

# 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: Speculative Buy**

Howard Halpern

**LWAY \$14.45 - (NasdaqNM)**

December 1, 2003

	FYE (12/00)	FYE (12/01)	FYE (12/02)	FYE (12/03) E*	FYE (12/04) E
Revenues (in millions)	\$9.2	\$10.7	\$12.2	<b>\$14.8</b>	<b>\$17.6</b>
Earnings per share (diluted)	\$0.21	\$0.28	\$0.36	<b>\$0.57</b>	<b>\$0.70</b>

52week range	\$18.50 – \$6.12	Fiscal year ends:	December
Shares outstanding	4.22 million	Revenue/shares (TTM)	\$3.35
Trading float	1.18 million	Price/Sales (TTM)	4.55X
Insider and institutional ownership	72.0%	Price/Sales (2004)	3.71X
Tangible Book value/shr <small>a/o 09-30-03</small>	\$3.49	Price/Earnings (TTM)*	31.7X
Price/Book	4.36X	Price/Earnings (2004)	21.8X

\* Excludes a \$0.14 per share gain from the sale of assets and a one-time loss from sale of marketable securities

*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 approximately 45 employees. Web site address is: [www.kefir.com](http://www.kefir.com)*

### **Key investment considerations:**

*We are maintaining our Speculative Buy rating and setting a twelve-month price target of \$17.75 per share based on our earnings estimate for fiscal 2004 and a discounted cash flow analysis. Our previous twelve-month price target was \$15.15 per share.*

*The Company reported 2003 third quarter revenue of \$3.837 million, which was an increase of 24.8% versus \$3.075 million in the same period last year. Net income was \$0.707 million or \$0.17 per diluted share versus \$0.531 million or \$0.12 per diluted share in the third quarter of 2002.*

*Based on results for the first nine months of 2003, we are increasing our revenue estimates to \$14.8 million and \$17.6 million in 2003 and 2004, respectively. Our prior 2003 and 2004 revenue expectations were \$14.7 million and \$17.1 million, respectively.*

*We continue to believe that our revenue forecasts, which call for annual growth in excess of 15%, can be achieved through: 1) The Company's marketing efforts; 2) Increasing acceptance of its organic products; 3) Growth of the La Fruta™ product line for the Hispanic market; and 4) Introduction of new products.*

*\* Please view our disclaimer located on page 8.*

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## ***The Company***

Lifeway Foods, Inc. (LWAY) manufactures a cultured dairy beverage called Kefir and also develops Kefir related products at its two manufacturing facilities in Illinois. Distribution of its products in Illinois are through approximately 1,200 local stores including major retail chains (i.e., Jewel Food Stores, Dominick's Finer Foods, and Whole Foods Market), via ten company owned trucks. Also, the Company distributes its products throughout the United States and to some part of Canada.

Danone Foods, Inc. the U.S. subsidiary of Groupe Danone of Paris, France, has a 20% ownership interest in the Company.

During the third quarter of 2003, the Company expanded its La Fruta™ product line to include "Horchata" and "Tres Leche" flavors. Also, introduced was a spreadable cheese in the "Tres Leche" flavor. La Fruta is sold nationwide through the Save-a-Lot chain and other retail and specialty grocery stores in Hispanic neighborhoods.

### ***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-month period ended September 30, 2003 versus the same period last year:

- Revenue increased to \$3.837 million versus \$3.075 million;
- Operating expenses increased to \$0.871 million versus \$0.750 million;
- EBITDA increased to \$1.232 million versus \$0.942 million;
- Net income was \$0.707 million or \$0.17 per diluted share versus net income of \$0.531 million or \$0.12 per diluted share.

The year-over-year revenue increase of 24.8% was primarily attributable to the Company's advertising program for its various Kefir-based products, which led to growth in sales of existing products. In addition, the expansion of its LaFruta line of drinkable yogurts also contributed to an increase in sales.

Gross margins increased to 50.3% versus 48.4% in the same period last year. The improvement in gross margins resulted from a decrease in raw material costs. Operating expenses, as a percentage of revenue, decreased to 22.7% versus 24.4% in the third quarter of 2002. The decrease in operating expenses, on a percentage basis, was primarily due to increased revenue and controlling costs relative to increased production.

