

Turning Point Brands



Industry: Tobacco

CEO: Lawrence Wexler

Ticker: TPB

Market Cap: \$511 Million

Price: \$25.99

6 Month Price Target: \$36

24 Month Price Target: \$65

Upside Potential: 38.5%/150%

Business Overview

The company's portfolio of brands includes various names in the OTP industry, such as Zig-Zag, Beech-Nut, Stoker's, Trophy, VaporBeast, Vapor Shark, and VaporFi. The company ships to approximately 800 distributors with an additional 100 secondary, indirect wholesalers in the U.S. As of December 31, 2018, the company's products were available in approximately 185,000 U.S. retail locations which, with the addition of retail stores in Canada, brings its total North American retail presence to an estimated 210,000 points of distribution. The company's sales team targets widespread distribution to all traditional retail channels, including convenience stores, where approximately 60% of all OTP volume is sold.

Turning Point Products

The company operates through three segments: Smokeless Products, Smoking Products, and NewGen Products.

Smokeless Products

This segment includes both loose leaf chewing tobacco and moist snuff tobacco (MST). The company's Smokeless focus brand is Stoker's in both chewing tobacco and MST. The company's chewing tobacco operations are facilitated through its long-standing relationship with Swedish Match, the manufacturer of its loose leaf chewing tobacco.

Smoking Products

This segment principally includes cigarette papers and Make-Your-Own (MYO) cigar wraps. MYO cigar wraps operations are facilitated by the company's commercial relationship with the patent

holder, Durfort. Additionally, the company sells Zig Zag rolling papers, the number 1 premium rolling paper in both the United States and Canada.

NewGen Products

This segment includes the company’s acquisitions of Smoke Free Technologies, doing business as VaporBeast (VaporBeast), The Hand Media and its subsidiaries, doing business as Vapor Shark (Vapor Shark), Vapor Supply, and International Vapor Group and its subsidiaries (IVG). VaporBeast operates as a distributor of liquid and device vapor products servicing the non-traditional retail channel. Vapor Shark operates as a distributor and manufacturer of premium vaping e-liquids with distribution through non-traditional retail, as well as Vapor Shark branded retail locations. Vapor Supply operates high-volume vapor outlets in the Oklahoma market in addition to a B2B wholesale vapor business. IVG operates a B2C eCommerce business with direct sales to consumers nationwide and internationally through the Direct-Vapor and VaporFi brands and runs a wholesale vaping business under the Direct-Vapor mark. Its acquisition of VaporBeast, Vapor Shark, Vapor Supply, and IVG accelerated its entry into the non-traditional retail outlets for vaporizers, e-liquids, and accessories.

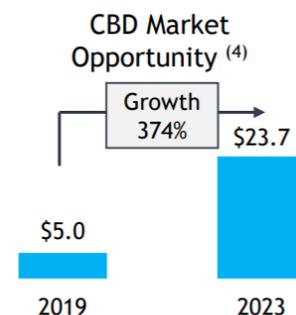
Update on Vaping Business

During the firm’s Q3 earnings call on November 3rd, CEO Larry Wexler announced that the Board of Directors would be reviewing strategic alternatives for the firm’s vaping distribution businesses. Included in this review will likely be a number of the VaporBeast businesses, such as VaporShark, which operates as a distributor. The headlines surrounding vaping dramatically disrupted the third party distribution business. Currently, it is unclear what the Board will decide upon, but nevertheless, will allow for the company to focus on growing their CBD business. The company has initiative reductions already in the vaping business, by laying off 10% of the workforce and forced shutdowns of manufacturing plants. These actions should result in at least \$10 million in savings on an annual basis.

Key Investment Drivers

CBD is the Growth Driver

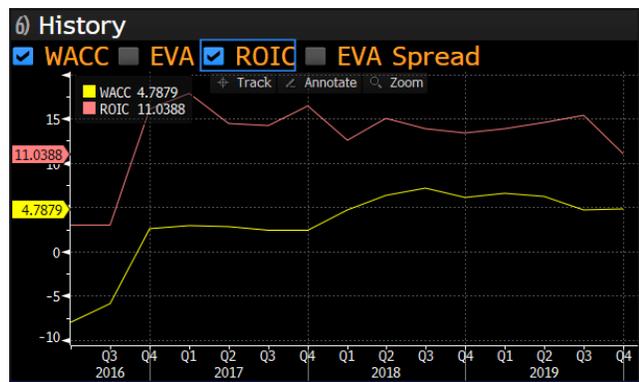
Although vaping was seen as a catalyst for many in the tobacco industry, Turning Point instead has CBD as a catalyst for growth. The CBD market in the United States is still very much in its infancy, as the production of hemp was only made legal in 2018 with the passage of the US Farm Bill. As a result, it will be critical for CBD to begin to educate potential customers who may be seeking a healthy alternative to marijuana. The CBD market is expected to grow by over 350% over the next four years according to Brightfield Research. By 2023, TPB has the



