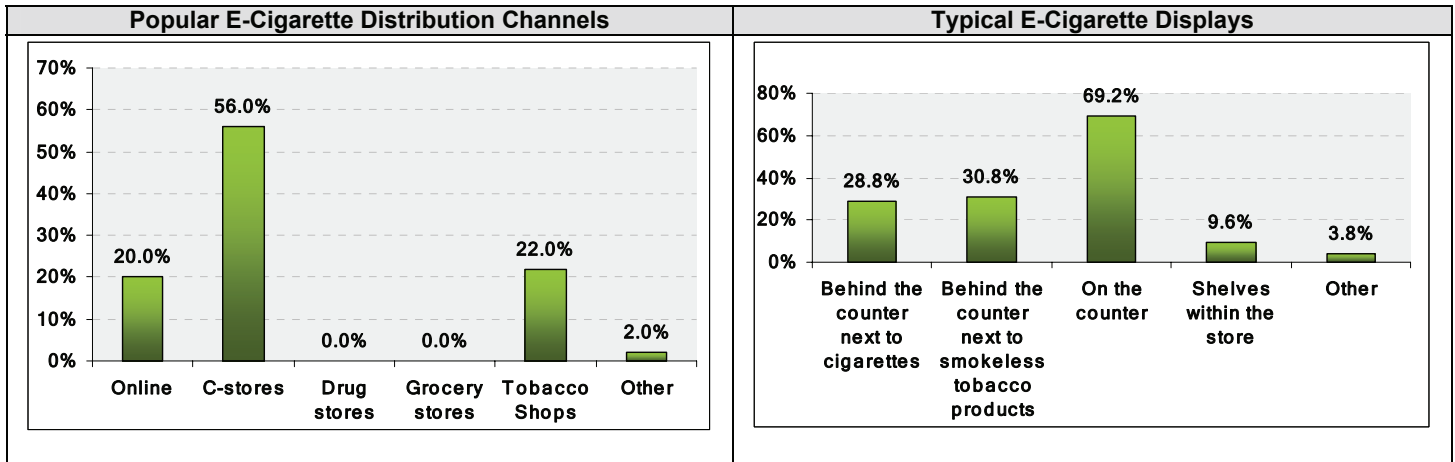
“I think that Envy will remain strong. I do not think that blu will be able to take over.”

“Cig2o. Most responsible people will move away from a fully disposable line and use a rechargeable. The Cig2o product actually tastes good and feels like smoking.”

Source: Wells Fargo Securities, LLC

C-stores Counters Reign Supreme in e-cig Distribution

We asked our industry trade contacts about e-cigarette distribution trends – both in sales channels as well as in-store displays. The most popular channel was thought to be c-stores, followed by tobacco shops and online. We note that online sales can be tax-free when shipping to out-of-state customers so we suspect this may help support online as a key distribution channel for e-cigarettes. Regarding e-cigarette displays, the majority of our respondents stated that “On the counter” is the most common spot for e-cigarettes in stores, followed by “behind the counter next to both smokeless tobacco products and cigarettes.” One respondent noted the inability to carry all the “add-ons” due to “space restrictions.” **Bottom Line – Similar to traditional cigs, c-stores are a popular distribution point for e-cigarettes; however, we feel the convenience and broad choice offered by the online channel will prove to be meaningful as well.**



Retailer Comments on E-Cigarette Distribution

“We have slow sales in our c-stores and tobacco stores, so my guess is that the on-line sales are the most popular.”

“I suspect online is bigger than c-store in NY and any other states with self service bans. We can’t carry all the add-ons that could go with the ecig because of space restrictions.”

“Challenge for c-store operators is merchandising space.”

“I suspect online is bigger than c-store in NY and any other states with self service bans. We can’t carry all the add-ons that could go with the e-cig because of space restrictions.”

“More store count on C-Stores, but CTS stores sell more per location.”

“Most e-cigarettes are being distributed by online sites. Second would be the tobacco shop trade channel.”

“Tobacco stores may have a benefit over C-stores early on since they have more time explaining this product to their customers”

“I think both C-Stores and Tobacco Shops are key distribution channels.”

