

# Taglich Brothers, Inc.

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## Initial Research Report

Rating: Speculative Buy

Lifeway Foods, Inc.

Howard Halpern

December 5, 2000

LWAY \$5.19 - (NasdaqNM)

	FYE (12/98)	FYE (12/99)	FYE (12/00)	FYE (12/01)
Revenues (in millions)	\$6.8	\$7.9	\$9.3	\$10.9
Earnings per share (diluted)	\$0.20	\$0.17	\$0.20	\$0.25
52week range	8.00 – 4.25	Fiscal year ends:	December	
Shares outstanding	4.32 million	Revenue/shares (2000)	\$2.14	
Trading float	1.6 million	Price/Sales (2000)	2.4X	
Insider ownership	2.7 million	Price/Sales (2001)	2.1X	
Tangible Book value/shr <small>a/o 9-30-00</small>	\$2.53	Price/Earnings (2000)	25.9X	
Price/Book	2.05X	Price/Earnings (2001)	20.8X	

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](http://www.kefir.com)

### Key investment considerations:

- We are initiating coverage of Lifeway Foods, Inc. (LWAY), with a Speculative Buy recommendation and a 12-month price target of \$8.50. We believe this equity has solid upside potential based on our 2001 earnings estimate and discounted cash flow model.
- Lifeway offers a unique drinkable product similar to but distinct from Yogurt called Lifeway Kefir. Kefir is a cultured dairy beverage that is also used as a base to produce various other products, such as Lifeway Farmer Cheese, SoyTreat™ and Basics Plus™.
- Most of Lifeway's products are functional foods. The functional food market, depending on the definition, ranges somewhere between \$15 to \$130 million (see Industry Overview). We believe the functional foods market, which is likely to expand, provides the Company with excellent growth opportunities.
- Danone Foods, Inc., the U.S. subsidiary of Groupe Danone of Paris, France, owns a 20% interest in Lifeway Foods. The two companies also signed a support agreement that allows management to utilize Danone's distribution channels throughout the United States.
- We expect annual revenue growth of at least 17% and earnings growth of at least 22%, annually over the next three years. We believe this will be accomplished through Lifeway's marketing program, which is educating American consumers as to the potential health benefits of their products, and as management utilizes the support agreement with Danone Foods.

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## ***The Company***

Lifeway Foods, Inc. was founded in 1986 and is based in Morton Grove, Illinois. The Company began by manufacturing a cultured dairy beverage called kefir for the American market. Today, the Company manufactures and develops kefir and kefir related products at two local manufacturing facilities. The 50,000-square-foot facility in Morton Grove is the largest kefir manufacturing facility in the United States. The dairy products they produce are considered specialty functional dairy foods for health-conscious consumers.

The Company has penetrated the consumer market in the U.S. by marketing their kefir and related products to health conscious consumers. They intend to broaden their consumer base in the U.S. by directing marketing efforts toward the mass-market and young kids. The effort to broaden their sales began in April of 1999, just a few months prior to completing a support agreement with Danone Foods, Inc., the U.S. subsidiary of Groupe Danone of Paris, France. This support agreement allows Lifeway Foods to access Danone's brokers and distributors throughout the United States. Danone Foods is the beneficial owner of 20% of the outstanding shares of Lifeway's common stock after acquiring shares from the Company and through private transactions since September 1999.

It should also be noted that during late 1992 the Company formed a wholly owned subsidiary corporation called LFI Enterprises, Inc. This subsidiary operates a "European" theme supper club facility, known as "Moscow Nites."

## ***Kefir***

What is kefir, and how can it potentially succeed within the United States? Kefir, which originated centuries ago in Eastern Europe, is a cultured milk drink with a slightly acidic taste. It is made with probiotic cultures obtained from the kefir grain, which is a complex and specific mixture of bacteria, that is held together by a polysaccharide matrix (an array of starch and cellulose molecules acting as a binding substance). The Company's mainstay product is their drinkable kefir, a milk-based cultured drink that is similar to, but distinct from, yogurt and has a consistency very similar to a milkshake.

The Company's drinkable kefir products are sold in several flavors under the name Lifeway Kefir and SoyTreat™. SoyTreat™ is similar to Lifeway Kefir except that it is made from soy instead of milk. They also sell several types of farmers cheese under the name Lifeway Farmer's Cheese and a sweet dessert cheese product under the name Sweet Kiss, which is similar in consistency to cream cheese. These products are primarily distributed throughout the United States, with a small amount being distributed internationally, primarily in Canada and Eastern Europe.

