Taglich Brothers, Inc.
The Standard of Excellence in the Microcap Market

Member: NASD, SIPC

# *Research Report – Update*

***Investors should consider this report as only a single factor in making their investment decision.***

## Lifeway Foods, Inc.

**Rating: Neutral**

Howard Halpern
June 8, 2004

**LWAY $10.69 - (NasdaqNM)**

| | FYE (12/01) | FYE (12/02) | FYE (12/03) | *FYE (12/04) E* | *FYE (12/05) E* |
|---|---|---|---|---|---|
| Revenue (in millions) | $10.7 | $12.2 | $14.9 | ***$17.1*** | ***$19.8*** |
| Earnings per share (diluted)* | $0.14 | $0.18 | $0.26 | ***$0.32*** | ***$0.37*** |

| | | | |
|---|---|---|---|
| 52week range* | $28.24 – $3.65 | Fiscal year ends: | December |
| Shares outstanding* | 8.44 million | Revenue/shares (TTM)* | $1.84 |
| Trading float | 2.36 million | Price/Sales (TTM)* | 5.81X |
| Insider and institutional ownership | 72.0% | Price/Sales (2004)* | 4.59X |
| Tangible Book value/shr* a/o 03-31-04 | $1.94 | Price/Earnings (TTM)* | 46.5X |
| Price/Book* | 5.51X | Price/Earnings (2004)* | 33.4X |

* All per share figures reflect the 2-1 stock split effective March 9, 2004.

*Lifeway Foods, Inc., is a manufacturer of cultured, probiotic and functional food products in the health food industry, and is America's leading supplier of the cultured dairy product known as Kefir. Their products are sold to health conscious consumers through health food stores and to the mass-market consumers through supermarkets. They currently have approximately 55 employees. Web site address is: www.kefir.com*

***Key investment considerations:***

***We are maintaining our Neutral rating. It is our view that based on our EBITDA and earnings per share estimates, LWAY's shares are fairly valued.***

***Lifeway Foods reported first quarter revenue of $3.935 million, which was an increase of 18.9% versus $3.309 million in the first quarter of 2003. Net income was $0.765 million or $0.09 per diluted share versus $0.993 million or $0.12 per diluted share in the first quarter of 2003. Last year's net income was positively impacted by approximately $0.07 per share from non-recurring items.***

***Investors should be aware that the Company and Danone have not renewed the term of an existing Support Agreement that ended on December 31, 2003. It is expected that this and other agreements would be discussed and possibly renegotiated pending the expiration of an existing Stockholders' Agreement on September 30, 2004.***

***Based on first quarter results and comments made by the Company in its latest 10Q filing, we are maintaining our revenue estimate for 2004 of $17.1 million. However, we are adjusting our 2005 revenue estimate to $19.8 million from our prior estimate of $19.9 million.***

***Given our revenue estimates and statements made by Management in the Company's first quarter 10Q filing, we are forecasting net income for 2004 of $2.680 million or $0.32 per diluted share. Our prior estimate called for net income of $2.430 million or $0.29 per diluted share. Our initial net income forecast for 2005 remains at $3.165 million or $0.37 per diluted share.***

**** Please view our disclaimer located on page 9.***

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## *The Company*

Lifeway Foods, Inc. (NasdaqNM: LWAY) manufactures a cultured dairy beverage called Kefir and also develops Kefir related products at its two manufacturing facilities in Illinois. Distribution of its twelve Kefir based products in Illinois are through approximately 1,200 local stores including major retail chains (i.e., Jewel Food Stores, Dominick's Finer Foods, Treasure Island Food Marts, Whole Foods, and independent retailers), via ten company owned trucks. Also, the Company distributes its products throughout the United States and to some parts of Canada (Ontario and Quebec), utilizing verbal distribution arrangements with a number of distributors. Management believes that verbal arrangements provide the necessary latitude to expand into new markets and establish new relationships on an ongoing basis.

Danone Foods, Inc., the U.S. subsidiary of Groupe Danone of Paris, France, has a 20% ownership interest in the Company. Since November 1999, Danone Foods President and CEO, Thomas Bunz has served on Lifeway's Board of Directors.

During March 2004, the Company formed Lifeway Foods Canada, as a unit of its subsidiary, LFI Enterprises, Inc., for the purpose of investigating commercial opportunities in Quebec. In addition, Management stated in the Company's first quarter 10Q filing that it is exploring potential acquisition opportunities in order to boost sales, while leveraging LWAY's distribution system and to consolidate and lower costs. Management anticipates closing an acquisition in 2004 or early 2005.

### Kefir

Lifeway Kefir contains ten active "friendly" microorganisms and is probiotic* in nature because it promotes the growth of those microorganisms naturally. The product is a good source of calcium, protein, minerals, and vitamins (i.e. B-complex vitamins) and is highly digestible due to its acidity and enzymes. Kefir is similar to, but distinct from, yogurt. The fermentation process produces a less sour tasting product. Also, less sugar is required; therefore, the product contains fewer calories.

