

## Research Report – Update

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

### Lifeway Foods, Inc.

**Rating: Speculative Buy**

Howard Halpern

August 25, 2010

**LWAY \$9.94 – (NasdaqGM)**

|                              | 2007A  | 2008A  | 2009A  | 2010E         | 2011E          |
|------------------------------|--------|--------|--------|---------------|----------------|
| Sales (in millions)          | \$38.7 | \$44.5 | \$58.1 | <b>\$63.1</b> | <b>\$ 67.2</b> |
| Earnings per share (diluted) | \$0.19 | \$0.11 | \$0.33 | <b>\$0.31</b> | <b>\$0.37</b>  |

|                                 |                  |                         |          |
|---------------------------------|------------------|-------------------------|----------|
| 52-Week range                   | \$14.11 – \$8.07 | Fiscal year ends:       | December |
| Shares outstanding a/o 06/30/10 | 16.7 million     | Revenue/shares (TTM)    | \$3.67   |
| Approximate float               | 4.8 million      | Price/Sales (TTM)       | 2.7X     |
| Market Capitalization           | \$166 million    | Price/Sales (2011) E    | 2.5X     |
| Tangible Book value/shr         | \$0.87           | Price/Earnings (TTM)    | 36.8X    |
| Price/Book                      | 11.4X            | Price/Earnings (2011) E | 26.9X    |

*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.*

#### Key investment considerations:

*We are maintaining our Speculative Buy rating on shares of Lifeway Foods, Inc. (NasdaqGM: LWAY) and lowering our 12-month price target to \$12.85 from \$13.00 per share. Our price target is based on a discounted three-year historic trailing price-to-sales multiple of 3.2X, applied to our 2011 sales estimate of \$4.02 per share.*

*Sales growth should be supported by increased brand awareness, penetration of the Northeastern and Western markets of the US, permanent distribution to Costco's Midwest warehouse, and a 90-day exclusive distribution agreement with Whole Foods for its new BioKefir.*

*On August 17, 2010, LWAY reported 2Q10 revenue increased by 7.4% to \$15.5 million, as brand awareness and distribution increased. EPS decreased by \$0.08 to \$0.07 per share. Both revenue and EPS fell short of our forecasts by \$1.3 million and \$0.04 per share, respectively. Lower than anticipated sales was due in part to a diversion of attention to the development of its new BioKifer product. EPS fell short due to the disallowance of prior tax credits and product development costs.*

*For 2010, we project sales growth of 8.5% to \$63.1 million and EPS of \$0.31. Our forecasts have decreased by \$0.08 per share in earnings and \$4.3 million in revenue.*

*For 2011, we project earnings of \$0.37 per share on sales of \$67.2 million. Previously we projected EPS of \$0.45 on sales of nearly \$78 million. Increasing brand awareness and the launch of BioKifer should enable LWAY to build on its existing customer base and enable margin expansion.*

*In 2Q10 Lifeway announced upcoming new retail distribution in Northern California at Costco stores, BJ's Wholesale Club's 180 stores, and Big Y Foods a New England based supermarket chain.*

**Please view our Disclosures pages 12 - 14**

**Recommendation**

**We are maintaining our Speculative Buy rating on shares of Lifeway Foods, Inc. (NasdaqGM: LWAY). We lowered our 12-month price target to \$12.85 per share from \$13.00 due to a reduction in our 2011 sales-per share expectations to \$4.02 from \$4.18.**

Investors could remain cautious, as food inflation talk has been a topic of discussion with the financial markets. The company’s largest commodity is milk. The futures market is forecasting milk’s average price to be \$15.90 in 2010, up over 40% from record low prices last year. Also, investors might view the sequential revenue decline of nearly \$400,000 as a reason to question sustainable growth. The three-year discounted trailing price-to-sales multiple is 3.2X.

We are valuing LWAY based on a historical approach by taking into consideration stock price fluctuations over the past three-years. Our valuation model (discounted by 20% to account for microcap and company specific risks) applies LWAY’s three-year average historic price-to-sales multiple to our sales per share estimate for 2011 of \$4.02 per share. The three-year average trailing price-to-sales multiple for LWAY is 4X.

As of December 31, 2009, Danone owned approximately 20.6% of LWAY’s common shares. If Danone sold its stake in Lifeway Foods, it would most likely have a negative effect of the company’s stock price. Agreements are in place keeping Danone from acquiring additional shares or introducing a Kefir product. The agreement expires on December 31, 2010 and is expected to be renewed as it has been each of the last nine years.

**The Company**

Lifeway Foods, Inc. (NasdaqGM: LWAY) manufactures a cultured dairy beverage called Kefir and also develops Kefir related products at its manufacturing and production facilities in Illinois (2), Pennsylvania (1), and Minnesota (1). Its Kefir-based product portfolio is distributed in Illinois through approximately 1,200 local stores including major retail chains (i.e., Jewel Food Stores, Dominick's Finer Foods, Whole Foods, and independent retailers). The product portfolio includes 40 different assorted cream cheese offerings that are distributed under the Cream Cheese Gourmet brand in the Philadelphia and New York metropolitan areas. Lifeway’s products are also distributed to stores throughout the US (Costco Midwest and Northern California, Stop & Shop Northeast, Kroger and Ralps – Midwest and West, BJ’s Wholesale Club stores, and Whole Foods nationwide for its BioKefir offering.

LWAY distributes its products in some parts of Canada (Ontario and Quebec). However, in order to make a meaningful sales impact in Canada, the company intends to acquire a small manufacturing facility within Canada. When the purchase is expected has not been disclosed. Verbal distribution agreements in the US offer latitude to expand into new markets and establish new relationships on an ongoing basis. The developments listed to the right have raised brand awareness and distribution opportunities.

|             |   |
|-------------|---|
| <b>2006</b> | <ul style="list-style-type: none"> <li>Acquired Helios Nutrition Limited (including Pride Main Street Dairy)</li> <li>Introduced ProBugs™ product line for kids. It is packaged in patented no spill spout pouches designed as cartoon bug characters</li> <li>Developed La Fruta, a yogurt like drink formulated to accommodate the Hispanic market</li> </ul> |
| <b>2008</b> | <ul style="list-style-type: none"> <li>Launched Starfruit™ Kefir boutique in Chicago. Starfruit offers several flavors of frozen Kefir (over 20 toppings), customized Kefir parfaits, and smoothie-style Kefir drinks</li> </ul>  |
| <b>2009</b> | <ul style="list-style-type: none"> <li>Acquired Philadelphia based Fresh Made, Inc., which was the nations second largest Kefir manufacturer. In 2008, Fresh Made generated sales of approximately \$10 million. In 2009, Fresh Made contributed \$7.9 million to LWAY’s sales.</li> </ul>  |