opportunity to corner a \$23 Billion dollar industry as they continue to grow their E-Commerce business as well as developing new products that can be sold in their retail partners stores. The company is expected to introduce a wide variety of products into the market in the coming quarters, including a disposable vaporizer and CBD tinctures. The firm's NewGen segment is also greatly increasing profitability for the firm as they sift from lower margin tobacco products. The firm released their CBD vape in October at a retail price of \$19.99 and within the month has sold out of all available inventory. Many retailers are attempting to assemble a suite of CBD products, and will continue to turn towards trusted partners like TPB who have produced quality products for years.

War Chest for Future Growth:

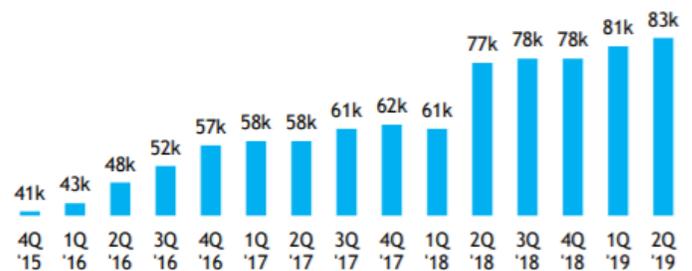
The company announced an issuance of convertible debt, which they plan to use for further growth through M&A. Management has been an excellent steward of the firm's capital, with a ROIC of 11% and a Return on Equity of 37%. Future acquisitions will most likely be used exclusively to continue to build the NewGen segment, while the traditional Smoking Products and Moist Snuff continue to produce stable cash flows. The company's asset light business model allows for incredibly strong free cash flow figures, which can also be utilized to invest in new products and sales teams.



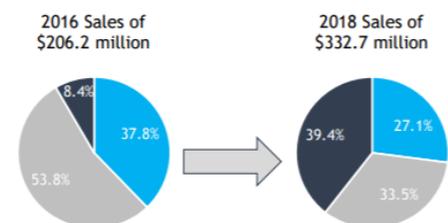
Strong Brand Growth

The management team has described TPB as a "Brand Company", a collection of iconic products that will continue to satisfy consumers well into the future. The company's iconic brands such as Stokers and Zig Zag are both leaders in their respective markets, with a 50% market share in the tub format of chewing tobacco and Zig Zag being the number 1 premium rolling paper in the United States and Canada. Stokers has been the legacy brand with the highest rates of growth for the company as they invest in expanding the sales team and partner with large retailers. Stokers Can's volume sales increased by 35% in Q2 of 2019 after the company announced a partnership with

STOKER'S MST STORES SELLING



SALES BY SEGMENT - 2016 TO 2018



Speedway Convenience stores. The Zig Zag rolling paper is an iconic brand which also offers catalyst for growth for the company. The firm has plans to release new products in 2019 and 2020 including pre-rolled cones and entirely organic papers. Turning Point Brands now has an incredibly diverse sales portfolio, and is no longer reliant on just one business unit. NewGen now accounts for a majority of sales with just below 40% accountability. The company fully expects this number to grow as the firm introduces new CBD products to the market and potentially having their vapes approved through the FDA's PMTA process.

Market Demographics

TPB's stock hasn't been available to avoid the negative sentiment directed towards Tobacco companies over the past few months after countless cases were reported of children being admitted to the hospital as a result around vaping. I covered a majority of this story in my Seeking Alpha article on the industry, and I will let that information contained in the post act as a backdrop for a more nuanced section that is directly applicable to TPB. Turning Point Brand's product portfolio offers a wide variety of tobacco and CBD alternatives that consumers who question the health effects of vaping. By offering a variety of products outside of vaping such as snus and tinctures, potential customers are offered a wide variety of products they can choose from. This is leveraged by a powerful B2C E-Commerce platform that gives TPB a competitive advantage over other companies introducing new product alternatives. By utilizing their E-Commerce platform to sell and receive feedback from consumers, they can make any modifications necessary to ensure customer satisfaction prior to releasing them in large nationwide chains that they already are partnered with.