* Probiotics are defined as live cultures consumed for a health benefit. These cultures are comprised of one or more types of bacteria. Probiotic cultures have recently undergone controlled scientific investigations. The results lend some credence to the old folklore that suggests fermented dairy products that contain probiotic cultures are healthful.

## *Recent Financials*

For the three months ended March 31, 2004 versus the same period last year:

- Revenue increased to $3.935 million versus $3.309 million;
- Operating expenses increased to $0.822 million versus $0.845 million;
- EBITDA increased to $1.110 million versus $0.803 million; and
- Net income was $0.765 million or $0.09 per diluted share versus net income of $0.993 million or $0.12 per diluted share. Net income in the first quarter of 2003 included a non-recurring gain of $1.246 million from the disposition of property and a loss from the sales of marketable securities of $0.347 million. We estimate that excluding the one-time gain and loss from the sale of securities net income was approximately $0.05 per diluted share.

The year-over-year revenue increase of 18.9% was primarily attributable to:

- Continued sales to a new customer obtained in June of 2003. Management believes that approximately half of the revenue increase was attributable to Sav-A-Lot, Ltd., which purchased a significant amount of 8 oz. bottles of Lifeway's LaFruta line. Sav-A-Lot is the 13th largest grocery chain in the U.S., operating in excess of 1,000 food stores;
- Steady growth in the ethnic and natural foods markets; and
- Growth experienced by its distributors.

Gross margins increased to 46.65% versus 44.81% in the same period last year. The improvement in gross margins resulted from negotiated contracts with vendors and the purchase of raw materials in bulk (excluding milk). It is important to note that the improvement occurred in spite of higher milk prices (an approximate 20% increase versus last year), which is the Company's largest raw material component.

Operating expenses, as a percentage of revenue, decreased to 22.41% versus 25.53% in the first quarter of 2003. The decrease in operating expenses, on a percentage basis, was primarily due to spreading fixed costs over a larger revenue base.

In comparison, Taglich Brothers' estimates called for revenues of $3.98 million and net income of $0.515 million or $0.06 per diluted share.

*Balance Sheet as of March 31, 2004*

The Company had cash and cash equivalents of $4.633 million and short-term marketable securities of $6.616 million. This compares to cash and cash equivalents of $4.598 million and short-term marketable securities of $6.303 million as of December 31, 2003. Working capital was $13.723 million versus $13.005 million in 2003. The Company's long-term liabilities stood at $0.469 million.

The Company's portfolio mix of marketable securities consists of:

- 80% fixed income securities; and
- 20% equity investments. The investment mix is as follows:
    - 85% in large cap value stock;
    - 10% in small cap growth stocks; and
    - 5% in large cap growth stocks.

In 2003 and the beginning of 2004, the Company transitioned away from higher-risk securities towards larger cap value, higher dividend yielding, and tax–advantaged equities.

We believe that LWAY will be able to fund its sales growth from cash on hand and internally generated funds. Management is not aware of any circumstances or trends, which would have a negative impact upon future sales or earnings and that there have been no material fluctuations in the standard seasonal variation of the Company's business.

## *Market Comment*

It is estimated that Lifeway Foods' target market, the functional and probiotic foods segment of the Food Industry, generates annual revenue in excess of $20 billion. Marketresearch.com predicts that by the end of the decade, the U.S. Functional Food Market will approach $30 billion. This would represent approximately 5.5% of the total Food Market. The Nutrition Business Journal estimates that the Functional Food Market currently represents 3.3% of the total U.S. Food Market.

## *Outlook*

We believe that annual revenue growth will exceed 14.5%; therefore, revenue should reach $17.1 million in 2004, which is unchanged from our prior report. Our revenue estimate for 2005 is $19.8 million, which is a 16% increase from our 2004 estimate. Our prior estimate called for revenue of $19.9 million. Our revenue forecasts are based on:

- Increased acceptance of the Company's products by consumers;
- Marketing initiatives such as:
    - Educating consumers about the potential beneficial uses of Kefir in the replenishment of 'good' bacteria in a person's intestinal system, especially after taking antibiotics or consuming alcohol;

  - Advertising in local newspapers (i.e., primarily in the Chicago area), in national magazines (i.e., Self, Shape, and Men's Fitness), and through local radio stations;
  - Product demonstrations in stores throughout the U.S.; and
  - Sponsoring and participating in various local sporting events around the country and exhibiting at trade shows.

– The Company building on its current distribution channel, which includes regional supermarket chains and/or regional super-center type stores;

– Introduction of new shrink-sleeve packaging for the Company's SoyTreat and Kefir product lines. The transition to this packaging should be completed during the third quarter of 2004; and

– Expansion of its La Fruta Product line in the Hispanic community. The U.S. Census Bureau, in a March 18, 2004 report, projects the nation's Hispanic population to grow from 35.6 million to 102.6 million over the next half century.