Their drinkable products are intended for use as a breakfast meal, snack, or as a base for lower-calorie dressings, dips, soups or sauces. Lifeway's drinkable products can be used as a milk substitute for children, pregnant women, nursing mothers. These products have shown the potential to help some people with digestive problems especially in reestablishing necessary intestinal microflora, which may have been destroyed by antibiotic or other medical treatment.

Lifeway Kefir, which contains seven active "friendly" microorganisms and is probiotic in nature because it promotes the growth of those microorganisms naturally, is also a good source of calcium, protein, minerals, and vitamins (i.e. B-complex vitamins). It is highly digestible due to its acidity and enzymes, which stimulates digestion of other foods. There are indications from limited studies that kefir has the ability to stimulate protein digestion and appetite, decrease cholesterol content in the blood, improve salivation and excretion of stomach and pancreatic enzymes. Numerous Naturopathic doctors (those who rely on natural remedies) consider kefir to be the best remedy for digestive troubles because it has a very low curd tension (the curd breaks up very easily into small particles). In addition, because the fermentation process produces a less sour tasting product than yogurt, less sugar is required to make a desirable product; therefore the end product contains fewer calories.

## ***Products***

Lifeway Foods, markets their products by emphasizing the verifiable nutritional characteristics, purity, and digestibility of their kefir and kefir-based products. Management has been able to market the world's first line of Fat Free Kefir and Fat Free Farmer Cheese in accordance with America's dietary trend to lower calories, fat and cholesterol intake.

### *Product Lines*

**Lifeway Kefir**, the Company's biggest revenue producing product, is available in various flavors, including - plain (regular and low-fat), raspberry, blueberry, strawberry, cherry, peach, banana-strawberry, cappuccino, chocolate and vanilla. This product is sold in the dairy section of health food stores and supermarkets across the country and sales volume should not vary throughout the year.

**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. This cheese is primarily composed of curds that provide a slight granular texture. The Company sells this product in the following varieties: regular, low fat, fat free, pressed, or as a sweet mixture with golden raisins called Sweet Kiss. The fruit sugar-flavored Sweet Kiss product is a cream cheese-like spread, which is intended to be used as a dessert spread or frosting. Lifeway Farmers Cheese can be used as a substitute for cream or ricotta cheese.

**SoyTreat™** is the world's first soy based kefir. The Company believes sales of this product will grow because of the health benefits related to soy based products. The product is made from organic soymilk, which is derived from non-genetically modified soybeans. SoyTreat™ can be consumed by people that desire the benefits of kefir, that are lactose intolerant, or by people that eat no animal products at all. We believe this product will gain acceptance by consumers especially as American consumers become aware of the potential health benefits of soy based products. Some of the benefits of soy are:

- Low in saturated fat, which can reduce a persons risk of heart disease;
- Can promote healthy cholesterol levels, stabilize blood sugar levels and burn body fat;
- Can help women in the area of bone loss, as it contains calcium.

**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 fraction of a dairy cow's 'first milk' or colostrum. It is loaded with immune-enhancing antibodies. Some research indicates that colostrum can have health benefits for those with a compromised immune system, adults and older children. The Company possesses exclusive worldwide rights to the patent for Basics Plus™ through a sub-license agreement with GalaGen, the exclusive supplier of Proventra™.

Lifeway Foods also sells a kefir starter through their Web site. It is a powdered form of kefir that is sold in envelope packets and allows consumers to make their own drinkable kefir by just adding milk.

## ***Distribution***

The Company distributes their products to over 7,000 stores in the United States, using verbal distribution arrangements with various wholesale distributors. The Company believes that these verbal distribution arrangements allow for the necessary latitude to expand into new areas and markets and establish new relationships with distributors on an ongoing basis. In Lifeway's home state of Illinois, they own and operate nine trucks that distribute their 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, Russia and the Ukraine.

The primary method for distribution in the United States is, through wholesale distributors who distribute the product to their retail accounts. The Company believes that its pricing is competitive with the prices generally paid by distributors for similar products. The Company prefers this method of distribution because it serves the needs of each retail store and ensures consistency and quality of product handling, quality control, flavor selection, and retail display. Under the distribution arrangements, each distributor must meet certain prescribed product handling, service and administrative requirements. These requirements include:

- Frequency of delivery;
- Replacement of damaged, old or substandard packages;
- Delivery of products directly to the refrigerated case in the retail store.