**Kefir**

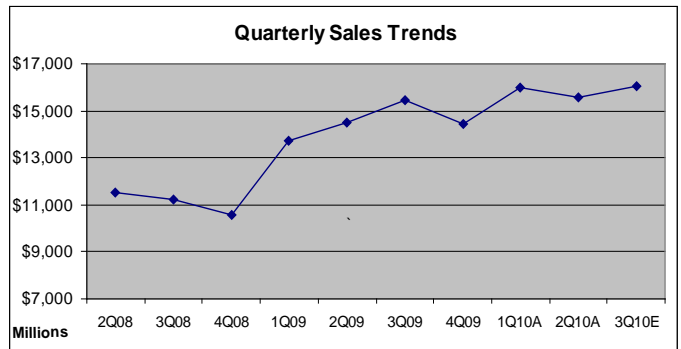
Lifeway Kefir contains ten active "friendly" microorganisms and is probiotic\* in nature because it promotes the growth of those microorganisms naturally. The product is a source of calcium, protein, minerals, and B-complex vitamins, and is highly digestible due to its acidity and enzymes. Kefir is similar to, but distinct from, yogurt due to a different fermentation process which produces a less sour taste. Less sugar is required so it 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.

**Outlook**

The graph illustrates the sequential sales declines in 2008 and a reversal in trend that we expect to extend into at least 3Q10.

LWAY generated weekly average sales of \$1.1 million during 2009. For 1Q10 the weekly sales run rate was \$1.2 million. However the sales rate dipped in 2Q10 to just under \$1.2 million. For 2010 the weekly run rate should average just over \$1.2 million and expand to just under \$1.3 million in 2011.



Expectations for weekly run rate gains over the next two years are based on:

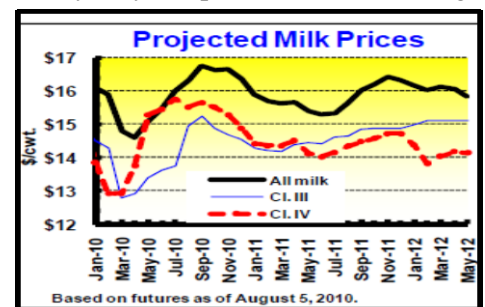
- Programs to build brand awareness, such as:
  - Product sampling
  - In store demonstrations
  - Use of coupons
- Gaining new distribution outlets, such as:
  - Costco. The Costco Midwest warehouse now purchases LWAY products regularly. Starting in 3Q10, Northern California regions will sell a mix of 12 Lifeway Kefir grab-n-go bottles in two flavors. Other regional warehouses for the West and Northeast regions will be purchasing product from LWAY on a rotational basis.
  - Big Y Foods will begin selling LWAY’s 32oz varieties of Kefir. Big Y is a New England based supermarket chain with over 60 stores.
  - Whole Foods signed a 90-day exclusive distribution agreement for three flavors of LWAY’s new BioKefir offering.
- Distribution through supermarkets in the northeast region of the US. Based on personal observation, it appears that some of Lifeway’s products are being sold at Stop & Shop, Wild by Nature, and Whole Foods locations on Long Island, NY
- Expanding distribution of La Fruita to the Hispanic community.

Milk Price Perspective

The July/August 2010 Dairy Market Report from the National Milk Producers Federation observed the following:

- According to history and the futures markets, this summer is the dairy price peak that comes once every three years
- Growing milk production is holding back the price recovery
- With continued growth in milk production in the U.S. and abroad, the only way for prices to rise is through demand growth. For that to occur global economic growth must continue

The July/August 2010 Dairy Market Report from the National Milk Producers Federation stated that the July 2010 revised all-milk price (defined as the milk-to-feed price ratio) was \$16.00, up \$0.50 from June 2010. The futures market is projecting average all-milk prices of \$15.90 in 2010 (in April 2010, the projection was \$16.00) and \$15.80 in 2011. For prices to meet the average for 2010, they would need to increase to approximately \$16.40 through the balance of 2010.



## ***Market Comment***

Lifeway Foods' product portfolio includes cultured dairy products known as Kefir, which includes probiotic functional cultures. There are no publicly traded direct Kefir competitors and with LWAY acquiring Kefir producers Helios and Fresh Made in 2006 and 2009, respectively, they became the dominant producer in the US. Dannon's Activia yogurt, the closest competitive product, generated volume growth of 9.3% in the first half of 2010. Danone aims to double per capita consumption of Activa in the US within the next four years. As acceptance of Activia increases, it should assist LWAY's growth through the acceptance by consumers of probiotic dairy products.

The company's target markets, health conscious consumers and the growing elderly US population, are driving the growth of the functional and probiotic foods segment of the food industry.

The following factors should benefit the company's product portfolio, as we view cultured yogurt sales as a proxy for kefir acceptance:

- LWAY has positioned its products to take advantage of growing consumption of functional foods and beverages. According to market research firm Aarkstore Enterprise, the global probiotics market is estimated to reach \$31.2 billion in 2014, an annual growth rate of 11.7% from 2009.
- The report Dairy Wholesaling in the US (IBISWorld February 2010) stated that domestic demand for dairy products would continue to depend on disposable income growth, population growth, and consumer preferences. The US population is forecast to grow at a marginal rate of 1.0% per annum over the five years to 2014, which will aid some volume growth. Real disposable income is forecast to grow at a relatively strong rate through 2014, supporting purchases of more expensive dairy foods. Consumers' concern about health and nutritional claims should drive demand for functional dairy products with probiotics, increased calcium, and organic varieties.

## ***Projections***

### Operations

For 2010, we project EPS of 0.31 per share, on sales of \$63.1 million, down from our prior forecast of \$67.4 million and \$0.39 per share. Our 8.5% sales growth forecast is based on organic growth of the company's flagship Kefir product (pictured to right), its ProBugs™ Organic Kefir for kids, and third quarter introduction of its new BioKefir product at Whole Foods nationwide. We project organic product sales of \$22.1 million (35% of total) and non-organic sales of \$41 million. The company does not disclose individual product sales, but based on our own observations, its original Kefir (pictured to the right) is its sales leader, followed by its organic product offerings, and ProBugs for kids.