Another headwind that is facing the Tobacco industry as a whole is the FDA's PMTA approval process, with all proposals being due by May of 2020. A Premarket Tobacco Approval Application must be submitted by a company attempting to sell, market, and distribute a new tobacco product on the mass market. Turning Point Brands is preparing their PMTA application for four different product classes and 50 separate SKU's. According to the company presentation, management believes that they will be one of the only open systems to gain PMTA approval from the FDA. The application for the process is incredibly cumbersome, with 10 sections and 163 subtasks, which make completing the process incredibly difficult for small manufacturers who don't have the resources or information to complete by the accelerated date of May 2020. The vapor market is incredibly fragmented in the early stages of industry growth, but TPB predicts the PMTA process will precipitate mass consolidation in the industry. One new data point that all companies must address is presenting data that children will not be likely to use the product. Companies like Juul obviously will struggle to show this data, but TPB has the data to prove this is not the case. According to data collected by the firm's E-Commerce platform, they have over 3 million transactions that show the average age of the purchaser is above 40, with 91% already using cigarettes. The design of the product is what largely affects these results, as according to former FDA Commissioner Scott Gottlieb, "Data show that refillable liquid vaping devices—so-called open systems—are primarily used by adults while

disposable, cartridge based e-cigs—“closed” systems like JUUL—are favored by minors. The former are typically sold in vape shops; the latter are available in convenience stores.”

The internal team that Turning Point Brands has created to finalize the PMTA process brings over 100+ years of experience navigating regulations affecting the Tobacco Industry at every level of government. Chief Counsel James Dobbins has over 25 years’ experience working with and submitting regulatory documents to the FDA while Dr. Sarah Evans, the former director of FDA Science, is overseeing the testing and literature review. The company has additionally outsourced multiple review processes to outside accredited testers for managing environmental and toxicology studies. Such a burdensome process will undoubtedly be a disruption for smaller companies with more limited resources.

Risk Factors for Turning Point

The risk factors that are most likely to have an adverse effect on Turning Point Brands are not uncommon to operators in the Tobacco industry. Regulation will remain the most significant concern for TPB management, as the industry has faced a growing regulatory burden over the last 50 years. The trend of regulation coupled with a general shift in consumer habits towards tobacco products has led to an overall decline in the industry over the last 50 years. Any new regulations that may affect the New Gen business segment for the company could significantly limit growth. This can be seen simply in the companies decision to seek strategic alternatives for their vaping distribution business line, which has faced significant challenges from the ban on sale of vape products in certain states and jurisdictions.

Turning Point management has strategically decided to be an asset-lite firm, outsourcing the production of all of their tobacco products to third parties. This presents a potential risk as the company is incredibly reliant on just three companies to supply the majority of their products. The company has signed long term contracts with Swedish Match (MST), Bollore (Zig-Zag), and Durfort (MYO Cigar Wraps) to manufacture their products. The company has long term contracts with Swedish Match and Bollore that should insulate the firm from any cancellation of the agreement, but Durfort could potentially cancel their partnership with TPB at any time. The firm must ensure the financial condition of each firm and in the event of a black swan event like a fire, the company may not be able to meet customer demand for their products.

Management

Executives at Turning Point Brands bring over 00 years of experience in the tobacco industry, as well as the skills needed to develop a world class E-commerce business. It will be critical for management to successfully navigate the PMTA process, which they firmly believe they are capable of.

Lawrence Wexler- President & Chief Executive Officer

Mr. Lawrence S. Wexler, has been the Chief Executive Officer and President of North Atlantic Trading Co Inc. since April 16, 2007. Mr. Wexler has been the Chief Executive Officer and

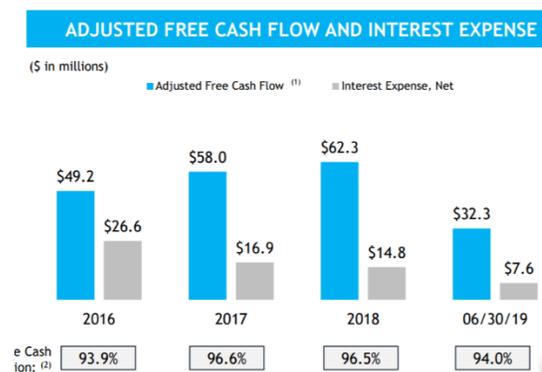
President of Turning Point Brands, Inc (Formerly North Atlantic Holding Co. Inc.) since June 2009. He served as the Chief Operating Officer of Turning Point Brands, Inc. since June 8, 2005. He served as President and Chief Operating Officer of North Atlantic Cigarette Company Inc.,(NACC), a subsidiary of North Atlantic Trading Co Inc. since December 2003. Prior to NACC, Mr. Wexler was a consultant to a number of emerging marketing, communication and financial companies, advising them on financial, marketing and strategic matters, at times in an operating role from 1998 to 2003. From 1977 to 1998, he was employed by Philip Morris, USA in various positions in the Sales, Marketing and Finance Departments including Group Director, Discount Brands. In this position, his group introduced the Basic and Alpine brands. Mr. Wexler served as Senior Vice President of Marketing of Philip Morris from 1992 to 1993 and Senior Vice President of Finance, Planning and Information Services from 1993 to 1998. He has been a Director of Turning Point Brands, Inc since 2013. Mr. Wexler holds a bachelor of science in administrative science from Yale and a master of business administration from Stanford.