“I think that Tobacco Shops may have the category more developed as the Drug and Convenience channels are challenged with more space/contract constraints. As space is carved out in the C-store channel you will see more development.”

“I believe it will soon be C-Stores”

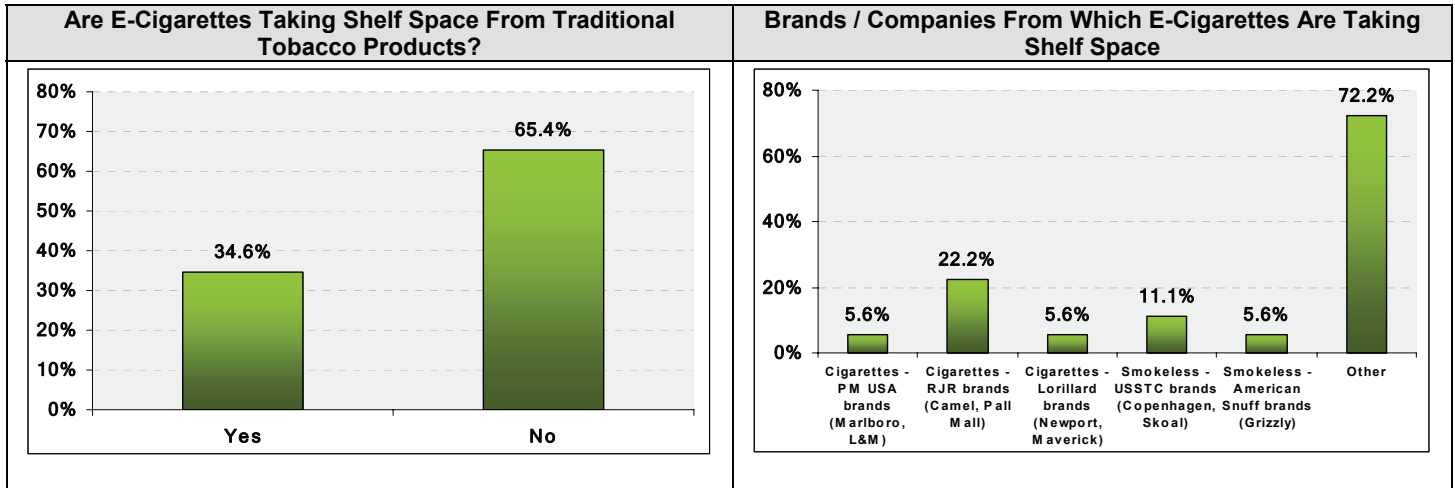
“Tobacco Shops and C-Stores in the brick and mortar arena
Online sales are a big contributor to the overall market.”

“I think it was online, and still may be, but the E-cigarette companies are finally getting in the door through the wholesalers and increasing distribution at the C-Store level.”

Source: Wells Fargo Securities, LLC

E-cigarettes Not Meaningfully Taking Shelf Space From Cigs and Smokeless (Yet)

Digging deeper into in-store trends, we asked our industry trade contacts about where e-cigarettes tend to be sold in stores and if the category is encroaching on traditional tobacco products. The majority of our survey respondents (65%) stated that e-cigarettes are not taking shelf space but a few respondents noted that, in time, this may occur. The cigar section was mentioned a few times as being encroached upon by e-cigarettes. **Bottom Line – e-cigarettes are not yet taking much shelf space from cigarettes but this could change as sales continue to rapidly grow.**



Retailer Comments on E-Cigarettes Taking Shelf Space From Traditional Tobacco Products
"So far it is an additional rack that is next to the cigarette fixture."
"Products are merchandised in several stand alone merchandising vehicles and not yet incorporated into cigarettes or OTP sections."
" Not yet, but they should be, and they will be soon. "
" Normally no , but some are putting (e-cigarettes) with OTP or under 24" line of cig fixture."
"They will in time."
"As an age-restricted product, many municipalities effectively prohibit self-serve placement . As a result, for consistency, this product will generally take space from other tobacco products stored behind the counter . In our case, cigars lost space to accommodate the units. "
" The space allocated to tobacco will continue to grow with the growth of other tobacco products. "
"Not yet but I do see them working into the OTP or cig section in the next few years."
"Not in our stores (400+ locations). We don't have any intention of adding them to the cigarette rack and would be concerned if any company suggested that."
"In most cases, the counter display is used for normal display of product. In the future, it would make sense to place them in the OTP section"
" Cigars "
"I feel that the electronic cigarettes would be taking space from the cigar section of the store . Typically the cigar shelves can be adjusted and the height of the products is usually greater."
" Altadis, Swisher, Swedish Match "
" Cigars - All Manufactures "