In comparison to the results reported by the Company, Taglich Brothers' estimates called for third quarter revenues of \$3.8 million and net income of \$0.597 million or \$0.14 per diluted share.

### ***Balance Sheet as of September 30, 2003***

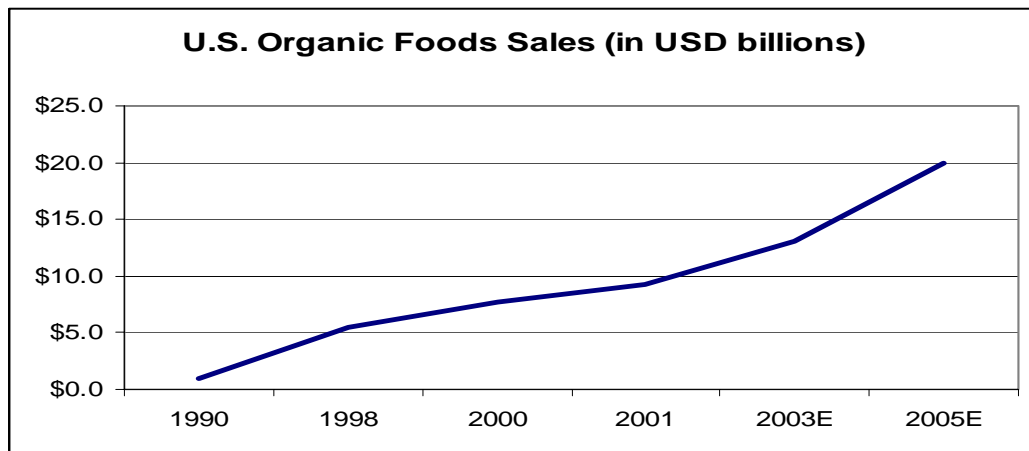
The Company had cash and cash equivalents of \$4.247 million and short-term marketable securities of \$6.272 million. This compares to cash and cash equivalents of \$2.731 million and short-term marketable securities of \$4.172 million as of December 31, 2002. Working capital was \$12.028 million versus \$8.561 million in 2002. The Company's long-term liabilities stood at \$0.478 million. We believe that LWAY will be able to fund its sales growth from 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 business.

### **Industry and Competition**

It is estimated that Lifeway Foods' target market in the functional and probiotic foods segment of the Food Industry was \$23 billion in 2002. 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.

In addition, the Company's organic products are targeting a market that generated approximately \$9.0 billion of sales in 2002, according to Marketreserach.com. The chart below indicates the growth potential for this segment:



Source: Organic Trade Association; Natural Marketing Institute; Maketreserach.com