Robert Lavan – Chief Financial Officer & SVP

Mr. Robert M. Lavan has been Chief Financial Officer of Turning Point Brands, Inc. since March 13, 2018 and serves as Senior Vice President. He was a Portfolio Manager and Analyst at J. Goldman & Co., L.P. since April 2012. In 2017, Mr. Lavan served as Chief Financial Officer of General Wireless Operations Inc., where he was responsible for revamping the company’s financial reporting systems and building a robust distribution platform that linked multiple eCommerce sites and Amazon. Mr. Lavan has an extensive background with both publicly traded and private-equity backed companies and brings to the Company experience in developing eCommerce platforms, expanding distribution networks, IT infrastructure and execution of mergers and acquisitions. Previously he was a Stock Analyst at Sigma Capital Management, LLC. Prior to joining the firm Mr. Lavan was a Senior Research Analyst at SAC Capital Advisors, L.P. from 2010 to 2011 and a Senior Research Analyst at Standard General, L.P. from 2007 to 2010. Previously he was an Analyst at The Blackstone Group from 2004 to 2007. He is the Chairman of General Wireless Operations Inc. Mr. Lavan received a B.S. in Computer Telecommunications from School of Engineering and Applied Science of the University of Pennsylvania in 2004.

Valuation

At the company’s current valuation, they are trading at a multiple of just 10.8x EV/EBITDA, falling from 15x in Q1 of 2019. The recent sell off as a result of the fears over vaping have created a great purchasing opportunity for a high growth company. The firm's capital light business model ensures profitability for the firm, especially in the form of Free Cash Flow. The firm has a Free Cash Flow conversion rate of over 90% since the company IPO’d in 2016. This efficiency has



allowed for the firm to reinvest profits from their stable tobacco business unit and invest them in the fast growing NewGen segment. These investments include sales force expansion and working capital for new product launches. Additionally, the firm can use these funds in the event of an industry downturn to maintain a healthy balance sheet, with Net Debt to EBITDA at 3.4x. The company announced their target debt ratio is anywhere between 2.5x to 3.5x. The firm in August announced the issuance of \$172.5 million, which was used to pay down expensive debt and gives the firm a \$150 million war chest to pursue further acquisitions. I believe that the potential for further acquisitions with their new ammunition can provide a huge opportunity for growth to the firm. As competitors like Altria are forced to write down investments in their Vaping businesses which were supposed to be a source of growth for the industry, TPB has a great growth potential in their CBD business. As the market recognizes that TPB is not exposed to potential negative consequences from vaping, I believe they will again return to a premium price over their competitors. The firm's growth story is still very much intact, and the sell off since August has largely been without warrant. Over the coming months as the firm continues to display impressive growth and launches new products, TPB stock should return towards the high 50 dollar range and beyond.

Financial Statements

INCOME STATEMENT						
Fiscal year	2017A	2018A	TTM 9/30/2019	2019`P	2020P	2021P
Revenue	286	333	376	432	497	572
Cost of sales	160	187	210	242	279	320
Gross Margin	44%	44%	44%	44%	44%	44%
Gross Profit	125	145	166	190	219	252
Selling General & Admin Exp.	73	78	97	110	117	125
R & D Exp.	2	3	3	4	5	6
Depreciation & Amort.	-	-	-	-	-	-
Other Operating Expense/(Income)	-	-	-	-	-	-
Operating profit (EBIT)	50	65	66	76	97	121
Interest Expense	(17)	(15)	(16)	(16)	(16)	(16)
Interest and Invest. Income	0	1	1	1	1	1
Net Interest Exp.	(16)	(14)	(15)	(15)	(15)	(15)
Restructuring Charges	-	(1)	(4)			
Merger & Related Restruct. Charges	-	-	(11)			
Impairment of Goodwill	-	-	-			

Legal Settlements	-	-	-			
Other Unusual Items	(4)	(6)	(5)			
Pretax profit	30	44	33	62	82	106
Taxes (enter expense as -)	(7)	(6)	(9)	13	17	22
Net income	23	38	23	49	65	84
Basic shares outstanding	19	19	20	20	20	20
Impact of dilutive securities	0	0	0	0	0	0
Diluted shares outstanding	19	19	20	20	20	20
Basic EPS	1.06	1.31	1.58	2.49	3.32	4.28
Diluted EPS	1.06	1.31	1.58	2.49	3.32	4.28
<u>Growth rates & margins</u>						
Revenue growth	-	16%	13%	15%	15%	15%
Gross profit as % of sales	44%	44%	44%	44%	44%	44%
Operating Income	17%	20%	18%	18%	19%	21%
Tax rate	24%	14%	28%	21%	21%	21%