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Research Report – Update

Lifeway Foods, Inc. **Rating: Speculative Buy**

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June 12, 2001

LWAY $7.05 - (NasdaqNM)

	FYE (12/98)	FYE (12/99)	FYE (12/00)	***FYE (12/01)***	***FYE (12/02)***
Revenues (in millions)	$6.8	$7.9	$9.2	***$11.2***	***$13.0***
Earnings per share (diluted)	$0.20	$0.17	$0.21	***$0.28***	***$0.33***

52week range	7.75 – 4.25	Fiscal year ends:	December
Shares outstanding	4.32 million	Revenue/shares (2001)	$2.59
Trading float	1.6 million	Price/Sales (2001)	2.7X
Insider ownership	63%	Price/Sales (2002)	2.4X
Tangible Book value/shr a/o 3-31-01	$2.57	Price/Earnings (2001)	25.2X
Price/Book	2.7X	Price/Earnings (2002)	21.4X

Lifeway Foods, Inc., based in Morton Grove, Illinois 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 about 45 employees. Web-site address is: www.kefir.com

Key investment considerations:

- ***We are maintaining coverage of Lifeway Foods, Inc. (LWAY) with a Speculative Buy recommendation and a fifteen-month price target of $10.52 per share. We believe this equity has solid upside potential based on our 2002 earnings estimate and discounted cash flow model.***
- ***Lifeway's primary products are functional foods. The functional food market, depending on the definition, ranges from annual sales of $15 to $130 billion. We believe the functional foods market, which is likely to expand, provides the Company with excellent growth opportunities for the next three to five years.***
- ***For the first quarter ended March 31, 2001, revenues increased by 16% to $2.6 million and net income increased by 74% to $0.329 million or $0.08 per fully diluted share. In comparison, Taglich Brothers' estimates called for first quarter revenues of $2.6 million and net income of $0.200 million or $0.05 per fully diluted share.***
- ***We expect revenues to grow by approximately 21.9% to $11.2 million in 2001 and in 2002 LWAY's revenues should grow to $13.0 million. We believe this revenue growth will be achieved through marketing efforts and the rollout of its organic product line in the second half of 2001.***
- ***Net income should reach $1.21 million or $0.28 per share in 2001 and increase to $1.43 million or $0.33 per share in 2002. Earnings growth for 2002 should be achieved through operating margin improvements.***

**** Please view our disclaimer located at the end of the text portion of this report.***

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The Company

Lifeway Foods, Inc. (LWAY) was founded in 1986 and is based in Morton Grove, Illinois. The Company manufactures a cultured dairy beverage called kefir and also develops kefir related products at its two manufacturing facilities. The Company's 50,000-square-foot facility is the largest kefir manufacturing facility in the United States.

LWAY distributes its products to over 8,000 stores throughout the United States, using verbal distribution arrangements with various wholesale distributors. In the Company's home state of Illinois, they own and operate nine trucks that distribute Lifeway products directly to 1,200-plus stores, including major retail chains such as Jewel Food Stores, Dominick's Finer Foods, Wild Oats Markets, Treasure Island Food Marts, Whole Foods, Cub Foods and Butera Food Stores. Additionally, the Company distributes its products internationally by exporting to Canada and Russia.

Recent Financials

The Company reported that revenues for the first quarter of 2001 increased by approximately 16% to $2.6 million, versus $2.3 million in the first quarter of 2000. The increase was primarily attributable to the Company's marketing program for its various Kefir-based products. EBITDA for the first quarter increased by 60.2% to $0.612 million versus $0.382 million in the first quarter of 2000.

Net income for the first quarter increased by 74.1% to $0.329 million or $0.08 per fully diluted share, versus $0.189 million or $0.04 per fully diluted share. The Company exceeded Taglich Brothers' first quarter estimate of $0.200 million or $0.06 per fully diluted share.

At the end of first quarter cash, cash equivalents and marketable securities were approximately $6.1 million and working capital was $7 million. The Company's long-term liabilities have decreased to $0.5 million from $1.2 million in the prior year. We believe that the Company will be able to fund its sales growth from internal operations for the foreseeable future.

Kefir

Kefir, which originated centuries ago in Eastern Europe, is a cultured milk drink with a slightly acidic taste and has a consistency very similar to a milkshake. It is made with probiotic cultures obtained from the kefir grain, which is a complex and specific mixture of bacteria. Kefer is similar to, but distinct from, yogurt because the fermentation process produces a less sour tasting product and less sugar is required. Therefore, the end product contains fewer calories.

Lifeway Kefir contains seven 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). It is highly digestible due to its acidity and enzymes.