Based on first quarter results, we are increasing our 2004 net income forecast to $2.680 million or $0.32 per diluted share from our prior forecast of $2.430 million or $0.29 per diluted share. Our forecast incorporates the following:

– The average price of milk likely to increase in excess of 15% nationally, according the United States Department of Agriculture. The Company intends to raise prices effective June 15, 2004 by approximately 20%. It is important to note that this is Lifeway's first major price increase in nearly three years; and

– Expenses associated with the listing additional shares on the NasdaqNM in connection with the Company's 2-1 stock split in March 2004;

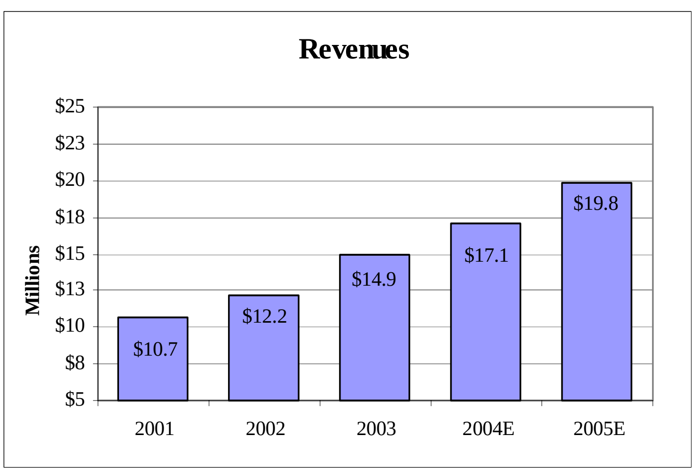
We have adjusted the following from our prior forecast:

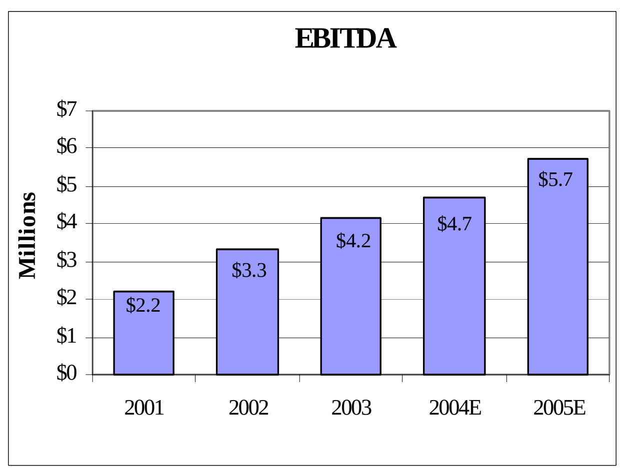
– Gross margins to 48.3% from 48.0%; and

– SG&A expenses, as a percentage of revenues, to 24.92% from 25.46%.

For 2005, our initial net income forecast remains at $3.165 million or $0.37 per diluted share, based on gross margins of 48.7% and SG&A expenses, as a percentage of revenue, of 23.33%.

The following chart shows our revenue and EBITDA projections:




Source: Company Filings and Taglich Brothers Estimates

## ***Risks***

*Commodities*

The Company's products use raw materials, such as milk, sugar, and fruit from unaffiliated suppliers. Lifeway is not limited or contractually bound to any supplier. The raw and packaging materials purchased by the Company are considered commodity items and are widely available on the open market. If the price of those commodity products were to unexpectedly rise in price, it could negatively impact margins.

*Regulation*

Lifeway is subject to regulation by federal, state and local governmental authorities regarding the distribution and sale of food products. Management believes that the Company is currently in compliance with all material government permits, licenses, qualifications and approvals for its operations; however, there can be no assurance that it will be able to maintain its existing licenses and permits. In addition, the Company believes that it is currently in compliance with all applicable environmental laws.

Also, the products exported to Canada are subject to strict quotas imposed by the Trade Control Policy Division of the Department of Foreign Affairs and International Trade of Canada. Management believes that the Company is in compliance with all applicable Canadian regulations.

*Legal Issue*

On April 14, 2003, Vera Smolansky (the Aunt of the Lifeway's CEO Julie Smolansky) filed a complaint seeking unspecified damages in the Circuit Court of Cook County, Illinois. The complainant names Lifeway Foods, Inc. as a defendant and alleges breaches of the Uniform Commercial Code, the Magnus-moss Warranty Act, and the Illinois Consumer Fraud Act with respect to the labeling of certain Lifeway products. The Company believes that the lawsuit is without merit and will vigorously defend itself against the claims.

*Corporate Governance*

Corporate governance may be an issue facing Lifeway Foods in light of new rules and regulation being issued by government regulatory agencies. This could mean that the Company will eventually be required to hire additional management personnel in order to diversify various operational functions.

*Growth Management*

We estimate that the LWAY will continue growing revenues in excess of 15% annually. As a result, the Company will need to meet the challenges associated with growth, such as management of raw materials and increased production staff. If Lifeway Foods is not successful in meeting these challenges, revenue growth may slow in future periods.

*Miscellaneous*

The Company's financial results and equity values are subject to other risks and uncertainties known and unknown, including but not limited to competition, operations, financial markets, regulatory risk, and/or other events. These risks may cause actual results to differ from expected results.