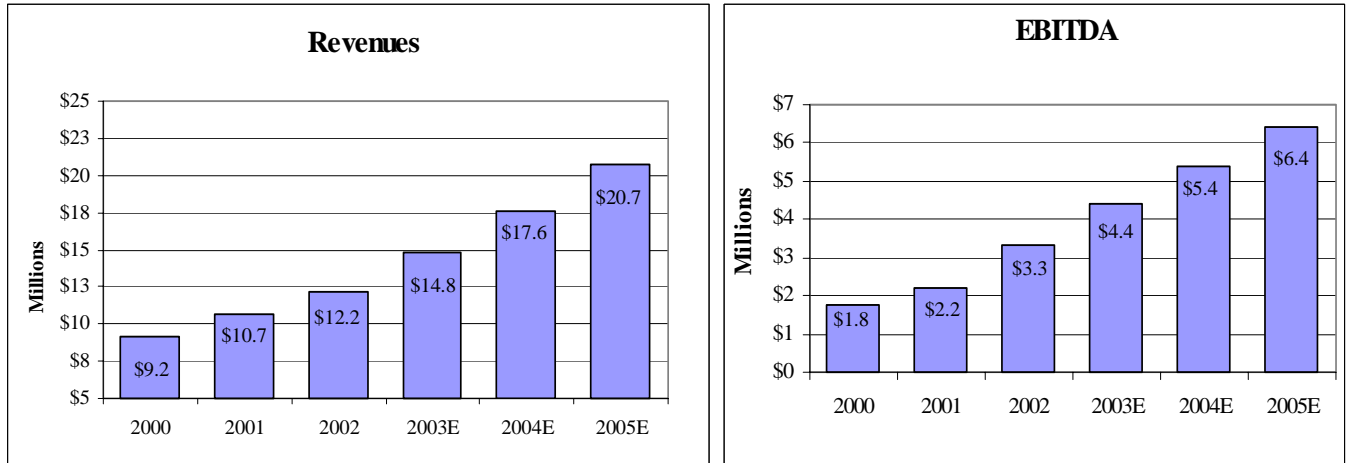
### **Outlook**

We believe annual revenue growth will exceed 15%; therefore, revenues should reach \$14.8 million in 2003 and \$17.6 million in 2004, from \$12.212 million in 2002. Our revenue forecasts are based on:

- Consumers increased acceptance of the Company's products;
- 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) and in national magazines (i.e., Self, Shape, and Men's Fitness); and
  - Sponsoring and participating in various local sporting events around the country and exhibiting at trade shows (ex: The Fancy Food Show held in New York during July 2003);
- The Company building on its current distribution channel, which includes regional supermarket chains and/or regional super-center type stores;
- Introduction of new packaging for the Company's non-fat Kefir products; and
- Expansion of its La Fruta Product line.

We believe that as a result of the projected revenue growth, the Company will be able to leverage operating efficiencies at its two owned manufacturing facilities. We estimate that gross margins will improve to 49.87% and 50.37% in 2003 and 2004, respectively, from 44.8% in 2002. Also, SG&A expenses, as a percentage of revenues, should approximate 24.59% and 23.59% in 2003 and 2004, respectively.

The following chart shows our revenue and EBITDA projections:



Source: Company Filings and Taglich Brothers Estimates

Based on our expectations for revenues and expenses and excluding the non-recurring gains from asset sales that occurred in the first quarter of 2003, we anticipate net income of \$2.405 million or \$0.57 per diluted share in 2003 and \$2.995 million or \$0.70 per diluted share in 2004.

The potential exists for Lifeway to take a fourth quarter charge for unrealized losses from its portfolio of marketable securities. If this were to occur, it would be to mitigate the tax liability associated with the non-recurring gain in the first quarter of 2003. Our estimates exclude all non-recurring gains and losses.

## ***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.

### ***Corporate Governance***

Corporate governance may be an issue facing the Company 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 Company 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 the Company 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 the first eleven months of 2003 has increased to 4,513 shares from 1,943 shares in 2002. Investors need to be aware that liquidity risks in the microcap market are characterized by low trading volume, high volatility of the stock price, and a wide bid-ask spread.