### ***Industry Overview***

The Food Industry in the United States has revenues that exceed \$500 billion a year. Functional and probiotic foods combined, 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. In 1998, the market was estimated to be approximately \$134 billion. There can be differences in the working definition of functional foods, but in general the American Dietetic Association considers functional foods to be – a modified food or ingredient that provides health benefits beyond the nutrition they contain. Using this definition the annual market for foods designed to provide specific medical benefits is estimated to be between \$10 billion to \$20 billion. Therefore depending on the definition, Lifeway Foods' target market ranges from \$15 billion to \$134 billion.

The functional food segment is the fastest growing area of the food industry, according to a report published by Sloan Trends & Solutions, a Palm Beach Florida based consultant. One reason for this growth is that nutrition is being perceived as a tool for disease prevention and the self-treatment of various health concerns. Also, contributing to growth are an aging population and the increase in disposable income. It is estimated that about 50% of U.S. shoppers are either highly or moderately involved in self-care, this translates into about 50 million consumers who might potentially purchase a functional food. We believe the Company is well positioned to take advantage of this growing market.

Traditionally, organic and natural products could only be found in health food stores, however today, mainstream supermarkets are attempting to meet the needs of consumers by offering a wide range of health foods, within their stores. 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. The store within the store concept should be helpful to Lifeway Foods as they can position their products in the health food section of a national or regional supermarket chain. In order to obtain maximum consumer coverage, Lifeway may place their products in both the regular dairy case and the designated health food section of a supermarket.

### ***Strategy***

Lifeway Foods is at the forefront of the specialty dairy and functional foods market. We believe that the distinctiveness of their products will provide management with a strategic advantage as they pursue their marketing and distribution efforts. We believe those efforts should lead to market penetration and expanded distribution opportunities.

**Marketing:** The Company's near-term focus is on the promotion of the verifiable nutritional characteristics, and the purity and taste of their kefir and kefir-based 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, they use newspaper and magazine advertising to provide educational information on their products. This information is intended to show consumers that the ingredient(s) used to manufacture their products may be beneficial to a person's overall health.

Also, the Company will attempt to gain further exposure through participation in various trade and consumer sampling shows, inside store demonstrations throughout the U.S, through the Internet, and catalog advertising.

**Distribution:** The Company has over fifty distributors nationwide and in certain large markets (i.e. East Coast), the Company has a higher concentration of distributors. In addition, the Company has five international distributors representing such regions such as Eastern Europe, Asia, and the Middle East. In the Chicago region the Company has their 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. The food chains will be far more profitable outlets than delicatessens, small groceries and health food stores. We believe the support agreement entered into with Danone Foods, will go along way in aiding the Company's effort to gain access to supermarket chains across the United States. The five-year agreement will allow Lifeway Foods access to Danone's brokers and distributors throughout the United States.

Management's growth strategy is to educate consumers and make selective acquisitions that will allow for a broadening of their potential customer base. The successful introduction of the Company's dietary supplement Lifeway Basics Plus™, as well as Lifeway SoyTreat™, are recent examples of products that can enlarge the Company's name recognition among the shopping public. We believe that any increase in public awareness will potentially lead to new mass-market consumers in the United States. Also, we believe that management will attempt to expand through selective acquisitions or alliances of compatible ingredients, product lines or businesses. The Company has been successful in acquiring not only a specific ingredient (Proventra™) to create a new product called Basics Plus™, but shelf space, which is of immense value in the food and dairy industry.

### ***Management Team***

**Michael Smolyansky – Chief Executive Officer, Chief Financial Officer, President, Treasurer, and Director:** Michael Smolyansky has been Chief Executive Officer, Chief Financial Officer, President, Treasurer and a Director of the Company since its inception in 1986. His prior experience was as a Project Engineer and Department Manager of E.J. Littell Machine Co., of Chicago, Illinois, where his primary responsibility was for the design of material handling equipment, between 1976 - 1985. Mr. Smolyansky is a graduate of the Kiev Institute of Technology (M.S., Mechanical Engineering, 1971).

**Valeriy Nikolenko – Vice President-Production and Secretary:** Vaeriy Nikolenko has been Secretary of the Company since 1993 and Vice President-Production since January 1996. He was employed from 1992 - 1993 as an electronic technician in the United States. He also served as Department Manager for a government controlled design bureau in Kiev, between 1982 - 1992. Mr. Nikolenko is a graduate of the Kiev Institute of Civil Aviation (M.S., Electronic Engineering, 1969).