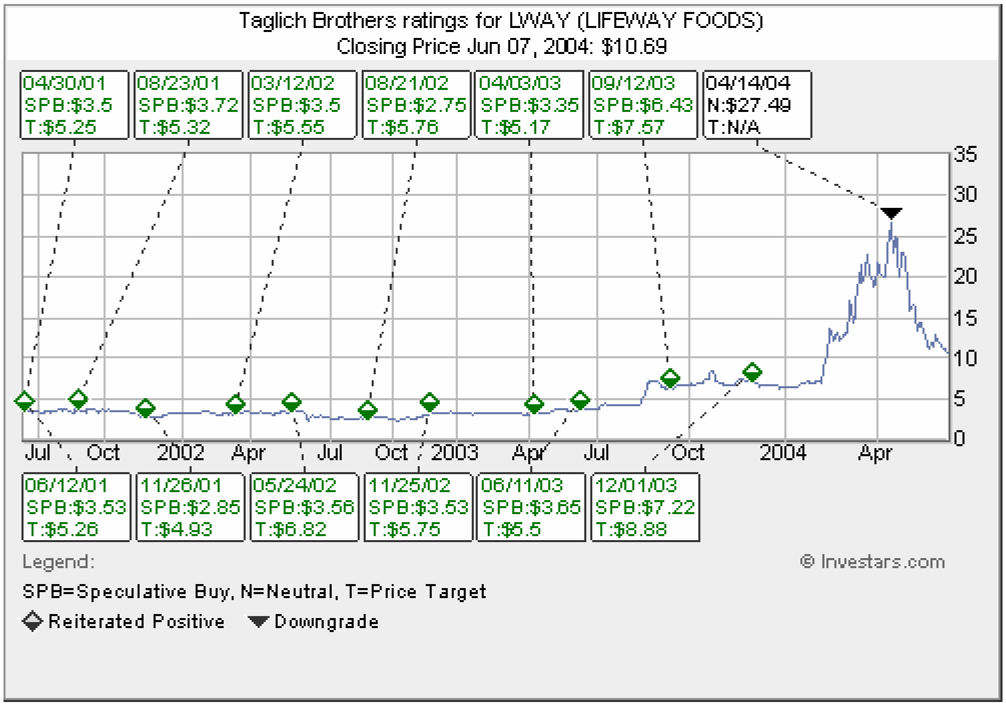
*Trading Volume*

Liquidity has the potential to be a concern. Based on our calculations average daily-volume during 2003 increased to 4,451 shares from 1,943 shares in 2002. During the first four month of 2004, average volume increased significantly to 219,295 shares traded a day. Even though volume has increased, it is still relatively low; therefore, investors need to be aware that by nature a thinly traded equity can have significant price volatility.

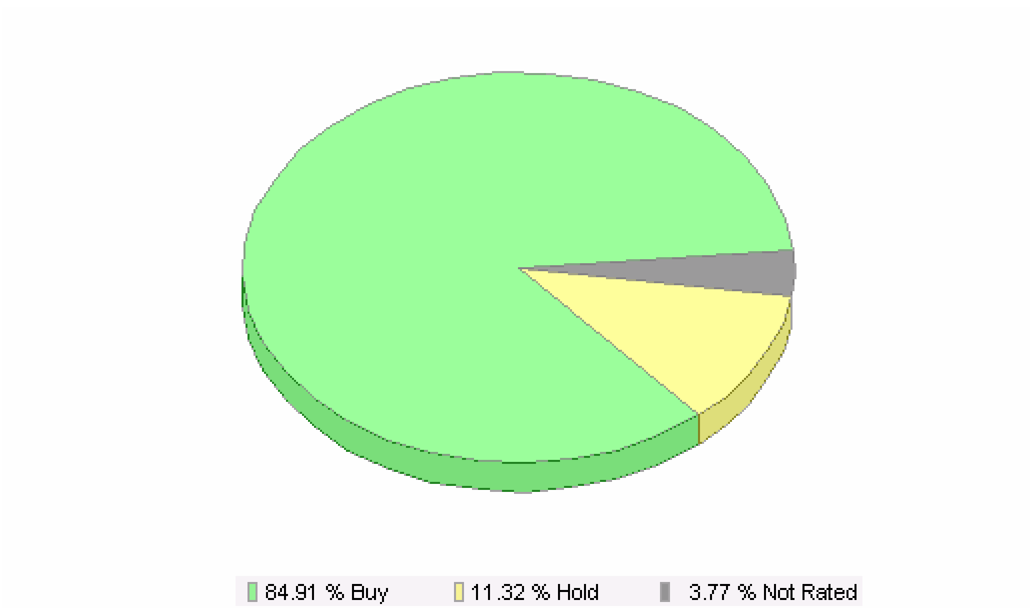
## ***Conclusion***

We are maintaining our Neutral rating, pending renewal of a Stockholders' Agreement with Danone by September 30, 2004. The Company and Danone did not renew the term of a Support Agreement, which expired on December 31, 2003. It is expected by the parties that this and other agreements would be discussed and possibly renegotiated pending the expiration, on September 30, 2004, of the Stockholders' Agreement.