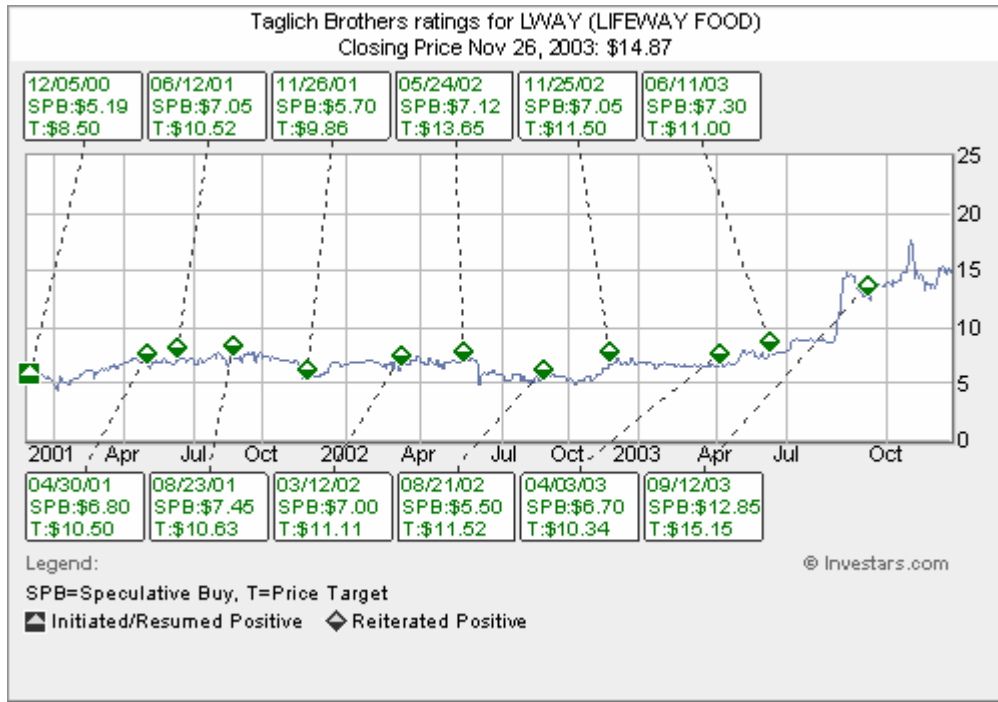
**Conclusion**

We are maintaining our coverage of Lifeway Foods, Inc. with a Speculative Buy recommendation and setting a twelve-month price target of \$17.75 per share. Our previous twelve-month price target was \$15.15 per share. Our price target is based on our 2004 earnings per share estimate and EBITDA forecasts, which is used as a proxy for cash flow.

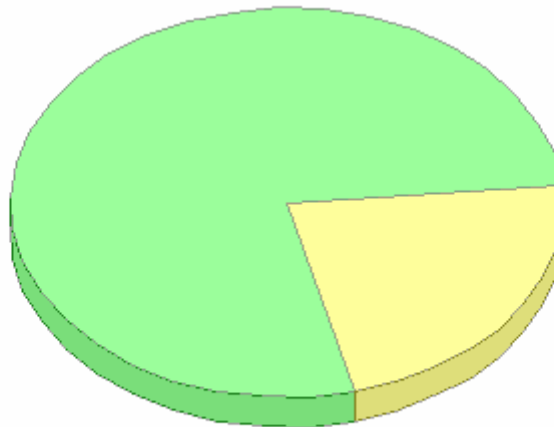
We estimate that the Company will earn \$0.70 per diluted share in 2004. Based on our models, we are forecasting EBITDA of \$4.424 million, \$5.380 million, and \$6.395 million in 2003, 2004, and 2005, respectively.

We obtained our price target by averaging the following valuation models and discounted them by 25% to account for microcap risk and Company specific risks mentioned earlier:

- A 34X P/E based on the Company's net income compound annual growth rate between 2000 and 2004, applied to our earnings per share estimate of \$0.70 for 2004; and
- A discounted cash flow model, using EBITDA as a proxy for cash flow and a 9.7% discount factor using the estimated five year growth rate for the Food Processing Industry according to [multexinvestor.com](http://multexinvestor.com) as of 11/17/03.