**Julie Smolyansky – Director of Sales and Marketing:** Julie Smolyansky has been Director of Sales and Marketing since September 1998, she is also the daughter of Michael Smolyansky. Ms. Smolyansky is a graduate of the University of Illinois (B.A., 1996), where she studied effects of advertising and cultural influences on consumer dieting behavior. Currently, she is also pursuing a M.B.A. at the Stuart Graduate School of Business at the Illinois Institute of Technology.

**Thomas Kunz – Director:** Thomas Kunz has been a director of the Company since November 1999. Mr. Kunz was designated as a director of the Company pursuant to the terms and conditions of a Stock Purchase Agreement and a Stockholders' Agreement between the Company and Danone Foods, Inc. His current position is as the President and Chief Executive Officer of The Dannon Company, Inc., an affiliate of Danone. In his present position, he has strategic and direct responsibilities for dairy products in the U.S. and Canada as well as responsibility for desserts, worldwide. Mr. Kunz graduated from the University of St. Geller in Switzerland with a MBA degree in economics.



### ***Important Developments***

May 24, 2000 – Lifeway Foods, Inc. common stock began trading on the Nasdaq National Market System with the Company's symbol remaining LWAY.

October 6, 1999 – Lifeway Foods, Inc. announced that Danone Groupe of Paris, France, through its United States holding Company, acquired a 15% common equity stake (the stake rose to 20% in December '99) in Lifeway Foods from the Company and certain shareholders in privately negotiated non-market transactions. The price paid to Lifeway Foods was \$10 per share of common stock.

### ***Recent Financials***

For the nine-months ending September 30, 2000 versus the nine-month period ending September 30, 1999:

- Revenues increased to \$6.8 million versus \$5.9 million;
- Gross profit as a percentage of revenues decreased to 48.8% from 52.0%;
- Total expenses increased to \$2.6 million from \$1.8 million;
- Net income was \$0.649 million or \$0.15 per share versus a net income of \$0.724 million or \$0.19 per share.

For the three months ending September 30, 2000 versus the same period last year:

- Revenues increased to \$2.3 million versus \$2.0 million;
- Gross profit as a percentage of revenues increased slightly to 52.8% from 52.3%;
- Total expenses increased to \$0.851 million from \$0.645 million;
- Net income was \$0.276 million or \$0.06 per share versus a net income of \$0.244 million or \$0.06/shr.

The increased revenue for the quarter (14%) and first nine months (16.1%) versus last year was related to increased demand for kefir and kefir related products due to the national marketing campaign that began last year. Gross margin in the third quarter remained relatively stable at 52.8% compared to 52.3% in the prior year's quarter. SG&A as a percentage of revenues for the quarter was 37.3%, this was a sequential decline from the first and second quarters of this year of 40% and 38.6%, respectively. We expect that SG&A, as a percentage of revenues will continue to decline, reaching a level of 33% for fiscal 2001. The decline in SG&A will be the result of the Company's ability to leverage their employees and overall production over a larger revenue base.

Cash and cash equivalents, at the end of the quarter was approximately \$5.0 million, an increase of \$0.36 million from December 31, 1999. Working capital was \$7.5 million, an increase of \$0.203 million compared to the second quarter of this year. Long-term debt at the end of the quarter was \$1.16 million versus \$2.26 million for the same period last year.

### ***Outlook***

We are extremely optimistic about Lifeway's future based on the promise inherent in their kefir products and the opportunities presented by the support agreement with Danone Foods. This agreement has the potential to bring kefir-based products into dairy sections of supermarkets across the country. We expect revenues to approach \$11 million for 2001. Revenue growth will depend on the ability to gain access to space in the dairy sections and health food sections of supermarkets (the store within a store concept). We are projecting revenues of slightly more than \$13 million for 2002. The Company has two manufacturing facilities that have a potential capacity for annual sales somewhere between \$60 - \$70 million. They currently have enough equipment in their facilities to manufacture approximately half of that capacity. Management believes that expansion to full capacity will only require a small capital outlay for equipment. Since 1997, the Company has averaged \$0.9 million in capital expenditures while building up existing capacity. This in our view is extremely positive, since any increase in consumer demand will allow management to leverage existing capacity.

