

The short case of Star Scientific

Star Scientific has had an interesting few months, says SunGard Astec Analytics' Andrew Shinn

MARKET PERSPECTIVE

One of the most popular short sales recently has been Star Scientific (NASDAQ:CIGX). Short sellers have borrowed and sold millions of shares of Star Scientific over the past four months. This activity can be traced back to Star Scientific's lawsuit against RJ Reynolds, which was filed in May 2001. The stock price whipsaws based on developments in the lawsuit.

Between last summer and early March 2011, short interest was roughly 13 million shares, or 13 per cent of 101 million shares float. Then on March 11, Star announced that the US Patent Office (USPO) declared that two of its patents, which are at the center of the ongoing lawsuit against R.J. Reynolds, are valid. Star's share price almost doubled from \$1.86 on March 7 to \$3.48 on March 14. Short sellers didn't immediately short many additional shares; short interest only increased 200,000 shares from 13.2 million shares at the beginning of March to 13.4 million shares on March 15. However, short interest climbed to 14.5 million shares on March 31 and 17.7 million shares at the end of April. Short interest now stands at 20.3 million shares as of June 30.

Star Scientific's lawsuit alleges that R.J. Reynolds infringed on Star patents that cover a proprietary way of curing tobacco that results in less bacterial contamination and fewer toxins. In June 2009, a jury determined that Star's patents were not valid and that R.J. Reynolds did not infringe upon the patents. Star lost almost three-quarters of its market value on June 17, 2009, as its share price dropped from \$4.21 to \$1.13 in one day. Fast forward to March of this year, and the stock price doubled in the same week that the company announced the USPO's decision.

Although many long investors seem to view the USPO announcement favourably, investors who shorted the stock evidently don't have faith that the 2009 jury verdict will be successfully appealed and eventually overturned. That may be because the 2009 verdict declared that R.J. Reynolds did not infringe upon the patents, regardless of the patents' validity.

In addition, the patents are not even owned by the shareholders of Star Scientific, so it's unclear who would receive the payout even if the case against R.J. Reynolds was concluded favorably for Star. According to Star's Form 10K filed with the US Securities and Exchange Commission, the patents are held by an entity called Regent Court Technologies, LLC, which is owned by Star's CEO, Jonnie R. Williams, and another

gentleman named Dr. Francis O'Donnell. Regent Court has an exclusive relationship with Star; Star pays Regent Court licencing fees to use the tobacco curing techniques covered by the patents. According to the 10K, "the Licence Agreement obligates [Star] to enforce and pay for United States and foreign patent rights." This arrangement is advantageous for Regent Court, because while it owns the patents and receives licensing fees, it does not have to pay to enforce the patent rights against alleged abusers such as R.J. Reynolds.

It's difficult to determine exactly how much Star pays in licensing fees to Regent Court, but the related-party transactions do not end there. Jonnie Williams and Francis O'Donnell are also co-owners of Starwood Industries, LLC. Starwood owns an aircraft that is used by executives at Star Scientific. According to Star's 10K, "payments made by our company to Starwood, Starwood Aviation or Messrs. Williams and O'Donnell as predecessors-in-interest to the aircrafts with respect to related expenses were \$1,654,000 in 2010, \$1,560,000 in 2009, \$1,401,582 in 2008, and were billed at cost."

Unfortunately, no mention is made as to how these payments of roughly \$1.5 million per year compare to other air transportation options for Star executives. Star states that "we have agreed to pay an hourly rate for the use of the aircraft of approximately \$3,970." As one point of comparison, privatejets.com's charter rates start at \$1,200 per hour.

Aside from the prospects from the lawsuit, Star Scientific is not profitable, yet the company is currently valued at \$550 million, with a price-to-sales ratio of 675 (price-to-earnings ratio is not available since the company is not profitable). It's true that Star almost doubled its revenue over the past two years, but it started at a very low level: \$451,000 in 2008 (revenue last year was \$848,000). Also, the company has lost millions of dollars over the past few years: \$28.3 million last year, \$22.8 million in 2009 and \$18.3 million in 2008. It's also not clear why general and administrative expenses were \$21 million, \$15 million, and \$15 million over the past three years, and cost of goods sold was more than \$2 million each year while revenue was one-half or one-quarter of that amount.

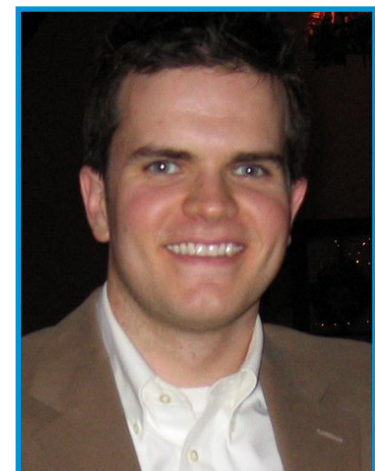
In addition to the income that Jonnie Williams receives as co-owner of Regent Court and Starwood Industries, his annual salary as CEO of Star Scientific for the last three years was \$1 million. His total compensation last year was

almost \$4 million. Paul Perito, Star's chairman, president and chief operating officer, also received a salary of \$1 million each year for the last three years, and his total compensation was over \$4 million in 2010. While Star lost money over the past three years, it continued to raise money from the stock market. Proceeds from the sale of stock and warrant exercise were \$28 million, \$20 million, and \$17 million over the past three years.

In addition to the prospect of a favourable end to the lawsuit against R.J. Reynolds, Star's share price may be buoyed by investors' faith in Star's Rock Creek Pharmaceuticals subsidiary. Rock Creek is developing a tobacco-based treatment that could be used as a treatment for various neurological diseases, such as Alzheimer's, Parkinson's, depression and schizophrenia. The substance, anatabine, is a minor alkaloid found in tobacco plants. Whether or not it is a treatment or cure for a neurological disease remains to be seen, but it's not currently generating any revenue.

In fact, the majority (\$785,000 of \$848,000) of Star's revenue in 2010 was from dissolvable tobacco. Star's dissolvable tobacco product competes with products from Camel, Marlboro, etc. Therefore, one can safely say that Star Scientific is the anti-thesis of a Graham and Dodd value play. Investors are not buying shares of Star for its current business; rather they are buying because of the merits of the litigation against R.J. Reynolds and the anatabine treatments for neurological diseases.

As for short sellers, the cost-to-borrow according to SunGard Astec's Lending Pit remains very high and it's possible that the stock price could remain elevated for a while. [SLT](#)



Andrew Shinn
Vice president, sales and development
SunGard Astec Analytics