Taglich Brothers Current Ratings Distribution



77.55 % Buy 22.45 % Hold

### 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.

**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. 2000	Dec. 2001	Dec. 2002	Mar. 2003	Jun. 2003	Sept. 2003
	Full Year	Full Year	Full Year	1st Qtr	2nd Qtr	3rd Qtr
<b>ASSETS</b>						
Current assets:						
Cash and cash equivalents	\$ 1,437	\$ 937	\$ 2,732	\$ 2,788	\$ 3,599	\$ 4,247
Marketable securities	4,850	5,755	4,172	5,644	6,303	6,272
Accounts receivable, net	1,182	1,317	1,435	1,731	1,731	1,878
Other receivables	-	53	60	58	64	58
Inventories	920	801	721	774	794	875
Prepaid expenses and other assets	-	34	1	4	1	1
Deferred income taxes	<u>167</u>	<u>561</u>	<u>692</u>	<u>440</u>	<u>286</u>	<u>240</u>
<b>Total current assets</b>	<b><u>8,556</u></b>	<b><u>9,456</u></b>	<b><u>9,813</u></b>	<b><u>11,438</u></b>	<b><u>12,778</u></b>	<b><u>13,572</u></b>
Property, plant and equipment, net	5,020	5,021	4,472	3,903	3,906	3,805
<b>Total assets</b>	<b><u>\$ 13,575</u></b>	<b><u>\$ 14,477</u></b>	<b><u>\$ 14,285</u></b>	<b><u>\$ 15,342</u></b>	<b><u>\$ 16,684</u></b>	<b><u>\$ 17,377</u></b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Current liabilities:						
Current maturities of notes payable	706	90	31	31	30	30
Margin account	-	432	-	-	-	-
Accounts payable	518	543	639	698	649	771
Accrued expenses	242	164	184	155	183	94
Taxes payable	<u>65</u>	<u>145</u>	<u>398</u>	<u>250</u>	<u>693</u>	<u>647</u>
<b>Total current liabilities</b>	<b><u>1,531</u></b>	<b><u>1,374</u></b>	<b><u>1,252</u></b>	<b><u>1,134</u></b>	<b><u>1,555</u></b>	<b><u>1,543</u></b>
Long-term liabilities	529	1,116	500	493	486	478
Deferred income taxes	376	436	453	408	423	399
<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
Stock subscription receivable	(15)	(15)	(15)	(15)	(15)	(15)
Retained earnings	4,851	6,072	7,600	8,594	9,285	9,992
Accumulated other comprehensive income, net of tax	(205)	(729)	(1,335)	(1,101)	(880)	(849)
Treasury stock, at cost	<u>-</u>	<u>(287)</u>	<u>(680)</u>	<u>(680)</u>	<u>(680)</u>	<u>(680)</u>
<b>Total stockholders' equity</b>	<b><u>11,140</u></b>	<b><u>11,550</u></b>	<b><u>12,080</u></b>	<b><u>13,307</u></b>	<b><u>14,219</u></b>	<b><u>14,957</u></b>
<b>Total liabilities and stockholders' equity</b>	<b><u>\$ 13,575</u></b>	<b><u>\$ 14,477</u></b>	<b><u>\$ 14,285</u></b>	<b><u>\$ 15,342</u></b>	<b><u>\$ 16,684</u></b>	<b><u>\$ 17,377</u></b>
SHARES OUT	4,318	4,269	4,218	4,218	4,218	4,218

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

	<u>FY2000</u>	<u>FY2001</u>	<u>FY2002</u>	<u>FY2003E*</u>	<u>FY2004E</u>
Revenue	\$ 9,177	\$ 10,684	\$ 12,212	\$ 14,797	\$ 17,550
Cost of goods sold	<u>5,308</u>	<u>6,449</u>	<u>6,744</u>	<u>7,418</u>	<u>8,710</u>
<b>Gross Profit</b>	3,869	4,235	5,468	7,379	8,840
<i>Gross Margins</i>	42.16%	39.64%	44.78%	49.87%	50.37%
Sales, general and administrative	<u>2,707</u>	<u>2,785</u>	<u>2,891</u>	<u>3,639</u>	<u>4,140</u>
<i>EBITDA</i>	1,772	2,216	3,385	4,424	5,380
<b>Operating Income</b>	1,162	1,450	2,578	3,740	4,700
<i>Operating Margin</i>	12.66%	13.57%	21.11%	25.28%	26.78%
Other Income (Expense)					
Interest income	369	235	187	120	120
Interest expense	(93)	(93)	(75)	(31)	(40)
Gain on sale of marketable securities	15	220	18	53	-
Other than temporary reduction of marketable securities	-	-	(236)	(347)	-
Gain on sale of assets	<u>-</u>	<u>-</u>	<u>-</u>	<u>1,246</u>	<u>-</u>
Total Other Income (Expense)	<u>291</u>	<u>362</u>	<u>(105)</u>	<u>1,042</u>	<u>80</u>
<b>Pre-Tax Income</b>	1,453	1,812	2,472	4,781	4,780
<i>Pre-Tax Margins</i>	15.84%	16.96%	20.24%	32.31%	27.24%
Income Tax Expense (Benefit)	<u>526</u>	<u>591</u>	<u>943</u>	<u>1,783</u>	<u>1,785</u>
<i>Tax Rate</i>	36.21%	32.59%	38.16%	37.29%	37.34%
<b>Net Income</b>	<u>\$ 927</u>	<u>\$ 1,221</u>	<u>\$ 1,529</u>	<u>\$ 2,998</u>	<u>\$ 2,995</u>
<b>EPS -- Fully Diluted</b>	<u>\$ 0.21</u>	<u>\$ 0.28</u>	<u>\$ 0.36</u>	<u>\$ 0.71</u>	<u>\$ 0.70</u>
Avg Shares Out-Fully Diluted	<u>4,318</u>	<u>4,318</u>	<u>4,266</u>	<u>4,220</u>	<u>4,270</u>
Percent of Revenue					
Cost of Revenues	57.84%	60.36%	55.22%	50.13%	49.63%
Sales, General and Administrative expenses	29.50%	26.07%	23.67%	24.59%	23.59%
<b>YEAR / YEAR GROWTH</b>					
Total Revenues	16.05%	16.42%	14.30%	21.16%	18.61%
Operating Income	9.12%	24.77%	79.34%	45.09%	25.67%
Pre-Tax Income	35.86%	24.67%	36.47%	93.41%	-0.03%
Net Income	35.85%	31.75%	25.21%	96.13%	-0.11%