In addition to utilizing Danone's broker and distribution network, we expect management to utilize some of their marketing and consumer education expertise. Shelf space is important, but consumers must be made aware that the Company's kefir-based products exist, taste good and have distinct health benefits. Over the past year,

Lifeway participated in approximately 12 trade shows such as the Fancy Food Show and Food Marketing Institute Show and approximately 15 consumer sampling events including the Chicago Marathon. In addition, the Company's products are being shown to consumers through the eyes of various media outlets. Recently, the benefits of their SoyTreat™ product were highlighted on *MSNBC* and in *Self Magazine*.

In our opinion, advertising and promotion will be a key to the success of Lifeway Foods' Kefir-based products. In 1999, the Company spent half a million dollars on advertising nationwide in various health food and health-related magazines (i.e. *Shape*, *Health*). So far this year, the Company has spent more than a half-million dollars in advertising, which, in our view, appears to be successful. We expect revenues to reach about \$10 million for 2000, which is up 68% from 1997. We expect to see annual revenue growth building towards 20% over the next two to three years.

### ***Other Considerations***

The Company faces very little direct competition in the United States for their 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. The Company's product lines are not subject to seasonality.

In connection with the support agreement between the Company and Danone Foods, Inc., the parties agreed that they would not compete with each other during the term of the support 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.

Lifeway Foods founder, Mr. Smolyansky, plays an extremely important role, overseeing virtually all aspects of the Company's operations. Mr. Smolyansky has begun the process of delegating authority to others within the Company and will hire additional management personnel as the Company continues to grow. Also, investors should be aware Dannon Foods, Inc., with their 20% ownership of Lifeway, has an influential presence on their Board of Directors.

An equity specific concern relates to average daily volume. Based on our calculations, from the beginning of January 2000 until the end of October 2000, the average daily-volume was approximately 2,300 shares. Investors need to be aware that by nature, a thinly traded equity can have significant price volatility.

### ***Conclusion***

We are initiating coverage of Lifeway Foods, Inc., with a **Speculative Buy** recommendation, and a twelve month price target of \$8.50 based on an average valuation using our earnings per share estimate for 2001 and EBITDA projections through 2002.

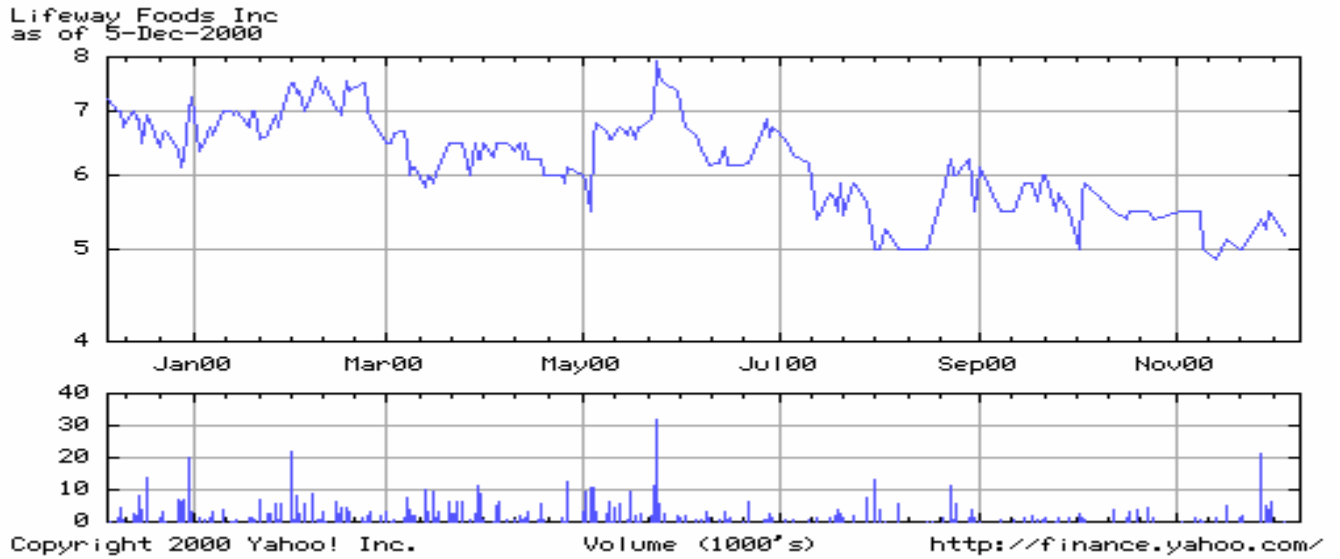
We believe the Company will post earnings of \$0.20 per share, on revenues of \$9.3 million for 2000 and \$0.25 per share on revenues of \$10.9 million for 2001. Our revenue estimate for 2001 represents about a 17% increase from 2000. Based on our model, we expect EBITDA to be \$2.27 million in 2000 and \$2.85 million in 2001. We also expect that the gross margin for 2000 will be about 49% and will decline slightly for 2001 to about 47.9%. The slight decline is related to the potential increase in raw material costs for their products.