Our reduced profit forecast reflects the shortfall in 2Q10 results, and higher projected commodity prices (i.e., conventional and organic milk) that will compress gross margin for the balance of the year. We project a gross margin of 37.7% for the 2H10, down from 41% in the 1H10. We also lowered our sales expense forecast by \$700,000 in anticipation of a reclassification of product sampling and in-store demonstration costs as selling expenses rather than the cost of goods sold.

For 2011, we project sales of \$67.2 million with net income of \$6.2 million or \$0.37 per share. The 6.5% sales growth should be driven by continued market penetration, spending on brand awareness, broader sales beyond Whole Foods for its BioKefir product, and organic sales of \$27 million or approximately 40% of sales. Our prior forecast was for sales growth of 15.9% to nearly \$78 million and EPS of \$0.45. The unanticipated sequential revenue decline in 2Q10 versus 1Q10 resulted in our reduced sales forecast to single digit growth.



Customer acceptance of the new BioKefir product and new distribution should support our 2011 sales forecast. Lifeway's ability to purchase lower priced (by at least 10%) class 2 milk starting in September 2010 should enable net income to grow by 21.3%, since gross margin should improve to 40.4% from 39.4% in 2010.

Our forecasts for 2010 and 2011 are predicated on:

- Maximizing distribution agreements by allowing for entry into all stores in one region or nationally over time.
- Expanding the distribution of the Kefir Wellness Snack Bar.
- Expanding sales within Canada by the end of 2010. We anticipate purchase of a small manufacturing facility by the end of 2010, in which case 2011 Canadian sales could reach at least \$1 million. With proper execution, the company's Canadian sales could be three-quarters of US sales by 2014.
- Keeping interest expense in check. If the company maintains an accelerated debt repayment program (it repaid \$4 million in 2009 and \$1.2 million so far in 2010) interest expense for 2010 and 2011 should decline to \$330,000 and \$280,000 million, respectively, versus \$433,000 in 2009.

Our forecasts do not include the franchising potential of its Starfruit Café concept. No franchising plan has been announced as of this writing.

### Finances

For 2010, we project cash earnings of \$7.7 million and a \$2.7 million increase in working capital. Cash from operations of \$5 million should enable the company to continue paying down the debt incurred to finance the Fresh Made acquisition and fund the purchase of a facility in Canada. Cash at the end of 2010 should increase to \$899,000 from \$630,000 at December 31, 2009.

Projected cash earnings of \$8.3 million for 2011 should cover an increase of approximately \$517,000 in working capital and repayment of debt obligations. Our year-end cash forecast for 2011 is approximately \$1.7 million, up approximately \$768,000 from our 2010 forecast.

### **Recent Financials**

For 2Q10, versus 2Q09:

- Sales increased to \$15.5 million from \$14.5 million. Our estimate was \$16.8 million.
- Gross margin contracted to 38.5% from 42.5%.
- Operating expenses increased to \$3.8 million from \$3.0 million.
- Net income was \$1.2 million or \$0.07 per share versus net income of \$2.5 million or \$0.15 per share. Our estimate was \$1.8 million or \$0.11 per share.

The 2Q10 revenue increase of 7.4% was due to the growing awareness of Lifeway's flagship line, Kefir and increased distribution of its ProBugs™ Organic Kefir for kids.

Gross margin contracted by four percentage points due to the higher cost of conventional milk, LWAY's largest raw material. 2Q09 experienced some of the lowest prices for milk on record. Conventional milk prices were approximately 45% higher during 2Q10 compared to last year.

For 2Q10, operating expenses increased by \$800,000 to \$3.8 million due to higher marketing and advertising expenses. Also, the company expensed \$100,000 related to the development of the BioKefir™ product line.

Total other income was nearly \$60,000 compared to \$1,176 in 2Q09. The increase was due to gains on sale of marketable securities. Additionally, interest expense decreased to \$80,164 from \$110,090 in 2Q10.

## Lifeway Foods, Inc.

In 2Q10, income taxes jumped to \$1 million compared with \$623,918 in 2Q09. Higher income tax expense was due to disallowed research and development credits from 2007 and 2008 that resulted in \$220,000 in additional taxes.

1H10 sales growth was 11.7%, as brand awareness and distribution continues to grow. With gross margin flat and operating expenses increasing by over 37%, net income decreased by approximately \$1 million to \$0.18 per share from \$0.24 per share in the 1H09.

### Finances

The company's debt to equity ratio of 0.3 versus 1.5 for the industry shows that LWAY is significantly less leveraged than other dairy product companies.

1H10 cash earnings and cash from operations totaled \$3.7 million and \$2.3 million, respectively, compared to \$5.4 million and \$3.4 million, respectively, in 1H09. Working capital needs increased by \$1.4 million due to increased accounts receivables and higher inventory levels to support sales growth, offset by a higher level of payables. The cash from operations enabled the company to increase cash by \$228,000 to \$859,000, pay down debt by \$1.2 million and repurchase \$1.4 million of common stock.

In 2Q10, cash earnings totaled \$1.5 million to support an increase in working capital of \$400,000. Cash from operations increased in the quarter by \$1.2 million, which helped cover capital expenditures, the repayment of debt, and repurchase of common stock.

|                                    | <u>6 Mos. 2010</u> | <u>6 Mos. 2009</u> | <u>% Δ</u> |
|------------------------------------|--------------------|--------------------|------------|
| Sales                              | \$ 31,511          | \$ 28,216          | 11.7%      |
| Cost of goods sold                 | 18,577             | 16,673             | 11.4%      |
| <b>Gross Profit</b>                | 12,933             | 11,542             | 12.1%      |
| Total Operating Expenses           | 8,031              | 5,844              | 37.4%      |
| <i>EBITDA</i>                      | 6,001              | 6,690              | -10.3%     |
| <b>Operating Income</b>            | 4,903              | 5,698              | -14.0%     |
| Total Other Income (Expense)       | (10)               | (231)              |            |
| <b>Pre-Tax Income</b>              | 4,893              | 5,467              | -10.5%     |
| Income Tax Expense (Benefit)       | 1,940              | 1,387              | 39.8%      |
| <i>Tax Rate</i>                    | 39.65%             | 25.38%             |            |
| <b>Net Income</b>                  | <u>\$ 2,953</u>    | <u>\$ 4,079</u>    | -27.6%     |
| <b>EPS -- Fully Diluted</b>        | <u>\$ 0.18</u>     | <u>\$ 0.24</u>     | -27.2%     |
| Avg Shares Out-Fully Diluted       | <u>16,732</u>      | <u>16,824</u>      |            |
| Margins                            |                    |                    |            |
| Gross Margins                      | 41.0%              | 40.9%              |            |
| Operating Margin                   | 15.6%              | 20.2%              |            |
| Pre-Tax Margins                    | 15.5%              | 19.4%              |            |
| Selling expense                    | 10.1%              | 13.9%              |            |
| General and Administrative expense | 10.6%              | 17.9%              |            |
| Source: company reports            |                    |                    |            |