\* Excluding the \$1.246 million gain on sale of assets and \$0.347 million other than temporary reduction of marketable securities our EPS estimate for 2003 is \$0.57 per fully diluted share.

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

	<u>Q1(03/02)</u>	<u>Q2 (06/02)</u>	<u>Q3 (09/02)</u>	<u>Q4 (12/02)</u>	<u>FY2002</u>
Revenue	\$ 2,888	\$ 3,003	\$ 3,075	\$ 3,247	\$ 12,212
Cost of goods sold	<u>1,523</u>	<u>1,761</u>	<u>1,586</u>	<u>1,874</u>	<u>6,744</u>
<b>Gross Profit</b>	1,365	1,242	1,488	1,373	5,468
<i>Gross Margins</i>	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	<u>649</u>	<u>734</u>	<u>750</u>	<u>758</u>	<u>2,891</u>
<i>EBITDA</i>	920	707	942	816	3,385
<b>Operating Income</b>	716	508	739	615	2,578
<i>Operating Margin</i>	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	<u>-</u>	<u>-</u>	<u>-</u>	<u>(236)</u>	<u>(236)</u>
Total Other Income (Expense)	<u>53</u>	<u>37</u>	<u>45</u>	<u>(241)</u>	<u>(105)</u>
<b>Pre-Tax Income</b>	769	545	783	374	2,472
<i>Pre-Tax Margins</i>	26.64%	18.16%	25.48%	11.52%	20.24%
Income Tax Expense (Benefit)	<u>322</u>	<u>194</u>	<u>252</u>	<u>176</u>	<u>943</u>
<i>Tax Rate</i>	41.82%	35.52%	32.18%	47.05%	38.16%
<b>Net Income</b>	<u>\$ 448</u>	<u>\$ 352</u>	<u>\$ 531</u>	<u>\$ 198</u>	<u>\$ 1,529</u>
<b>EPS -- Fully Diluted</b>	<u>\$ 0.10</u>	<u>\$ 0.08</u>	<u>\$ 0.12</u>	<u>\$ 0.05</u>	<u>\$ 0.36</u>
Avg Shares Out-Fully Diluted	<u>4,270</u>	<u>4,269</u>	<u>4,269</u>	<u>4,255</u>	<u>4,266</u>
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%
<b>YEAR / YEAR GROWTH</b>					
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)E	FY2003E*
Revenue	\$ 3,309	\$ 3,776	\$ 3,837	\$ 3,875	\$ 14,797
Cost of goods sold	<u>1,826</u>	<u>1,734</u>	<u>1,908</u>	<u>1,950</u>	<u>7,418</u>
<b>Gross Profit</b>	1,483	2,042	1,929	1,925	<b>7,379</b>
<i>Gross Margins</i>	44.81%	54.08%	50.28%	49.68%	<b>49.87%</b>
Operating Expenses:					
Sales, general and administrative	845	938	871	985	<b>3,639</b>
Total Operating Expenses	<u>845</u>	<u>938</u>	<u>871</u>	<u>985</u>	<u><b>3,639</b></u>
<b>EBITDA</b>	803	1,279	1,232	1,110	<b>4,424</b>
<b>Operating Income</b>	638	1,104	1,058	940	<b>3,740</b>
<i>Operating Margin</i>	19.28%	29.23%	27.58%	24.26%	<b>25.28%</b>
Other Income (Expense)					
Interest income	33	37	25	25	<b>120</b>
Interest expense	(8)	(8)	(8)	(8)	<b>(31)</b>
	-	16	37	-	<b>53</b>
Other than temporary reduction of marketable securities	(347)	-	-	-	<b>(347)</b>
Gain on sale of assets	<u>1,246</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u><b>1,246</b></u>
Total Other Income (Expense)	<u>926</u>	<u>45</u>	<u>54</u>	<u>17</u>	<u><b>1,042</b></u>
<b>Pre-Tax Income</b>	1,564	1,149	1,112	957	<b>4,781</b>
<i>Pre-Tax Margins</i>	47.26%	30.42%	28.99%	24.70%	<b>32.31%</b>
Income Tax Expense (Benefit)	<u>570</u>	<u>457</u>	<u>405</u>	<u>350</u>	<u><b>1,783</b></u>
<i>Tax Rate</i>	36.47%	39.83%	36.45%	36.57%	<b>37.29%</b>
<b>Net Income</b>	<u>\$ 993</u>	<u>\$ 691</u>	<u>\$ 707</u>	<u>\$ 607</u>	<u><b>\$ 2,998</b></u>
<b>EPS -- Fully Diluted</b>	<u>\$ 0.24</u>	<u>\$ 0.16</u>	<u>\$ 0.17</u>	<u>\$ 0.14</u>	<u><b>\$ 0.71</b></u>
Avg Shares Out-Fully Diluted	<u>4,218</u>	<u>4,218</u>	<u>4,218</u>	<u>4,225</u>	<u><b>4,220</b></u>
Percent of Revenue					
Cost of Revenues	55.19%	45.92%	49.72%	50.32%	50.13%
Sales, General and Administrative expenses	25.53%	24.85%	22.70%	25.42%	24.59%
<b>YEAR / YEAR GROWTH</b>					
Total Revenues	14.57%	25.75%	24.78%	19.35%	21.16%
Operating Income	-10.90%	117.31%	43.28%	52.82%	45.09%
Pre-Tax Income	103.26%	110.61%	41.98%	155.82%	93.41%
Net Income	121.93%	96.52%	33.03%	206.41%	96.13%