We believe Lifeway Foods is undervalued based on our earnings for 2001 and discounted cash flow model. In our opinion the primary reason for the Company's undervaluation is the lack of Wall Street coverage. In addition, until consumers and investors are educated about the potential benefits kefir and kefir based products, the Company is likely to remain undervalued.

To obtain our price target we averaged the following:

Lifeway Foods, Inc.

- A 27.5X P/E (based on the trailing twelve month average for the Food Processing Industry) to our 2001 earnings per share estimate of \$0.25 (provides a valuation of \$6.875 per share);
- Our discounted cash flow model, using EBITDA as a proxy for cash flow and an 8.5% discount factor using the capital asset pricing model (provides a valuation of \$10.15 per share)



(Chart courtesy of Yahoo.)



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

	December 1998 Full Year	December 1999 Full Year	June 2000 Second Quarter	September 2000 Third Quarter
<b>ASSETS</b>				
Current assets:				
Cash and cash equivalents	\$ 628	\$ 4,641	\$ 5,158	\$ 5,000
Marketable securities	340	1,564	882	1,583
Accounts receivable, net	847	966	1,139	1,085
Other receivables	16	57	18	50
Inventories	852	844	714	645
Prepaid expenses and other assets	12	-	-	-
Deferred income taxes	37	52	27	143
<b>Total current assets</b>	<b>2,732</b>	<b>8,124</b>	<b>7,939</b>	<b>8,506</b>
Property, plant and equipment, net	4,148	4,528	4,802	4,876
Intangible assets, net	10	5	3	1
<b>Total assets</b>	<b>\$ 6,890</b>	<b>\$ 12,658</b>	<b>\$ 12,743</b>	<b>\$ 13,383</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>				
Current liabilities:				
Current maturities of notes payable	85	92	93	94
Accounts payable	514	480	391	549
Accrued expenses	167	193	150	322
<b>Total current liabilities</b>	<b>766</b>	<b>765</b>	<b>634</b>	<b>965</b>
Long-term liabilities	1,315	1,234	1,188	1,163
Deferred income taxes	172	248	264	327
<b>Stockholders' equity:</b>				
Common stock, no par value; authorized 10,000,000 shares; outstanding 3,785,677 at December 31, 1998 and 4,318,444 at December 31, 1999, June 30, 2000 and September 30, 2000	1,427	6,509	6,509	6,509
Stock subscription receivable	-	(15)	(15)	(15)
Retained earnings	3,241	3,924	4,297	4,573
Accumulated other comprehensive income, net of tax	(12)	(7)	(133)	(139)
Treasury stock, at cost	(19)	-	-	-
<b>Total stockholders' equity</b>	<b>4,638</b>	<b>10,411</b>	<b>10,658</b>	<b>10,928</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 6,890</b>	<b>\$ 12,658</b>	<b>\$ 12,743</b>	<b>\$ 13,383</b>
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)