Additionally, we believe that based on our EBITDA and earnings per share estimates for 2004, LWAY's shares are fairly valued, given its internal growth rates and microcap risk. Between 2000 and 2004, the Company's compounded annual growth rates are 34 percent and 27.5 percent, respectively, for net income and EBITDA.




Taglich Brothers Current Ratings Distribution



<u>Meaning of Ratings</u>

Buy

We believe the Company is undervalued relative to its market and peers. We believe its risk reward ratio strongly advocates purchase of the stock relative to other stocks in the marketplace. Remember, with all equities there is always downside risk.

Speculative Buy

We believe that the long run prospects of the Company are positive. We believe its risk reward ratio advocates purchase of the stock. We feel the investment risk is higher than our typical “buy” recommendation. In the short run, the stock may be subject to high volatility and continue to trade at a discount to its market.

Neutral

We will remain neutral pending certain developments.

Underperform

We believe that the Company may be fairly valued based on its current status. Upside potential is limited relative to investment risk.

Sell

We believe that the Company is significantly overvalued based on its current status. The future of the Company's operations may be questionable and there is an extreme level of investment risk relative to reward.

**Some notable Risks within the Microcap Market**

**Stocks in the Microcap segment of the market have many risks that are not as prevalent in Large-cap, Blue Chips or even Small-cap stocks. Often it is these risks that cause Microcap stocks to trade at discounts to their peers. The most common of these risks is liquidity risk, which is typically caused by small trading floats and very low trading volume which can lead to large spreads and high volatility in stock price. In addition, Microcaps tend to have significant company specific risks that contribute to lower valuations. Investors need to be aware of the higher probability of financial default and higher degree of financial distress inherent in the microcap segment of the market.**

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From time to time our analysts may choose to withhold or suspend a rating on a company. We continue to publish informational reports on such companies; however, they have no ratings or price targets. In general, we will not rate any company that has too much business or financial uncertainty for our analysts to form an investment conclusion, or that is currently in the process of being acquired.

**Public Companies mentioned in this report:**

Groupe Danone (NYSE: DA)

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**I, Howard Halpern, the research analyst of this report, hereby certify that the views expressed in this report accurately reflect my personal views about the subject securities and issuers; and that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this report.**

## Lifeway Foods, Inc.
## Consolidated Balance Sheets
## (in thousands)

| | Dec. 2001 Year End | Dec. 2002 Year End | Dec. 2003 Year End | Mar. 2004 1st Qtr End |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Current assets: | | | | |
| Cash and cash equivalents | $ 937 | $ 2,732 | $ 4,598 | $ 4,633 |
| Marketable securities | 5,755 | 4,172 | 6,303 | 6,616 |
| Accounts receivable, net | 1,317 | 1,435 | 1,800 | 2,007 |
| Other receivables | 53 | 60 | 166 | 161 |
| Inventories | 801 | 721 | 812 | 795 |
| Prepaid income taxes | - | - | 306 | 343 |
| Prepaid expenses and other assets | 34 | 1 | 1 | 5 |
| Deferred income taxes | 561 | 692 | 27 | 27 |
| **Total current assets** | **9,456** | **9,813** | **14,012** | **14,587** |
| Property, plant and equipment, net | 5,021 | 4,472 | 3,733 | 3,617 |
| **Total assets** | **$ 14,477** | **$ 14,285** | **$ 17,745** | **$ 18,205** |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | | |
| Current liabilities: | | | | |
| Current maturities of notes payable | 90 | 31 | 28 | 24 |
| Margin account | 432 | - | - | - |
| Accounts payable | 543 | 639 | 795 | 739 |
| Accrued expenses | 164 | 184 | 184 | 101 |
| Taxes payable | 145 | 398 | - | - |
| **Total current liabilities** | **1,374** | **1,252** | **1,007** | **864** |
| Long-term liabilities | 1,116 | 500 | 473 | 469 |
| Deferred income taxes | 436 | 453 | 472 | 449 |
| **Stockholders' equity:** | | | | |
| Common stock, no par value; authorized 10,000,000 shares | 6,509 | 6,509 | 6,509 | 6,509 |
| Stock subscription receivable | (15) | (15) | (15) | (15) |
| Retained earnings | 6,072 | 7,600 | 9,822 | 10,588 |
| Accumulated other comprehansive income, net of tax | (729) | (1,335) | 156 | 21 |
| Treasury stock, at cost | (287) | (680) | (680) | (680) |
| **Total stockholders' equity** | **11,550** | **12,080** | **15,793** | **16,423** |
| **Total liabilities and stockholders' equity** | **$ 14,477** | **$ 14,285** | **$ 17,745** | **$ 18,205** |
| SHARES OUT | 8,538 | 8,437 | 8,437 | 8,442 |