\* Excluding the \$1.246 million gain on sale of assets and \$0.347 million other than temporary reduction of marketable securities our EPS estimate for the first quarter and full year of 2003 is \$0.10 and \$0.57 per fully diluted share, respectively.

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

	<u>Q1(03/04)E</u>	<u>Q2 (06/04)E</u>	<u>Q3 (09/04)E</u>	<u>Q4 (12/04)E</u>	<u>FY2004E</u>
Revenue	\$ 3,975	\$ 4,475	\$ 4,525	\$ 4,575	\$ 17,550
Cost of goods sold	<u>2,125</u>	<u>2,075</u>	<u>2,185</u>	<u>2,325</u>	<u>8,710</u>
<b>Gross Profit</b>	1,850	2,400	2,340	2,250	<b>8,840</b>
<i>Gross Margins</i>	46.54%	53.63%	51.71%	49.18%	<b>50.37%</b>
Operating Expenses:					
Sales, general and administrative	965	1,025	1,050	1,100	<b>4,140</b>
Total Operating Expenses	<u>965</u>	<u>1,025</u>	<u>1,050</u>	<u>1,100</u>	<u><b>4,140</b></u>
<i>EBITDA</i>	1,055	1,545	1,460	1,320	<b>5,380</b>
<b>Operating Income</b>	885	1,375	1,290	1,150	<b>4,700</b>
<i>Operating Margin</i>	22.26%	30.73%	28.51%	25.14%	<b>26.78%</b>
Other Income (Expense)					
Interest income	30	30	30	30	<b>120</b>
Interest expense	<u>(10)</u>	<u>(10)</u>	<u>(10)</u>	<u>(10)</u>	<u><b>(40)</b></u>
Total Other Income (Expense)	<u>20</u>	<u>20</u>	<u>20</u>	<u>20</u>	<u><b>80</b></u>
<b>Pre-Tax Income</b>	905	1,395	1,310	1,170	<b>4,780</b>
<i>Pre-Tax Margins</i>	22.77%	31.17%	28.95%	25.57%	<b>27.24%</b>
Income Tax Expense (Benefit)	<u>330</u>	<u>550</u>	<u>480</u>	<u>425</u>	<u><b>1,785</b></u>
<i>Tax Rate</i>	36.46%	39.43%	36.64%	36.32%	<b>37.34%</b>
<b>Net Income</b>	<u>\$ 575</u>	<u>\$ 845</u>	<u>\$ 830</u>	<u>\$ 745</u>	<u><b>\$ 2,995</b></u>
<b>EPS -- Fully Diluted</b>	<u>\$ 0.14</u>	<u>\$ 0.20</u>	<u>\$ 0.19</u>	<u>\$ 0.17</u>	<u><b>\$ 0.70</b></u>
Avg Shares Out-Fully Diluted	<u>4,255</u>	<u>4,265</u>	<u>4,275</u>	<u>4,285</u>	<u><b>4,270</b></u>
Percent of Revenue					
Cost of Revenues	53.46%	46.37%	48.29%	50.82%	49.63%
Sales, General and Administrative expenses	24.28%	22.91%	23.20%	24.04%	23.59%
YEAR / YEAR GROWTH					
Total Revenues	20.14%	18.52%	17.93%	18.06%	18.61%
Operating Income	38.72%	24.57%	21.92%	22.34%	25.67%
Pre-Tax Income	-42.12%	21.46%	17.77%	22.26%	-0.03%