The Company manufactures and distributes the following products:

- **Lifeway Kefir**, the Company's biggest revenue producing product. It is sold in the dairy section of health food stores and supermarkets across the country.
- **Lifeway Farmers Cheese** is currently the Company's second biggest revenue generator. This product is a cultured soft cheese, low in fat, cholesterol and calories.
- **SoyTreat™** is the world's first soy based kefir. Sales of this product should benefit as the health benefits related to soy based products become better known by consumers. SoyTreat™ can be consumed by people that desire the benefits of kefir and are lactose intolerant or by people that eat no animal products at all.
- **Basics Plus™** is a functional food, and is the only dairy-based dietary supplement in existence. In our view, this is an exciting product for the Company as it combines all the benefits of Lifeway Kefir

with a unique immune-supporting ingredient called Proventra™. Proventra™, developed by GalaGen Inc. of Minneapolis, a dairy research consortium originated by Land O' Lakes, is an ingredient uniquely processed and extracted from antibodies present in the protein of a dairy cow's 'first milk' or colostrum. It is loaded with immune-enhancing antibodies.

Industry and Competition

Functional and probiotic foods form a segment within the food industry that has been growing in popularity. Foods in this segment include natural functional foods (i.e. cranberry juice, green tea, etc.), foods and ingredients for specific health use, formulas for infants and elderly, medical foods, nutraceuticals and drug foods. The market is estimated to be approximately $130 billion. An alternative definition offered by the American Dietetic Association is that a functional food is a modified food or ingredient that provides health benefits beyond the nutrition it contains. Using this definition the annual market for foods designed to provide specific medical benefits is estimated to be $15 billion. Therefore depending on the definition, Lifeway Foods' target market ranges from $15 billion to $130 billion.

The functional food segment continues to be the fastest growing area of the food industry. Some of the factors driving this growth are:

- The perception of nutrition as a tool for disease prevention and the self-treatment of various health concerns;
- An aging population;
- An increase in disposable income.

To meet the needs of consumers, some supermarket chains have created a store within a store concept, thus allowing consumers to find health foods easily within the larger supermarket store. This trend should be helpful to Lifeway Foods as they can position their products in the health food section of a national or regional supermarket chain.

The Company faces very little direct competition in the United States for its drinkable kefir product, although the Company's kefir-based products are subject to competition from other yogurt and dairy products. Many producers of yogurt and other dairy products are well established and have significantly greater financial resources than Lifeway Foods.

Strategy

Lifeway Foods remains at the forefront of the specialty dairy and functional foods market. This is evidenced by the recent introduction of its new line of organic kefir products at the Natural Products Expo in California in March 2001. Lifeway Organic™ will meet the organic standards and specifications necessary to provide customers with a high quality product. By offering an organic kefir and cheese product line the Company will build upon its non-dairy SoyTreat™ products and thus allow for the opportunity to broaden its customer base. We believe the rollout of this new product line will not impact revenues until the second half of 2001.

Marketing: The Company remains focused on its promotion of the verifiable nutritional characteristics, and the purity and taste aspects of its products. Advertising is done through local radio stations and is directed to both users and non-users of cultured milk products of all kinds. In addition, newspaper and magazine advertising is used to impart educational information to potential customers.

The Company continues to gain exposure through participation at various trade shows, consumer sampling shows, and inside store demonstrations throughout the United States. Lifeway will be demonstrating its product offerings at the upcoming Fancy Food Show at the Jacob Javits Center in New York City during the second week of July 2001.

Distribution: The Company has over fifty distributors nationwide and in certain large geographical locations such as the East Coast, the Company has a higher concentration of distributors. In addition, the Company has three international distributors. In the Chicago region the Company has its own direct distribution through a company-owned fleet of trucks, as well as numerous independent distributors. Management believes that as product lines expand and name recognition grows, they will attract additional distributors, particularly for the nation's 1,700 food chains.

In April 2001, Lifeway announced the broadening of its distribution channel through the signing of a distribution agreement with Jelian Foods, Inc. of Concord, Ontario in Canada. Jelian Foods will be the distributor in Canada for the Company's SoyTreat™ product, and will also have the opportunity to distribute other products made by Lifeway Foods. Jelian Foods distributes natural and specialty products to over 500 stores in Canada, including mainstream grocery store chains. We view this as a positive step since it is in line with the Company's goal of broadening its customer base. We will update the progress being made with this distribution channel in our next report after second quarter results are released in late July or early August.