Lifeway Foods, Inc.
Quarterly Income Statement Model
For the Years Ended December 31,
(in thousands)

| | FY2001 | FY2002 | FY2003 | **FY2004E** | **FY2005E** |
|---|---|---|---|---|---|
| Revenue | $ 10,684 | $ 12,212 | $ 14,878 | **$ 17,085** | **$ 19,825** |
| Cost of goods sold | 6,449 | 6,744 | 7,841 | **8,829** | **10,170** |
| **Gross Profit** | 4,235 | 5,468 | 7,037 | **8,256** | **9,655** |
| *Gross Margins* | 39.64% | 44.78% | 47.30% | **48.32%** | **48.70%** |
| Sales, general and administrative | 2,785 | 2,891 | 3,558 | **4,257** | **4,625** |
| *EBITDA* | 2,216 | 3,385 | 4,167 | **4,684** | **5,705** |
| **Operating Income** | 1,450 | 2,578 | 3,479 | **3,999** | **5,030** |
| *Operating Margin* | 13.57% | 21.11% | 23.38% | **23.41%** | **25.37%** |
| Other Income (Expense) | | | | | |
| Interest income | 235 | 187 | 97 | **101** | **125** |
| Interest expense | (93) | (75) | (41) | **(38)** | **(40)** |
| Gain on sale of marketable securities | 220 | 18 | (1,294) | **268** | - |
| Other than temporary reduction of marketable securities | - | (236) | 89 | - | - |
| Gain on sale of assets | - | - | 1,246 | - | - |
| Total Other Income (Expense) | 362 | (105) | 98 | **332** | **85** |
| **Pre-Tax Income** | 1,812 | 2,472 | 3,576 | **4,331** | **5,115** |
| *Pre-Tax Margins* | 16.96% | 20.24% | 24.04% | **25.35%** | **25.80%** |
| Income Tax Expense (Benefit) | 591 | 943 | 1,355 | **1,651** | **1,950** |
| *Tax Rate* | 32.59% | 38.16% | 37.89% | **38.11%** | **38.13%** |
| **Net Income** | $ 1,221 | $ 1,529 | $ 2,221 | **$ 2,680** | **$ 3,165** |
| **EPS -- Fully Diluted** | $ 0.28 | $ 0.36 | $ 0.26 | **$ 0.32** | **$ 0.37** |
| Avg Shares Out-Fully Diluted * | 8,636 | 8,531 | 8,437 | **8,457** | **8,500** |
| Percent of Revenue | | | | | |
| Cost of Revenues | 60.36% | 55.22% | 52.70% | 51.68% | 51.30% |
| Sales, General and Administrative expenses | 26.07% | 23.67% | 23.92% | 24.92% | 23.33% |
| YEAR / YEAR GROWTH | | | | | |
| Total Revenues | 16.42% | 14.30% | 21.83% | 14.84% | 16.04% |
| Operating Income | 24.77% | 79.34% | 34.96% | 14.95% | 25.78% |
| Pre-Tax Income | 24.67% | 36.47% | 44.67% | 21.09% | 18.10% |
| Net Income | 31.75% | 25.21% | 45.31% | 20.66% | 18.08% |

* Adjusted for the 2-1 stock split effective March 9, 2004

Lifeway Foods, Inc.
Quarterly Income Statement Model
For the Year Ended December 31, 2002
(in thousands)

| | Q1(03/02) | Q2 (06/02) | Q3 (09/02) | Q4 (12/02) | **FY2002** |
|---|---|---|---|---|---|
| Revenue | $ 2,888 | $ 3,003 | $ 3,075 | $ 3,247 | **$ 12,212** |
| Cost of goods sold | 1,523 | 1,761 | 1,586 | 1,874 | **6,744** |
| **Gross Profit** | 1,365 | 1,242 | 1,488 | 1,373 | **5,468** |
| *Gross Margins* | *47.25%* | *41.37%* | *48.41%* | *42.29%* | **44.78%** |
| Operating Expenses: | | | | | |
| Sales, general and administrative | 649 | 734 | 750 | 758 | **2,891** |
| Total Operating Expenses | 649 | 734 | 750 | 758 | **2,891** |
| *EBITDA* | 920 | 707 | 942 | 816 | **3,385** |
| **Operating Income** | 716 | 508 | 739 | 615 | **2,578** |
| *Operating Margin* | *24.79%* | *16.92%* | *24.02%* | *18.94%* | **21.11%** |
| Other Income (Expense) | | | | | |
| Interest income | 37 | 53 | 67 | 29 | **187** |
| Interest expense | (20) | (19) | (19) | (16) | **(75)** |
| Gain on sale of marketable securities | 36 | 3 | (3) | (18) | **18** |
| Other than temporary reduction of marketable securities | - | - | - | (236) | **(236)** |
| Total Other Income (Expense) | 53 | 37 | 45 | (241) | **(105)** |
| **Pre-Tax Income** | 769 | 545 | 783 | 374 | **2,472** |
| *Pre-Tax Margins* | *26.64%* | *18.16%* | *25.48%* | *11.52%* | **20.24%** |
| Income Tax Expense (Benefit) | 322 | 194 | 252 | 176 | **943** |
| *Tax Rate* | *41.82%* | *35.52%* | *32.18%* | *47.05%* | **38.16%** |
| **Net Income** | $ 448 | $ 352 | $ 531 | $ 198 | **$ 1,529** |
| **EPS -- Fully Diluted** | $ 0.10 | $ 0.08 | $ 0.12 | $ 0.05 | **$ 0.36** |
| Avg Shares Out-Fully Diluted | 4,270 | 4,269 | 4,269 | 4,255 | **4,266** |
| Percent of Revenue | | | | | |
| Cost of Revenues | 52.75% | 58.63% | 51.59% | 57.71% | 55.22% |
| Sales, General and Administrative expenses | 22.46% | 24.45% | 24.39% | 23.35% | 23.67% |
| YEAR / YEAR GROWTH | | | | | |
| Total Revenues | 9.54% | 9.20% | 15.51% | 23.19% | 14.30% |
| Operating Income | 65.75% | 53.23% | 109.89% | 91.06% | 79.34% |
| Pre-Tax Income | 36.37% | 43.02% | 75.31% | -10.77% | 36.47% |