	<u>FY1997</u>	<u>FY1998</u>	<u>FY1999</u>	<u>FY2000E</u>	<u>FY2001E</u>	<u>FY2002E</u>
Sales	\$ 5,961	\$ 6,795	\$ 7,908	\$ 9,269	\$ 10,925	\$ 13,075
Cost of goods sold	<u>3,435</u>	<u>3,697</u>	<u>4,665</u>	<u>4,727</u>	<u>5,695</u>	<u>6,900</u>
<b>Gross Profit</b>	2,526	3,098	3,243	4,541	5,230	6,175
<i>Gross Margins</i>	42.38%	45.59%	41.01%	49.00%	47.87%	47.23%
Sales, general and administrative	<u>1,486</u>	<u>1,759</u>	<u>2,178</u>	<u>3,503</u>	<u>3,600</u>	<u>3,965</u>
<i>EBITDA</i>	1,316	1,730	1,506	1,664	2,270	2,850
<b>Operating Income</b>	1,040	1,339	1,065	1,038	1,630	2,210
<i>Operating Margin</i>	17.45%	19.71%	13.47%	11.20%	14.92%	16.90%
Other Income (Expense)						
Interest income	47	38	110	276	290	195
Interest expense	(124)	(106)	(112)	(92)	(110)	(85)
Gain on sale of marketable securities	-	35	7	263	-	-
Rental income	214	-	-	-	-	-
Total Other Income (Expense)	<u>137</u>	<u>(33)</u>	<u>5</u>	<u>447</u>	<u>180</u>	<u>110</u>
<b>Pre-Tax Income</b>	1,177	1,306	1,070	1,485	1,810	2,320
<i>Pre-Tax Margins</i>	19.75%	19.22%	13.53%	16.02%	16.57%	17.74%
Income Tax Expense (Benefit)	<u>477</u>	<u>543</u>	<u>387</u>	<u>606</u>	<u>722</u>	<u>935</u>
<i>Tax Rate</i>	40.51%	41.60%	36.21%	40.80%	39.89%	40.30%
<b>Net Income</b>	<u>\$ 700</u>	<u>\$ 763</u>	<u>\$ 682</u>	<u>\$ 879</u>	<u>\$ 1,088</u>	<u>\$ 1,385</u>
<b>EPS -- Fully Diluted</b>	<u>\$ 0.19</u>	<u>\$ 0.20</u>	<u>\$ 0.17</u>	<u>\$ 0.20</u>	<u>\$ 0.25</u>	<u>\$ 0.32</u>
Avg Shares Out-Fully Diluted	<u>3,776</u>	<u>3,781</u>	<u>3,933</u>	<u>4,318</u>	<u>4,350</u>	<u>4,350</u>
Percent of Revenue						
Cost of Revenues	57.62%	54.41%	58.99%	51.00%	52.13%	52.77%
Sales, General and Administrative expenses	24.93%	25.88%	27.54%	37.80%	32.95%	30.33%
<b>YEAR / YEAR GROWTH</b>						
Total Revenues		13.99%	16.37%	17.21%	17.87%	19.68%
Operating Income		28.80%	-20.49%	-2.52%	57.02%	31.55%
Pre-Tax Income		10.94%	-18.08%	38.78%	21.92%	24.73%
Net Income		8.90%	-10.51%	28.79%	23.79%	25.00%

Lifeway Foods, Inc.  
For the Years Ended December 31, 2000  
(in thousands)

	<u>Q1(03/00)</u>	<u>Q2 (06/00)</u>	<u>Q3 (09/00)</u>	<u>Q4 (12/00)E</u>	<u>FY2000E</u>
Sales	\$ 2,273	\$ 2,287	\$ 2,284	\$ 2,425	\$ <b>9,269</b>
Cost of goods sold	<u>1,137</u>	<u>1,288</u>	<u>1,077</u>	<u>1,225</u>	<u><b>4,727</b></u>
<b>Gross Profit</b>	1,136	999	1,206	1,200	<b>4,541</b>
<i>Gross Margins</i>	49.98%	43.67%	52.83%	49.48%	<b>49.00%</b>
Sales, general and administrative	<u>910</u>	<u>883</u>	<u>851</u>	<u>860</u>	<u><b>3,503</b></u>
<i>EBITDA</i>	382	274	508	496	<b>1,664</b>
<b>Operating Income</b>	226	116	356	340	<b>1,038</b>
<i>Operating Margin</i>	9.96%	5.08%	15.57%	14.02%	<b>11.20%</b>
Other Income (Expense)					
Interest income	26	86	85	80	<b>276</b>
Interest expense	(25)	(21)	(21)	(25)	<b>(92)</b>
Gain on sale of marketable securities	82	120	61	-	<b>263</b>
Rental income	-	-	-	-	<b>-</b>
Total Other Income (Expense)	<u>82</u>	<u>185</u>	<u>125</u>	<u>55</u>	<u><b>447</b></u>
<b>Pre-Tax Income</b>	308	301	481	395	<b>1,485</b>
<i>Pre-Tax Margins</i>	13.56%	13.15%	21.04%	16.29%	<b>16.02%</b>
Income Tax Expense (Benefit)	<u>119</u>	<u>116</u>	<u>205</u>	<u>165</u>	<u><b>606</b></u>
<i>Tax Rate</i>	38.73%	38.73%	42.62%	41.77%	<b>40.80%</b>
<b>Net Income</b>	<u>\$ 189</u>	<u>\$ 184</u>	<u>\$ 276</u>	<u>\$ 230</u>	<u><b>\$ 879</b></u>
<b>EPS -- Fully Diluted</b>	<u>\$ 0.04</u>	<u>\$ 0.04</u>	<u>\$ 0.06</u>	<u>\$ 0.05</u>	<u><b>\$ 0.20</b></u>
Avg Shares Out-Fully Diluted	<u>4,318</u>	<u>4,318</u>	<u>4,318</u>	<u>4,318</u>	<u><b>4,318</b></u>
Percent of Revenue					
Cost of Revenues	50.02%	56.33%	47.17%	50.52%	51.00%
Sales, General and Administrative expenses	40.02%	38.59%	37.26%	35.46%	37.80%
YEAR / YEAR GROWTH					
Total Revenues	22.63%	12.13%	14.10%	20.46%	17.21%
Operating Income	-36.94%	-74.43%	-11.24%	-328.48%	-2.52%
Pre-Tax Income	-9.69%	-31.87%	20.61%	-454.37%	38.78%
Net Income	-9.70%	-31.86%	12.97%	-657.77%	28.79%