### Debt

Debt as of June 30, 2010 totaled \$10.8 million, of which \$4.4 million is short-term. Total debt consisted of a note payable to Private Bank (\$6.9 million, matures February 2014), a line of credit with Private Bank (\$750,000 matures February 2011), a line of credit with Morgan Stanley (\$2.3 million, no maturity date), and subordinated notes payable to Ilya Mandel and Michael Edelson (\$872,119, matures February 2011).

### Marketable Securities

The company's \$3.4 million portfolio of marketable securities (at fair value as of June 30, 2010) consisted of:

- 71.3% fixed income type securities (government agency obligations and bonds - corporate/municipal); and
- 28.7% in equities, mutual funds, and preferred securities.

At June 30, 2010, the company had total unrealized losses of \$0.2 million.

### Risks

In our view, these are the principal risks underlying the stock:

#### Commodities

The price of conventional and organic raw materials such as milk, sugar, and fruit from unaffiliated suppliers can be volatile, causing wide variations in the gross margin.

Regulation

Lifeway is subject to federal, state and local regulation regarding the distribution and sale of food products. Products exported to Canada are subject to strict quotas imposed by the Canadian government. This is why the company is seeking to manufacture product within Canada.

Groupe Danone SA Relationship

On December 31, 2009, the company entered into a seventh extension of the stockholders' agreement with Danone Foods, Inc. on December 31, 2009 (the terms of the non-compete period and standstill period of the stockholders' agreement expire on December 31, 2010). As of December 31, 2009, Danone owned approximately 20.6% of LWAY's common shares. If Danone were to sell its stake in Lifeway Foods, the stock price could be adversely affected.

Internal Controls

The company identified at March 31, 2010 two material weaknesses in the company's internal controls: 1) an incomplete and undocumented system for tracking current programs for advertising and sales promotions with current customers and 2) not posting monthly activity to the company's general ledger. Management is creating a system for documenting advertising and promotional costs, including analyzing the benefits received from customers, and improving review procedures for posting and updating the monthly financial activity. At June 30, 2010, improvements to internal controls have not been implemented.

Management Control

Ludmila Smolyansky (mother of the company's CEO and CFO), chairperson of the board of directors, beneficially owns or controls approximately 45.1% of common shares outstanding as of June 30, 2010. The chairperson has the ability to substantially influence matters submitted to stockholders for approval, this could have a negative impact if her interests do not coincide with other shareholders on a particular issue.

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. During 2008 average daily volume was 35,147 shares traded daily and declined further in 2009 to 23,313 shares traded a day. During the first seven months of 2010, average daily volume fell further to 16,294. Average daily volume remains relatively low; therefore, investors need to be aware that by nature a thinly traded equity can have significant price volatility.

Lifeway Foods, Inc.  
Consolidated Balance Sheets  
2007 – 2011E  
(in thousands)

|  | 2007A                   | 2008A                   | 2009A                   | 6 Mos.10A               | 2010E                   | 2011E                   |
|--|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
| <b>ASSETS</b>  |                         |                         |                         |                         |                         |                         |
| Current assets:  |                         |                         |                         |                         |                         |                         |
| Cash and cash equivalents                                | \$ 596                  | \$ 277                  | \$ 630                  | \$ 858                  | \$ 899                  | \$ 1,667                |
| Marketable securities                                    | 6,989                   | 5,262                   | 5,044                   | 3,412                   | 3,400                   | 3,300                   |
| Accounts receivable, net                                 | 4,210                   | 4,766                   | 6,000                   | 7,781                   | 7,357                   | 7,648                   |
| Other receivables  | 43                      | 40                      | 50                      | 142                     | 65                      | 75                      |
| Inventories  | 3,507                   | 3,098                   | 3,297                   | 4,155                   | 4,133                   | 4,106                   |
| Prepaid income taxes                                     | 241                     | 356                     | 1,309                   | -                       | 2,000                   | 2,500                   |
| Prepaid expenses and other assets                        | 21                      | 23                      | 41                      | 70                      | 50                      | 57                      |
| Deferred income taxes                                    | 312                     | 920                     | 251                     | 389                     | 150                     | 650                     |
| <b>Total current assets</b>                              | <b><u>15,919</u></b>    | <b><u>14,742</u></b>    | <b><u>16,622</u></b>    | <b><u>17,357</u></b>    | <b><u>18,054</u></b>    | <b><u>20,003</u></b>    |
| Property, plant and equipment, net                       | 9,679                   | 11,063                  | 14,282                  | 14,890                  | 15,000                  | 16,750                  |
| Other assets   | 500                     | 500                     | 500                     | 500                     | 500                     | 500                     |
| Intangible assets, net                                   | 8,671                   | 8,351                   | 20,066                  | 19,714                  | 19,700                  | 19,650                  |
| <b>Total assets</b>                                      | <b><u>\$ 34,768</u></b> | <b><u>\$ 34,656</u></b> | <b><u>\$ 51,470</u></b> | <b><u>\$ 52,462</u></b> | <b><u>\$ 53,254</u></b> | <b><u>\$ 56,903</u></b> |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>              |                         |                         |                         |                         |                         |                         |
| Current liabilities:                                     |                         |                         |                         |                         |                         |                         |
| Current maturities of notes payable                      | 1,136                   | 928                     | 4,842                   | 4,432                   | 3,800                   | 1,352                   |
| Checks written in excess of bank balances                | -                       | -                       | 343                     | 847                     | -                       | -                       |
| Accounts payable   | 1,594                   | 2,260                   | 2,764                   | 2,259                   | 2,920                   | 3,114                   |
| Accrued expenses   | 414                     | 458                     | 614                     | 532                     | 650                     | 721                     |
| <b>Total current liabilities</b>                         | <b><u>3,144</u></b>     | <b><u>3,647</u></b>     | <b><u>8,564</u></b>     | <b><u>8,674</u></b>     | <b><u>7,370</u></b>     | <b><u>5,186</u></b>     |
| Long-term liabilities -- notes payable                   | 4,097                   | 3,108                   | 6,890                   | 6,398                   | 5,932                   | 4,932                   |
| Deferred income taxes                                    | 1,713                   | 1,607                   | 3,445                   | 3,263                   | 3,400                   | 4,000                   |
| <b>Stockholders' equity:</b>                             |                         |                         |                         |                         |                         |                         |
| Common stock, no par value; authorized 10,000,000 shares | 6,509                   | 6,509                   | 6,509                   | 6,509                   | 6,509                   | 6,509                   |
| Paid-in capital  | 1,121                   | 1,202                   | 1,966                   | 2,019                   | 1,995                   | 1,995                   |
| Retained earnings  | 20,471                  | 22,384                  | 27,953                  | 30,907                  | 33,093                  | 39,328                  |
| Accumulated other comprehensive income, net of tax       | (209)                   | (499)                   | (10)                    | (52)                    | 302                     | 300                     |
| Treasury stock, at cost                                  | (2,078)                 | (3,302)                 | (3,847)                 | (5,256)                 | (5,347)                 | (5,347)                 |
| <b>Total stockholders' equity</b>                        | <b><u>25,814</u></b>    | <b><u>26,294</u></b>    | <b><u>32,571</u></b>    | <b><u>34,127</u></b>    | <b><u>36,552</u></b>    | <b><u>42,785</u></b>    |
| <b>Total liabilities and stockholders' equity</b>        | <b><u>\$ 34,768</u></b> | <b><u>\$ 34,656</u></b> | <b><u>\$ 51,470</u></b> | <b><u>\$ 52,462</u></b> | <b><u>\$ 53,254</u></b> | <b><u>\$ 56,903</u></b> |
| SHARES OUT   | 16,828                  | 16,724                  | 16,724                  | 16,657                  | 16,724                  | 16,724                  |