Lifeway Foods, Inc.
Quarterly Income Statement Model
For the Year Ended December 31, 2003
(in thousands)

| | Q1(03/03) | Q2 (06/03) | Q3 (09/03) | Q4 (12/03) | **FY2003** |
|---|---|---|---|---|---|
| Revenue | $ 3,309 | $ 3,776 | $ 3,837 | $ 3,956 | **$ 14,878** |
| Cost of goods sold | 1,826 | 1,734 | 1,908 | 2,373 | **7,841** |
| **Gross Profit** | 1,483 | 2,042 | 1,929 | 1,583 | **7,037** |
| *Gross Margins* | *44.81%* | *54.08%* | *50.28%* | *40.02%* | **47.30%** |
| Operating Expenses: | | | | | |
| Sales, general and administrative | 845 | 938 | 871 | 904 | **3,558** |
| Total Operating Expenses | 845 | 938 | 871 | 904 | **3,558** |
| *EBITDA* | 803 | 1,279 | 1,232 | 853 | **4,167** |
| **Operating Income** | 638 | 1,104 | 1,058 | 679 | **3,479** |
| *Operating Margin* | *19.28%* | *29.23%* | *27.58%* | *17.16%* | **23.38%** |
| Other Income (Expense) | | | | | |
| Interest income | 33 | 37 | 25 | 2 | **97** |
| Interest expense | (8) | (8) | (8) | (18) | **(41)** |
| Gain (loss) on sale of marketable securities | (347) | 16 | 37 | (1,000) | **(1,294)** |
| Other than temporary reduction of marketable securities | - | - | - | 89 | **89** |
| Gain (loss) on sale of assets | 1,246 | - | - | - | **1,246** |
| Total Other Income (Expense) | 926 | 45 | 54 | (927) | **98** |
| **Pre-Tax Income** | 1,564 | 1,149 | 1,112 | (248) | **3,576** |
| *Pre-Tax Margins* | *47.26%* | *30.42%* | *28.99%* | *-6.27%* | **24.04%** |
| Income Tax Expense (Benefit) | 570 | 457 | 405 | (78) | **1,355** |
| *Tax Rate* | *36.47%* | *39.83%* | *36.45%* | *31.46%* | **37.89%** |
| **Net Income** | $ 993 | $ 691 | $ 707 | $ (170) | **$ 2,221** |
| **EPS -- Fully Diluted** | $ 0.12 | $ 0.08 | $ 0.08 | $ (0.02) | **$ 0.26** |
| Avg Shares Out-Fully Diluted | 8,437 | 8,437 | 8,437 | 8,436 | **8,437** |
| Percent of Revenue | | | | | |
| Cost of Revenues | 55.19% | 45.92% | 49.72% | 59.98% | 52.70% |
| Sales, General and Administrative expenses | 25.53% | 24.85% | 22.70% | 22.86% | 23.92% |
| YEAR / YEAR GROWTH | | | | | |
| Total Revenues | 14.57% | 25.75% | 24.78% | 21.85% | 21.83% |
| Operating Income | -10.90% | 117.31% | 43.28% | 10.36% | 34.96% |
| Pre-Tax Income | 103.26% | 110.61% | 41.98% | -166.27% | 44.67% |
| Net Income | 121.93% | 96.52% | 33.03% | -185.77% | 45.31% |

Lifeway Foods, Inc.
Quarterly Income Statement Model
For the Years Ended December 31, 2004
(in thousands)