Outlook

We are optimistic about Lifeway's future based on the promise inherent in its kefir products and the development of its new organic product line. We believe revenues should grow to $11.2 million in 2001 and $13.0 million in 2002, from $9.2 million in 2000. Revenue growth will depend on the Company's ability to maintain and grow its shelf space within the United States and grow its shelf space rapidly in Canada as a result of its recently announced agreement with a Canadian distributor.

Lifeway will be able to leverage its assets as sales grow. The Company's two manufacturing facilities have a potential annual sales capacity of approximately $65 million. Currently, enough manufacturing equipment is in place to generate about $30 million in annual revenues. In our view this is extremely positive, since any increase in consumer demand will allow management to leverage existing capacity.

Other Considerations

Danone Foods, Inc. the U.S. subsidiary of Groupe Danone of Paris, France, has a 20% ownership interest in the Company. A support agreement was entered into stating that each party would not compete with each other during the term of the agreement and for three years after termination of the agreement with respect to certain yogurt, cheese and kefir products. Specifically, the Company agreed not to produce or sell any type of yogurt, Italian style cheese, chilled desserts or any soy-based products, other than those that are kefir based or are already being produced and sold by the Company, in the U.S. and Western Europe. Danone agreed not to produce or sell any type of kefir-based products in the United States.

An equity specific concern relates to average daily volume. Based on our calculations, since the beginning of 2001, the average daily-volume has been approximately 2,200 shares. Investors need to be aware that by nature, a thinly traded equity can have significant price volatility.

Conclusion

We are maintaining our coverage of Lifeway Foods, Inc., with a Speculative Buy recommendation, and fifteen-one month price target of $10.52. Our price target is based on an average valuation using our earnings per share estimate for 2002 and a discounted cash flow model using EBITDA as a proxy for cash flow.

We believe the Company will post earnings of $0.28 per fully diluted share, on revenues of $11.2 million for 2001 and $0.33 per fully diluted share, on revenues of $13.0 million for 2002. Our revenue estimate for 2002 represents an annual compounded growth rate of 18.0% based on the $7.9 million in revenues that the Company reported in 1999. Based on our model, we expect EBITDA to be $2.5 million in 2001 and $2.9 million in 2002. We expect EBITDA to grow at a compounded annual rate of approximately 16.6% through 2004.

We believe Lifeway Foods is undervalued based on our earnings for 2002 and discounted cash flow model. In our opinion the primary reason for the Company's undervaluation is the lack of Wall Street coverage and lack of investor knowledge about Kefir. Until consumers and investors are educated about the potential benefits of kefir and kefir based products, the Company is likely to remain undervalued.

To obtain our price target we averaged the following valuations:

- A 25.9X P/E (based on the trailing twelve month average for the Food Processing Industry) applied to our 2002 earnings per share estimate of $0.33. This provides a valuation of $8.55 per share;
- Our discounted cash flow model, using EBITDA as a proxy for cash flow and an 15.4% discount factor using the estimated five year growth rate for the food processing industry. This provides a valuation of $12.49 per share.

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

	December 1998 Full Year	December 1999 Full Year	December 2000 Full Year	March 2001 First Quarter
ASSETS				
Current assets:				
Cash and cash equivalents	$ 628	$ 4,641	$ 1,437	$ 1,832
Marketable securities	340	1,564	4,850	4,279
Accounts receivable, net	847	966	1,182	1,437
Other receivables	16	57	-	5
Inventories	852	844	920	795
Prepaid expenses and other assets	12	-	-	-
Deferred income taxes	37	52	167	169
Total current assets	**2,732**	**8,124**	**8,556**	**8,518**
Property, plant and equipment, net	4,148	4,528	5,020	5,028
Intangible assets, net	10	5	-	-
Total assets	**$ 6,890**	**$ 12,658**	**$ 13,575**	**$ 13,546**
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current liabilities:				
Current maturities of notes payable	85	92	706	688
Accounts payable	514	480	518	594
Accrued expenses	166	192	242	175
Taxes payable	-	-	65	93
Total current liabilities	**765**	**764**	**1,531**	**1,550**
Long-term liabilities	1,315	1,234	529	523
Deferred income taxes	172	248	376	382
Stockholders' equity:				
Common stock, no par value; authorized 10,000,000 shares	1,427	6,509	6,509	6,509
Stock subscription receivable	-	(15)	(15)	(15)
Retained earnings	3,241	3,924	4,851	5,180
Accumulated other comprehansive income, net of tax	(12)	(7)	(205)	(583)
Treasury stock, at cost	(19)	-	-	-
Total stockholders' equity	**4,638**	**10,411**	**11,140**	**11,091**
Total liabilities and stockholders' equity	**$ 6,889**	**$ 12,657**	**$ 13,575**	**$ 13,546**
SHARES OUT	3,786	4,318	4,318	4,318