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

|                                       | <u>2007A</u>    | <u>2008A</u>    | <u>2009A</u>    | <u>2010E</u>           | <u>2011E</u>           |
|---------------------------------------|-----------------|-----------------|-----------------|------------------------|------------------------|
| Sales                                 | \$ 38,729       | \$ 44,461       | \$ 58,116       | \$ <b>63,056</b>       | \$ <b>67,150</b>       |
| Cost of goods sold                    | <u>26,310</u>   | <u>31,704</u>   | <u>37,218</u>   | <u><b>38,227</b></u>   | <u><b>40,035</b></u>   |
| <b>Gross Profit</b>                   | 12,420          | 12,758          | 20,898          | <b>24,828</b>          | <b>27,115</b>          |
| Operating Expenses:                   |                 |                 |                 |                        |                        |
| Sales                                 | 3,744           | 4,098           | 5,988           | <b>9,561</b>           | <b>10,400</b>          |
| General and administrative            | 4,238           | 4,468           | 5,971           | <b>6,780</b>           | <b>6,980</b>           |
| Total Operating Expenses              | <u>7,982</u>    | <u>8,567</u>    | <u>11,959</u>   | <u><b>16,341</b></u>   | <u><b>17,380</b></u>   |
| <i>EBITDA</i>                         | 5,487           | 5,284           | 10,919          | <b>10,586</b>          | <b>11,735</b>          |
|                                       | <u>1,278</u>    | <u>1,492</u>    | <u>5,090</u>    | <u><b>4,659</b></u>    | <u><b>5,755</b></u>    |
| <b>Operating Income</b>               | 4,437           | 4,191           | 8,939           | <b>8,488</b>           | <b>9,735</b>           |
| Other Income (Expense)                |                 |                 |                 |                        |                        |
| Interest income                       | 350             | 343             | 199             | <b>206</b>             | <b>200</b>             |
| Interest expense                      | (410)           | (299)           | (443)           | <b>(327)</b>           | <b>(280)</b>           |
| Gain on sale of marketable securities | 540             | (734)           | (278)           | <b>55</b>              | <b>-</b>               |
| Other                                 | (0)             | (959)           | (3)             | <b>-</b>               | <b>-</b>               |
| Rental income                         | 48              | 49              | 35              | <b>8</b>               | <b>20</b>              |
| Total Other Income (Expense)          | <u>528</u>      | <u>(1,599)</u>  | <u>(490)</u>    | <u><b>(59)</b></u>     | <u><b>(60)</b></u>     |
| <b>Pre-Tax Income</b>                 | 4,965           | 2,592           | 8,449           | <b>8,429</b>           | <b>9,675</b>           |
| Income Tax Expense (Benefit)          | <u>1,813</u>    | <u>680</u>      | <u>2,879</u>    | <u><b>3,290</b></u>    | <u><b>3,440</b></u>    |
| <b>Net Income</b>                     | <u>\$ 3,153</u> | <u>\$ 1,912</u> | <u>\$ 5,570</u> | <u><b>\$ 5,139</b></u> | <u><b>\$ 6,235</b></u> |
| <b>EPS -- Fully Diluted*</b>          | <u>\$ 0.19</u>  | <u>\$ 0.11</u>  | <u>\$ 0.33</u>  | <u><b>\$ 0.31</b></u>  | <u><b>\$ 0.37</b></u>  |
| Avg Shares Out-Fully Diluted*         | <u>16,856</u>   | <u>16,761</u>   | <u>16,798</u>   | <u><b>16,736</b></u>   | <u><b>16,710</b></u>   |
| Margins                               |                 |                 |                 |                        |                        |
| Gross Margins                         | 32.1%           | 28.7%           | 36.0%           | <b>39.4%</b>           | <b>40.4%</b>           |
| Operating Margin                      | 11.5%           | 9.4%            | 15.4%           | <b>13.5%</b>           | <b>14.5%</b>           |
| Pre-Tax Margins                       | 12.8%           | 5.8%            | 14.5%           | <b>13.4%</b>           | <b>14.4%</b>           |
| Selling expense                       | 9.7%            | 9.2%            | 10.3%           | <b>15.2%</b>           | <b>15.5%</b>           |
| General and Administrative expense    | 10.9%           | 10.1%           | 10.3%           | <b>10.8%</b>           | <b>10.4%</b>           |
| <i>Tax Rate</i>                       | 36.5%           | 26.2%           | 34.1%           | <b>39.0%</b>           | <b>35.6%</b>           |
| YEAR / YEAR GROWTH                    |                 |                 |                 |                        |                        |
| Total Revenues                        | 39.7%           | 14.8%           | 30.7%           | <b>8.5%</b>            | <b>6.5%</b>            |
| Net Income                            | 8.8%            | (39.3%)         | 263.9%          | <b>(7.7%)</b>          | <b>21.3%</b>           |