Source: Wells Fargo Securities, LLC

"Typical" E-cigarette Consumer is Drawn to Convenience, Health Benefits, and Cheaper Cost of E-cigarettes vs. Traditional Cigarettes

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Although responses varied widely, the majority of responses identified e-cigarette users as current smokers who are trying to cut down or quit for health reasons (e-cigarettes have a much lower number of harmful chemicals than regular cigs), current smokers who use e-cigarettes as a way to “smoke” in areas where there are smoking bans (work, public areas, non-smoking apartments, etc.). Some responses spoke to the cheaper cost of e-cigarettes vs. regular cigs as well as the wide-ranging variety of flavors available for e-cigarettes. Battery-operated e-cigarettes, which are available in both rechargeable and disposable formats, allow the user to maintain the “ritual” of smoking and produce a non-toxic vapor rather than smoke, that is produced when the e-cigarette is “vaped”. **Bottom Line – e-cigarettes’ appeal stems from a variety of perceived advantages over traditional cigarettes, most commonly the perceptions that e-cigarettes are healthier, cheaper, and can be used almost anywhere.**

Trade Comments on Who the “Typical” E-Cigarette Consumer is and What is Appealing About E-cigarettes
“I think young people - between 18 and 30”
“ Anyone with a nicotine addiction. E cig use is not as restricted as traditional tobacco use and users will find them attractive as a substitute nicotine delivery method. I also believe there is a market for those who will try e cigs to stop smoking. ”
“Long term smoker, not wanting to quit. Provides the visual, emotional and physical needs of the smoker. ”
“Allows smokers to smoke in place where normal cigarettes are not allowed. Some call centers in our area are allowing their employees to use e-cigarettes at work. Parents now feel okay to smoke in car with children. Smokers are also saying it’s accepted at some workplaces and entertainment facilities. Smoking in apts that are non-smoking apts.”
“regular smoker who is trying to avoid problems with non smokers in certain situations.”
“Consumers are primarily those wanting to quit or are consumers that want to smoke in places where there are smoking restrictions or feel less social pressure.”
“ Just a fad that appeals to people today!”
“Typical consumer is in who smokes already, but is interested in saving money, and trying something new.”
“The traveler/business professional who cannot smoke in “common” areas where the used to.”
“Two consumers-- one focused primarily on cessation , and the other looking for temporary nicotine relief between cigarettes. ”
“Someone who wants to quit because of health. ”
“heavy smoker that is adventurous or cannot get to a place to smoke”
“E-cigarette consumers tend to fall into two categories: Those who believe that it is a healthier alternative to cigarettes and those who are looking for a cheaper alternative to cigarettes (particularly in high cigarette tax states).”
“There isn't a “typical” right now. You have the health conscious to the construction workers to the systems analysts who can't smoke on campus.”
“ 18 to 35 , looking to smoke at work.”
“I believe all cigarette customers are willing to try the electronic cigarettes.”
“1.) Consumer that cannot smoke in public places but does not have access to smoking areas; 2.) Travelers; 3.) Smokers concerned with second hand smoke in homes and cars; 4.) Being in NY, e cigs are cheaper than reg cigs”
“2 types - the smoker who is not quitting but wants to be able to enjoy a 'smoke' in restricted areas and the smoker who is trying to quit and feels e-cigarettes are a bridge to stop smoking ”
“Everyday smokers that use e-cigarettes where they can't smoke traditional cigarettes. ”
“It is a wide range because most smokers agree that they are looking to save money and are interested in many of the benefits of e cigs: no smoke, less smell, no tar. ”
“Hard to understand this customer at this point but I feel like they are traditional smokers who are trying to quit or smoke less. ”
“Smoker; under age 45; looking for options ”
“Adult male and female between 25-35. Use for cessation and healthier nicotine delivery. ”
“women,it’s easier than going outside.”
“Person who is trying to quit or someone who often finds him/herself in places they cannot smoke. ”
“People trying to quit or trying to cope with smoke restrictions ”
“Existing cigarette consumers for use in restricted cigarette smoking areas ”
“Young trend setters”
“Smokers because they can smoke them most anywhere. ”
“Too early to tell for certain. Believe a lot of different people are looking at and trying these products ”
“40 to 50 wanting to cut back on smoking . Some maybe 15% want to use them at work. ”