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

	FY1997	FY1998	FY1999	FY2000	**FY2001E**	**FY2002E**
Sales	$ 5,961	$ 6,795	$ 7,908	$ 9,177	**$ 11,186**	**$ 13,000**
Cost of goods sold	3,435	3,697	4,665	5,308	**6,472**	**7,525**
Gross Profit	2,526	3,098	3,243	3,869	**4,714**	**5,475**
Gross Margins	42.38%	45.59%	41.01%	42.16%	**42.14%**	**42.12%**
Sales, general and administrative	1,486	1,759	2,178	2,707	**2,857**	**3,175**
EBITDA	1,316	1,730	1,506	1,772	**2,457**	**2,940**
Operating Income	1,040	1,339	1,065	1,162	**1,857**	**2,300**
Operating Margin	17.45%	19.71%	13.47%	12.66%	**16.60%**	**17.69%**
Other Income (Expense)						
Interest income	47	38	110	369	**307**	**340**
Interest expense	(124)	(106)	(112)	(93)	**(100)**	**(100)**
Gain on sale of marketable securities	-	35	7	15	**85**	**-**
Rental income	214	-	-	-	**-**	**-**
Total Other Income (Expense)	137	(33)	5	291	**292**	**240**
Pre-Tax Income	1,177	1,306	1,070	1,453	**2,149**	**2,540**
Pre-Tax Margins	19.75%	19.22%	13.53%	15.84%	**19.21%**	**19.54%**
Income Tax Expense (Benefit)	477	543	387	526	**935**	**1,110**
Tax Rate	40.51%	41.60%	36.21%	36.21%	**43.52%**	**43.70%**
Net Income	$ 700	$ 763	$ 682	$ 927	**$ 1,214**	**$ 1,430**
EPS -- Fully Diluted	$ 0.19	$ 0.20	$ 0.17	$ 0.21	**$ 0.28**	**$ 0.33**
Avg Shares Out-Fully Diluted	3,776	3,781	3,933	4,318	**4,323**	**4,350**
Percent of Revenue						
Cost of Revenues	57.62%	54.41%	58.99%	57.84%	57.86%	57.88%
Sales, General and Administrative expenses	24.93%	25.88%	27.54%	29.50%	25.54%	24.42%
YEAR / YEAR GROWTH						
Total Revenues		13.99%	16.37%	16.05%	21.90%	16.21%
Operating Income		28.80%	-20.49%	9.12%	59.80%	23.86%
Pre-Tax Income		10.94%	-18.08%	35.86%	47.87%	18.19%
Net Income		8.90%	-10.51%	35.85%	30.92%	17.82%

Lifeway Foods, Inc.
For the Years Ended December 31, 2001
(in thousands)

	Q1(03/01)	Q2 (06/01)E	Q3 (09/01)E	Q4 (12/01)E	**FY2001E**
Sales	$ 2,636	$ 2,800	$ 2,850	$ 2,900	**$ 11,186**
Cost of goods sold	1,547	1,600	1,625	1,700	**6,472**
Gross Profit	1,089	1,200	1,225	1,200	**4,714**
Gross Margins	*41.31%*	*42.86%*	*42.98%*	*41.38%*	**42.14%**
Sales, general and administrative	657	715	740	745	**2,857**
EBITDA	612	635	635	605	**2,457**
Operating Income	432	485	485	455	**1,857**
Operating Margin	*16.39%*	*17.32%*	*17.02%*	*15.69%*	**16.60%**
Other Income (Expense)					
Interest income	72	70	80	85	**307**
Interest expense	(25)	(25)	(25)	(25)	**(100)**
Gain on sale of marketable securities	85	-	-	-	**85**
Total Other Income (Expense)	132	45	55	60	**292**
Pre-Tax Income	564	530	540	515	**2,149**
Pre-Tax Margins	*21.39%*	*18.93%*	*18.95%*	*17.76%*	**19.21%**
Income Tax Expense (Benefit)	235	230	235	235	**935**
Tax Rate	*41.72%*	*43.40%*	*43.52%*	*45.63%*	**43.52%**
Net Income	$ 329	$ 300	$ 305	$ 280	**$ 1,214**
EPS -- Fully Diluted	$ 0.08	$ 0.07	$ 0.07	$ 0.06	**$ 0.28**
Avg Shares Out-Fully Diluted	4,318	4,325	4,325	4,325	**4,323**
Percent of Revenue					
Cost of Revenues	58.69%	57.14%	57.02%	58.62%	57.86%
Sales, General and Administrative expenses	24.93%	25.54%	25.96%	25.69%	25.54%
YEAR / YEAR GROWTH					
Total Revenues	16.00%	22.42%	24.80%	24.30%	21.90%
Operating Income	90.80%	317.63%	36.41%	-1.94%	59.80%
Pre-Tax Income	82.98%	76.21%	12.37%	41.57%	47.87%
Net Income	74.05%	62.79%	10.61%	0.65%	30.92%