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

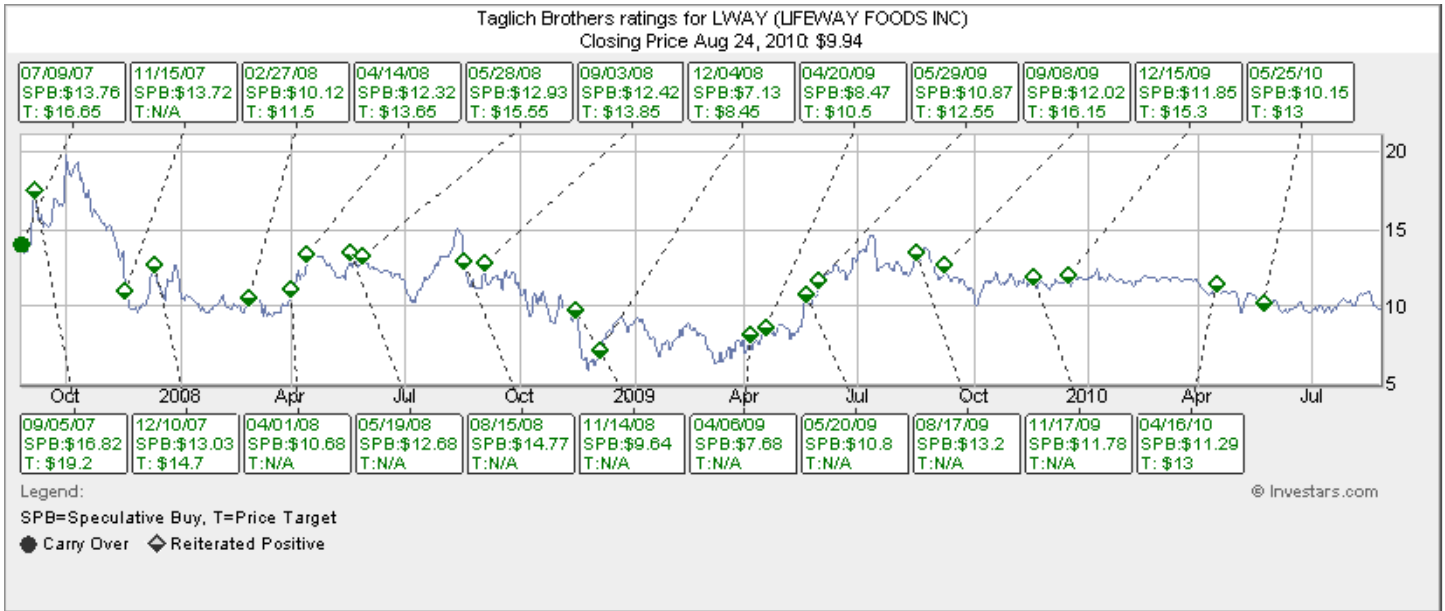
|                            | 1Q09A           | 2Q09A           | 3Q09A           | 4Q09A          | 2009A           | 1Q10A           | 2Q10A           | 3Q10E           | 4Q10E          | 2010E           | 1Q11E           | 2Q11E           | 3Q11E           | 4Q11E          | 2011E           |
|----------------------------|-----------------|-----------------|-----------------|----------------|-----------------|-----------------|-----------------|-----------------|----------------|-----------------|-----------------|-----------------|-----------------|----------------|-----------------|
| Sales                      | \$ 13,736       | \$ 14,479       | \$ 15,434       | \$ 14,466      | \$ 58,116       | \$ 15,964       | \$ 15,547       | \$ 16,065       | \$ 15,480      | \$ 63,056       | \$ 16,715       | \$ 16,850       | \$ 17,175       | \$ 16,410      | \$ 67,150       |
|                            | 8,217           | 8,332           | 9,181           | 11,489         | 37,218          | 9,022           | 9,555           | 9,700           | 9,950          | 38,227          | 9,685           | 9,775           | 10,250          | 10,325         | 40,035          |
| Cost of goods sold         | 5,519           | 6,148           | 6,253           | 2,978          | 20,898          | 6,942           | 5,991           | 6,365           | 5,530          | 24,828          | 7,030           | 7,075           | 6,925           | 6,085          | 27,115          |
| <b>Gross Profit</b>        | <i>40.18%</i>   | <i>42.46%</i>   | <i>40.52%</i>   | <i>20.58%</i>  | <b>35.96%</b>   | <i>43.48%</i>   | <i>38.54%</i>   | <i>39.62%</i>   | <i>35.72%</i>  | <b>39.38%</b>   | <i>42.06%</i>   | <i>41.99%</i>   | <i>40.32%</i>   | <i>37.08%</i>  | <b>40.38%</b>   |
| Operating Expenses:        |                 |                 |                 |                |                 |                 |                 |                 |                |                 |                 |                 |                 |                |                 |
| Sales                      | 1,308           | 1,387           | 1,231           | 2,062          | 5,988           | 2,527           | 2,183           | 2,450           | 2,400          | 9,561           | 2,575           | 2,425           | 2,600           | 2,800          | 10,400          |
| G&A                        | 1,668           | 1,606           | 1,783           | 915            | 5,971           | 1,666           | 1,654           | 1,660           | 1,800          | 6,780           | 1,675           | 1,695           | 1,685           | 1,925          | 6,980           |
| Total Operating Exp        | 2,976           | 2,993           | 3,014           | 2,977          | 11,959          | 4,193           | 3,837           | 4,110           | 4,200          | 16,341          | 4,250           | 4,120           | 4,285           | 4,725          | 17,380          |
| <b>Operating Income</b>    | 2,544           | 3,155           | 3,239           | 1              | 8,939           | 2,748           | 2,154           | 2,255           | 1,330          | 8,488           | 2,780           | 2,955           | 2,640           | 1,360          | 9,735           |
| Other Income (Expense)     | 62              | 49              | 34              | 54             | 199             | 55              | 53              | 50              | 48             | 206             | 50              | 50              | 50              | 50             | 200             |
| Interest income            | (154)           | (110)           | (100)           | (78)           | (443)           | (96)            | (80)            | (79)            | (72)           | (327)           | (70)            | (70)            | (70)            | (70)           | (280)           |
| Interest expense           | (150)           | 54              | (178)           | (4)            | (278)           | (29)            | 84              | -               | -              | 55              | -               | -               | -               | -              | -               |
| Gain on sale of securities | -               | (3)             | -               | -              | (3)             | -               | -               | -               | -              | -               | -               | -               | -               | -              | -               |
| Other                      | 9               | 12              | 12              | 2              | 35              | 1               | 3               | 2               | 2              | 8               | 5               | 5               | 5               | 5              | 20              |
| Rental income              |                 |                 |                 |                |                 |                 |                 |                 |                |                 |                 |                 |                 |                |                 |