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

	<u>FY2000A</u>	<u>FY2001A</u>	<u>FY2002A</u>	<u>9 Mos. 2003A</u>
<i>Cash Flows from Operating Activities</i>				
Net Income	\$ 927	\$ 1,221	\$ 1,529	\$ 2,391
Depreciation and amortization	610	777	808	515
Gain on sale of marketable securities	(15)	(250)	(18)	293
Other than temporary reductions of marketable securities	-	-	236	(1,246)
Provision for doubtful accounts	-	15	-	-
Deferred income taxes	<u>150</u>	<u>48</u>	<u>(65)</u>	<u>31</u>
	1,672	1,812	2,490	1,984
<i>Changes In:</i>				
Accounts receivable	(216)	(150)	(119)	(443)
Other receivables	57	(53)	(8)	3
Inventories	(76)	119	80	(155)
Prepaid expenses and other assets	-	(34)	32	0
Accounts payable	(38)	26	96	132
Accrued expenses	50	(4)	20	(89)
Taxes payable	65	80	253	249
Net Changes in Working Capital	<u>(158)</u>	<u>(15)</u>	<u>355</u>	<u>(303)</u>
<b>Net cash Provided by Operations</b>	<u>1,514</u>	<u>1,797</u>	<u>2,845</u>	<u>1,681</u>
<i>Cash Flows from Investing Activities</i>				
Purchase of marketable securities	(8,808)	(9,247)	(3,316)	(6,914)
Sale of marketable securities	5,202	7,687	4,025	5,371
Sales of Assets	-	-	-	1,713
Change in margin account	75	357	(432)	-
Purchase of property, plant and equipment	<u>(1,096)</u>	<u>(713)</u>	<u>(259)</u>	<u>(314)</u>
<b>Net cash used in Investing</b>	<u>(4,627)</u>	<u>(1,916)</u>	<u>17</u>	<u>(143)</u>
<i>Cash Flows from Financing Activities</i>				
Repayment of notes payable	(91)	(94)	(675)	(23)
Purchase of treasury stock	-	(287)	(393)	-
Stock issuance costs	-	-	-	-
<b>Net cash provided by Financing</b>	<u>(91)</u>	<u>(381)</u>	<u>(1,068)</u>	<u>(23)</u>
Net change in Cash	(3,204)	(500)	1,795	1,515
Cash Beginning of Period	<u>4,641</u>	<u>1,437</u>	<u>936</u>	<u>2,732</u>
Cash End of Period	<u>\$ 1,437</u>	<u>\$ 936</u>	<u>\$ 2,731</u>	<u>\$ 4,247</u>