"It is the consumer that is trying to **reduce their smoking habit and/or quit altogether.**"

"People that are **looking for a smoking option** where you are now no longer able to enjoy (bars, stores, even in our own homes)."

Source: Wells Fargo Securities, LLC

General Comments on E-Cigarette Trends

Retailer Comments on E-Cigarette Trends
"A few new players are touting "American Made" which may be a selling point. It will be a buying point since a lot of manufacturers are having issues getting product in from China. "
"A lot of very poor quality items in the market."
"Could not believe the different number of brands at the recent NATO show. We are waiting for the smoke to clear until we completely dive into the category. "
"There are so many smoking restrictions now, that the e-cig not only appears to be healthier - but the smoker can get their nicotine fix at any time."
"Too many companies trying to get established. Most will not survive."
"NJOY seems to be on the way out. It seems they have over leveraged themselves with their "rechargeables" line."
"Lorillard will take control and put e-cig into their cigs contracts."
"E-cigarettes have a larger variety of flavors – cherry, bourbon. Customers eNJOY the change."
"No consistency among the brands. There are many different sizes, filters, batteries etc. This will hurt long term rechargeable sales and will keep consumers buying disposables."
"The purchase of BLU by Lorillard will help drive interest in the industry. Refill packs continue to grow as an increasing amount of consumers purchase starter packs. The e-cigarettes are being developed to be the same size as a normal cigarette, and they are being placed in a box similar to a normal cigarette box. "
"The different flavored products seem to be gaining some momentum."
"There still appears to be a lack of education on the consumer's part. Also, FDA regulations and potential excise taxes will play a major part as the category goes forward."
"Disposables are the best sellers, probably due to the low entry price points."
"More activity with in C-Stores."
"Lots of trial purchases occurring."
"Low quality brands are going out of business."
"Up until this point e-cig companies were focusing on retail distribution. The next challenge will be to develop brand awareness and equity. "
"Every week I receive minimally a call/email from another new brand trying to get distribution. The retail price points have reduced significantly (\$5.99 - \$29.99) as compared to prices at the end of 2010 (\$50 - \$80) due to introduction of disposable products."
"Confusion still exists for retailers and wholesalers. Still a lot of junk out in the market. Until there is more defined regulation from the FDA this will continue as more companies get into the category to make a quick buck. Price is a big driver at this time, not necessarily quality. "
"Consumers still don't understand what exactly they are used for. Clerks don't know how to explain them to consumers."
"We are up about 50% in e-cig units YOY."
"Seems like there are a lot of people working to get into this sub-category. It will be interesting to see what Lorillard does with Blu. Their introduction of a snus product was less that stellar, Blu has its place in the markets and has pockets of the country where they do well. May force the other majors to make moves on other e-cig manufacturers."
"We are certainly seeing it become more competitive and I think you will see the margins go down as we have already seen some price decreases due to competition. It is one of the reasons wholesalers were receptive to bringing it in because of the good points on margin."
"Concerns always loom on taxation and regulation."

Source: Wells Fargo Securities, LLC

E-cigarette History – 10,000 Foot Overview

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

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

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

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

According to our survey, leading brands include NJOY, blu, 21st 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

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

E-cigarettes are typically 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. 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

There are currently no federal or state excise taxes imposed on e-cigarettes. 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.

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