| Total Other Income (Ex)    | (233)           | 1               | (232)           | (26)           | (490)           | (69)            | 60              | (27)            | (22)           | (59)            | (15)            | (15)            | (15)            | (15)           | (60)            |
| <b>Pre-Tax Income</b>      | 2,311           | 3,156           | 3,008           | (25)           | 8,449           | 2,679           | 2,214           | 2,228           | 1,308          | 8,429           | 2,765           | 2,940           | 2,625           | 1,345          | 9,675           |
| Income Tax Expense (Ben)   | 763             | 624             | 1,637           | (145)          | 2,879           | 910             | 1,030           | 875             | 475            | 3,290           | 1,020           | 995             | 925             | 500            | 3,440           |
| <b>Net Income</b>          | <u>\$ 1,547</u> | <u>\$ 2,532</u> | <u>\$ 1,371</u> | <u>\$ 120</u>  | <u>\$ 5,570</u> | <u>\$ 1,769</u> | <u>\$ 1,185</u> | <u>\$ 1,353</u> | <u>\$ 833</u>  | <u>\$ 5,139</u> | <u>\$ 1,745</u> | <u>\$ 1,945</u> | <u>\$ 1,700</u> | <u>\$ 845</u>  | <u>\$ 6,235</u> |
| <b>EPS</b>                 | <u>\$ 0.09</u>  | <u>\$ 0.15</u>  | <u>\$ 0.08</u>  | <u>\$ 0.01</u> | <u>\$ 0.33</u>  | <u>\$ 0.11</u>  | <u>\$ 0.07</u>  | <u>\$ 0.08</u>  | <u>\$ 0.05</u> | <u>\$ 0.31</u>  | <u>\$ 0.10</u>  | <u>\$ 0.12</u>  | <u>\$ 0.10</u>  | <u>\$ 0.05</u> | <u>\$ 0.37</u>  |
| Avg Shares                 | 16,847          | 16,790          | 16,799          | 16,755         | 16,798          | 16,762          | 16,702          | 16,745          | 16,735         | 16,736          | 16,725          | 16,715          | 16,705          | 16,695         | 16,710          |
| Margins                    |                 |                 |                 |                |                 |                 |                 |                 |                |                 |                 |                 |                 |                |                 |
| Gross Margins              | 40.2%           | 42.5%           | 40.5%           | 20.6%          | 36.0%           | 43.5%           | 38.5%           | 39.6%           | 35.7%          | 39.4%           | 42.1%           | 42.0%           | 40.3%           | 37.1%          | 40.4%           |
| Operating Margin           | 18.5%           | 21.8%           | 21.0%           | 0.0%           | 15.4%           | 17.2%           | 13.9%           | 14.0%           | 8.6%           | 13.5%           | 16.6%           | 17.5%           | 15.4%           | 8.3%           | 14.5%           |
| Pre-Tax Margins            | 16.8%           | 21.8%           | 19.5%           | (0.2%)         | 14.5%           | 16.8%           | 14.2%           | 13.9%           | 8.4%           | 13.4%           | 16.8%           | 17.4%           | 15.3%           | 8.2%           | 14.4%           |
| Percent of Revenue         |                 |                 |                 |                |                 |                 |                 |                 |                |                 |                 |                 |                 |                |                 |
| Cost of Revenues           | 59.8%           | 57.5%           | 59.5%           | 79.4%          | 64.0%           | 56.5%           | 61.5%           | 60.4%           | 64.3%          | 60.6%           | 57.9%           | 58.0%           | 59.7%           | 62.9%          | 59.6%           |
| Selling expense            | 9.5%            | 9.6%            | 8.0%            | 14.3%          | 10.3%           | 15.8%           | 14.0%           | 15.3%           | 15.5%          | 15.2%           | 15.4%           | 14.4%           | 15.1%           | 17.1%          | 15.5%           |
| G&A expense                | 12.1%           | 11.1%           | 11.5%           | 6.3%           | 10.3%           | 10.4%           | 10.6%           | 10.3%           | 11.6%          | 10.8%           | 10.0%           | 10.1%           | 9.8%            | 11.7%          | 10.4%           |
| Tax rate                   | 33.0%           | 19.8%           | 54.4%           | 570.5%         | 34.1%           | 34.0%           | 46.5%           | 39.3%           | 36.3%          | 39.0%           | 36.9%           | 33.8%           | 35.2%           | 37.2%          | 35.6%           |
| Year/Year Growth           |                 |                 |                 |                |                 |                 |                 |                 |                |                 |                 |                 |                 |                |                 |
| Total Revenues             | 23.5%           | 25.7%           | 37.3%           | 36.8%          | 30.7%           | 16.2%           | 7.4%            | 4.1%            | 7.0%           | 8.5%            | 4.7%            | 8.4%            | 6.9%            | 6.0%           | 6.5%            |
| Net Income                 | 86.1%           | 104.0%          | 120.8%          | (100.6%)       | 113.3%          | 8.1%            | (31.7%)         | (30.4%)         | 123276.9%      | (5.0%)          | 1.1%            | 37.2%           | 17.1%           | 2.3%           | 14.7%           |