| | Q1(03/04)A | Q2 (06/04)E | Q3 (09/04)E | Q4 (12/04)E | **FY2004E** |
|---|---|---|---|---|---|
| Revenue | $ 3,935 | $ 4,200 | $ 4,400 | $ 4,550 | **$ 17,085** |
| Cost of goods sold | 2,099 | 2,050 | 2,225 | 2,455 | **8,829** |
| **Gross Profit** | 1,836 | 2,150 | 2,175 | 2,095 | **8,256** |
| *Gross Margins* | *46.65%* | *51.19%* | *49.43%* | *46.04%* | **48.32%** |
| Operating Expenses: | | | | | |
| Sales, general and administrative | 882 | 1,075 | 1,125 | 1,175 | **4,257** |
| Total Operating Expenses | 882 | 1,075 | 1,125 | 1,175 | **4,257** |
| *EBITDA* | 1,110 | 1,245 | 1,220 | 1,090 | **4,684** |
| **Operating Income** | 954 | 1,075 | 1,050 | 920 | **3,999** |
| *Operating Margin* | *24.24%* | *25.60%* | *23.86%* | *20.22%* | **23.41%** |
| Other Income (Expense) | | | | | |
| Interest income | 41 | 20 | 20 | 20 | **101** |
| Interest expense | (8) | (10) | (10) | (10) | **(38)** |
| Total Other Income (Expense) | 302 | 10 | 10 | 10 | **332** |
| **Pre-Tax Income** | 1,256 | 1,085 | 1,060 | 930 | **4,331** |
| *Pre-Tax Margins* | *31.91%* | *25.83%* | *24.09%* | *20.44%* | **25.35%** |
| Income Tax Expense (Benefit) | 491 | 410 | 400 | 350 | **1,651** |
| *Tax Rate* | *39.06%* | *37.79%* | *37.74%* | *37.63%* | **38.11%** |
| **Net Income** | $ 765 | $ 675 | $ 660 | $ 580 | **$ 2,680** |
| **EPS -- Fully Diluted** | $ 0.09 | $ 0.08 | $ 0.08 | $ 0.07 | **$ 0.32** |
| Avg Shares Out-Fully Diluted | 8,437 | 8,450 | 8,465 | 8,475 | **8,457** |
| Percent of Revenue | | | | | |
| Cost of Revenues | 53.35% | 48.81% | 50.57% | 53.96% | 51.68% |
| Sales, General and Administrative expenses | 22.41% | 25.60% | 25.57% | 25.82% | 24.92% |
| YEAR / YEAR GROWTH | | | | | |
| Total Revenues | 18.94% | 11.23% | 14.67% | 15.01% | 14.84% |
| Operating Income | 49.51% | -2.61% | -0.77% | 35.53% | 14.95% |

Lifeway Foods, Inc.
Cash Flow Statement
(in thousands)

| | FY2001A | FY2002A | FY2003A | Q1 2004A |
|---|---|---|---|---|
| *Cash Flows from Operating Activities* | | | | |
| Net Income | $ 1,221 | $ 1,529 | $ 2,222 | $ 765 |
| Depreciation and amortization | 777 | 808 | 688 | 156 |
| Amortization of discounts on securities | - | - | - | - |
| Gain on sale of marketable securities | (250) | (18) | 1,294 | (268) |
| Gain on sale of assets | - | - | (1,246) | - |
| Other than temporary reductions of marketable securities | - | 236 | - | - |
| Issuance of common stock in exchange for services rendered | - | - | - | - |
| Decrease in allowance for doubtful accounts | - | - | - | - |
| Provision for doubtful accounts | 15 | - | - | - |
| Deferred income taxes | 48 | (65) | 9 | 75 |
| | 1,812 | 2,490 | 2,967 | 728 |
| *Changes In:* | | | | |
| Accounts receivable | (150) | (119) | (365) | (206) |
| Other receivables | (53) | (8) | (106) | 5 |
| Inventories | 119 | 80 | (91) | 16 |
| Prepaid income taxes | - | - | (306) | (37) |
| Prepaid expenses and other assets | (34) | 32 | 0 | (5) |
| Accounts payable | 26 | 96 | 156 | (56) |
| Accrued expenses | (4) | 20 | 0 | (83) |
| Taxes payable | 80 | 253 | (398) | - |
| Net Changes in Working Capital | (15) | 355 | (1,109) | (366) |
| **Net cash Provided by Operations** | 1,797 | 2,845 | 1,857 | 362 |
| | | | | |
| *Cash Flows from Investing Activities* | | | | |
| Purchase of marketable securities | (9,247) | (3,316) | (4,284) | (3,141) |
| Sale of marketable securities | 7,687 | 4,025 | 3,025 | 2,863 |
| Sales of Assets | - | - | 1,713 | - |
| Change in margin account | 357 | (432) | - | - |
| Purchase of property, plant and equipment | (713) | (259) | (415) | (41) |
| **Net cash used in Investing** | (1,916) | 17 | 39 | (319) |
| | | | | |
| *Cash Flows from Financing Activities* | | | | |
| Repayment of notes payable | (94) | (675) | (31) | (8) |
| Proceeds from issuance of common stock | - | - | - | - |
| Purchase of treasury stock | (287) | (393) | - | - |
| Stock issuance costs | - | - | - | - |
| **Net cash provided by Financing** | (381) | (1,068) | (31) | (8) |
| | | | | |
| Net change in Cash | (500) | 1,795 | 1,867 | 35 |
| Cash Beginning of Period | 1,437 | 936 | 2,732 | 4,598 |
| | | | | |
| Cash End of Period | $ 936 | $ 2,732 | $ 4,598 | $ 4,633 |