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

	Q1(03/02)E	Q2 (06/02)E	Q3 (09/02)E	Q4 (12/02)E	**FY2002E**
Sales	$ 3,100	$ 3,200	$ 3,300	$ 3,400	**$ 13,000**
Cost of goods sold	1,775	1,835	1,890	2,025	**7,525**
Gross Profit	1,325	1,365	1,410	1,375	**5,475**
Gross Margins	*42.74%*	*42.66%*	*42.73%*	*40.44%*	**42.12%**
Sales, general and administrative	755	770	805	845	**3,175**
EBITDA	730	755	765	690	**2,940**
Operating Income	570	595	605	530	**2,300**
Operating Margin	*18.39%*	*18.59%*	*18.33%*	*15.59%*	**17.69%**
Other Income (Expense)					
Interest income	85	85	85	85	**340**
Interest expense	(25)	(25)	(25)	(25)	**(100)**
Total Other Income (Expense)	60	60	60	60	**240**
Pre-Tax Income	630	655	665	590	**2,540**
Pre-Tax Margins	*20.32%*	*20.47%*	*20.15%*	*17.35%*	**19.54%**
Income Tax Expense (Benefit)	260	290	295	265	**1,110**
Tax Rate	*41.27%*	*44.27%*	*44.36%*	*44.92%*	**43.70%**
Net Income	$ 370	$ 365	$ 370	$ 325	**$ 1,430**
EPS -- Fully Diluted	$ 0.09	$ 0.08	$ 0.09	$ 0.07	**$ 0.33**
Avg Shares Out-Fully Diluted	4,350	4,350	4,350	4,350	**4,350**
Percent of Revenue					
Cost of Revenues	57.26%	57.34%	57.27%	59.56%	57.88%
Sales, General and Administrative expenses	24.35%	24.06%	24.39%	24.85%	24.42%
YEAR / YEAR GROWTH					
Total Revenues	17.58%	14.29%	15.79%	17.24%	16.21%
Operating Income	31.95%	22.68%	24.74%	16.48%	23.86%
Pre-Tax Income	11.69%	23.58%	23.15%	14.56%	18.19%
Net Income	12.56%	21.67%	21.31%	16.07%	17.82%

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

	FY1998A	FY1999A	FY2000A	Q1 2001A
Cash Flows from Operating Activities				
Net Income	$ 763	$ 682	$ 927	$ 329
Depreciation and amortization	391	441	610	180
Amortization of discounts on securities	-	(7)	-	-
Gain on sale of marketable securities	(35)	(7)	(15)	(85)
Issuance of common stock in exchange for services rendered	31	-	-	-
Decrease in allowance for doubtful accounts	(48)	-	-	-
Deferred income taxes	115	54	150	4
	1,217	1,165	1,672	428
Changes In:				
Accounts receivable	19	(118)	(216)	(256)
Other receivables	(1)	(41)	57	(5)
Inventories	(237)	8	(76)	125
Prepaid expenses and other assets	(4)	12	-	-
Accounts payable	119	(34)	38	77
Accrued expenses	(262)	26	50	(68)
Taxes payable	-	-	65	29
Net Changes in Working Capital	(366)	(148)	(83)	(98)
Net cash Provided by Operations	850	1,017	1,589	329
Cash Flows from Investing Activities				
Purchase of marketable securities	(305)	(1,846)	(8,808)	(4,017)
Sale of marketable securities	218	646	5,202	4,296
Purchase of property, plant and equipment	(593)	(794)	(1,096)	(188)
Net cash used in Investing	(680)	(1,994)	(4,702)	90
Cash Flows from Financing Activities				
Repayment of notes payable	(92)	(96)	(91)	(24)
Proceeds from issuance of common stock	-	5,138	-	-
Stock issuance costs	-	(52)	-	-
Net cash provided by Financing	(92)	4,990	(91)	(24)
Net change in Cash	78	4,013	(3,204)	395
Cash Beginning of Period	551	628	4,641	1,437
Cash End of Period	$ 628	$ 4,641	$ 1,437	$ 1,832