Lifeway Foods, Inc.  
Cash Flow Statement  
2007 – 2011E  
(in thousands)

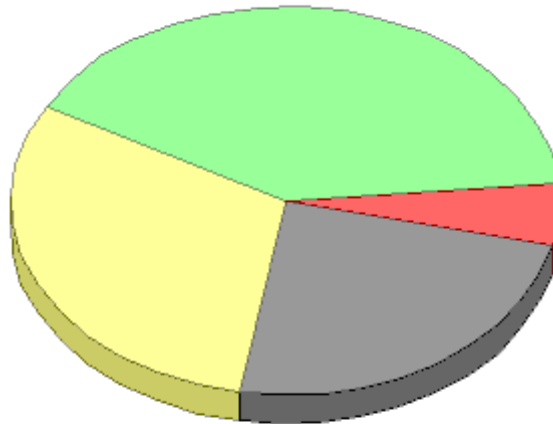
|  | 2007A          | 2008A          | 2009A           | 6 Mos.10       | 2010E          | 2011E           |
|--|----------------|----------------|-----------------|----------------|----------------|-----------------|
| <i>Cash Flows from Operating Activities</i>                |                |                |                 |                |                |                 |
| Net Income   | \$ 3,153       | \$ 1,912       | \$ 5,570        | \$ 2,953       | \$ 5,139       | \$ 6,235        |
| Depreciation and amortization                              | 1,050          | 1,093          | 1,811           | 1,036          | 2,316          | 2,400           |
| Gain on sale of marketable securities                      | (540)          | 734            | 278             | (55)           | 29             | -               |
| Other than temporary reductions of marketable securities   | -              | 959            | -               | -              | -              | -               |
| Issuance of common stock in exchange for services rendered | 49             | 97             | 145             | 62             | 150            | 150             |
| Decrease in allowance for doubtful accounts                | (41)           | 71             | (75)            | -              | -              | -               |
| Deferred income taxes                                      | (224)          | (509)          | 390             | (290)          | 101            | (500)           |
|  | <u>3,447</u>   | <u>4,356</u>   | <u>8,122</u>    | <u>3,706</u>   | <u>7,736</u>   | <u>8,285</u>    |
| <i>Changes In:</i>   |                |                |                 |                |                |                 |
| Accounts receivable  | (226)          | (627)          | (613)           | (1,781)        | (1,357)        | (291)           |
| Other receivables  | 28             | 3              | (8)             | (93)           | (15)           | (10)            |
| Inventories  | (984)          | 409            | 173             | (858)          | (836)          | 27              |
| Prepaid income taxes                                       | 27             | (116)          | (476)           | 604            | (691)          | (500)           |
| Prepaid expenses and other assets                          | (9)            | (2)            | 10              | (29)           | (10)           | (7)             |
| Accounts payable   | 131            | 666            | 299             | (505)          | 156            | 194             |
| Accrued expenses   | (66)           | 44             | 96              | (83)           | 36             | 71              |
| Net Changes in Working Capital                             | <u>(1,100)</u> | <u>378</u>     | <u>(519)</u>    | <u>(1,435)</u> | <u>(2,717)</u> | <u>(517)</u>    |
| <b>Net cash Provided by Operations</b>                     | <u>2,347</u>   | <u>4,734</u>   | <u>7,603</u>    | <u>2,272</u>   | <u>5,019</u>   | <u>7,768</u>    |
| <i>Cash Flows from Investing Activities</i>                |                |                |                 |                |                |                 |
| Purchase of marketable securities                          | (5,745)        | (5,782)        | (6,157)         | (539)          | -              | -               |
| Sale of marketable securities                              | 7,168          | 5,323          | 6,928           | 1,503          | -              | -               |
| Acquisition of Fresh Made, net of cash acquired            | -              | -              | (11,043)        | -              | -              | -               |
| Purchase of property, plant and equipment                  | <u>(1,825)</u> | <u>(2,157)</u> | <u>(1,766)</u>  | <u>(1,293)</u> | <u>(2,000)</u> | <u>(1,000)</u>  |
| <b>Net cash used in Investing</b>                          | <u>(901)</u>   | <u>(2,616)</u> | <u>(12,037)</u> | <u>(226)</u>   | <u>(2,000)</u> | <u>(1,000)</u>  |
| <i>Cash Flows from Financing Activities</i>                |                |                |                 |                |                |                 |
| Repayment of notes payable                                 | (1,945)        | (1,196)        | (4,004)         | (1,153)        | (2,000)        | (6,000)         |
| Proceeds from note payable                                 | 300            | -              | 9,354           | 250            | 250            | -               |
| Purchase of treasury stock                                 | (753)          | (1,239)        | (906)           | (1,419)        | (1,500)        | -               |
| Checks written in excess of bank balances                  | -              | -              | 343             | 504            | 500            | -               |
| <b>Net cash provided by Financing</b>                      | <u>(2,398)</u> | <u>(2,436)</u> | <u>4,787</u>    | <u>(1,817)</u> | <u>(2,750)</u> | <u>(6,000)</u>  |
| Net change in Cash   | (952)          | (319)          | 353             | 228            | 269            | 768             |
| Cash Beginning of Period                                   | <u>1,548</u>   | <u>596</u>     | <u>277</u>      | <u>630</u>     | <u>630</u>     | <u>899</u>      |
| Cash End of Period   | <u>\$ 596</u>  | <u>\$ 277</u>  | <u>\$ 630</u>   | <u>\$ 859</u>  | <u>\$ 899</u>  | <u>\$ 1,667</u> |

Lifeway Foods, Inc.

Price Chart



Taglich Brothers Current Ratings Distribution



40.51 % Buy 30.38 % Hold 24.05 % Not Rated 5.06 % Sell

| Investment Banking Services for Companies Covered in the Past 12 Months |   |       |
|---|---|-------|
| Rating  | # | %     |
| Buy   | 2 | 8.70% |
| Hold  | 0 | 0     |
| Sell  | 1 | 100%  |
| Not Rated   | 0 | 0     |

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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.**

**Public Companies mentioned in this report:**

|                 |                    |
|-----------------|--------------------|
| Groupe Danone   | (OTC Other: DANYO) |
| 99C Only Stores | (NYSE: NDN)        |

Meaning of Ratings

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.