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

	<u>Q1(03/01)E</u>	<u>Q2 (06/01)E</u>	<u>Q3 (09/01)E</u>	<u>Q4 (12/01)E</u>	<u>FY2001E</u>
Sales	\$ 2,575	\$ 2,625	\$ 2,825	\$ 2,900	\$ <b>10,925</b>
Cost of goods sold	<u>1,355</u>	<u>1,390</u>	<u>1,450</u>	<u>1,500</u>	<u><b>5,695</b></u>
<b>Gross Profit</b>	1,220	1,235	1,375	1,400	<b>5,230</b>
<i>Gross Margins</i>	47.38%	47.05%	48.67%	48.28%	<b>47.87%</b>
Sales, general and administrative	<u>880</u>	<u>895</u>	<u>905</u>	<u>920</u>	<u><b>3,600</b></u>
<i>EBITDA</i>	500	500	630	640	<b>2,270</b>
<b>Operating Income</b>	340	340	470	480	<b>1,630</b>
<i>Operating Margin</i>	13.20%	12.95%	16.64%	16.55%	<b>14.92%</b>
Other Income (Expense)					
Interest income	75	75	70	70	<b>290</b>
Interest expense	(30)	(30)	(25)	(25)	<b>(110)</b>
Gain on sale of marketable securities	-	-	-	-	-
Rental income	-	-	-	-	-
Total Other Income (Expense)	<u>45</u>	<u>45</u>	<u>45</u>	<u>45</u>	<u><b>180</b></u>
<b>Pre-Tax Income</b>	385	385	515	525	<b>1,810</b>
<i>Pre-Tax Margins</i>	14.95%	14.67%	18.23%	18.10%	<b>16.57%</b>
Income Tax Expense (Benefit)	<u>152</u>	<u>145</u>	<u>210</u>	<u>215</u>	<u><b>722</b></u>
<i>Tax Rate</i>	39.48%	37.66%	40.78%	40.95%	<b>39.89%</b>
<b>Net Income</b>	<u>\$ 233</u>	<u>\$ 240</u>	<u>\$ 305</u>	<u>\$ 310</u>	<u><b>\$ 1,088</b></u>
<b>EPS -- Fully Diluted</b>	<u>\$ 0.05</u>	<u>\$ 0.06</u>	<u>\$ 0.07</u>	<u>\$ 0.07</u>	<u><b>\$ 0.25</b></u>
Avg Shares Out-Fully Diluted	<u>4,350</u>	<u>4,350</u>	<u>4,350</u>	<u>4,350</u>	<u><b>4,350</b></u>
Percent of Revenue					
Cost of Revenues	52.62%	52.95%	51.33%	51.72%	52.13%
Sales, General and Administrative expenses	34.17%	34.10%	32.04%	31.72%	32.95%
YEAR / YEAR GROWTH					
Total Revenues	13.30%	14.77%	23.71%	19.59%	17.87%
Operating Income	50.17%	192.77%	32.19%	41.18%	57.02%
Pre-Tax Income	24.89%	28.00%	7.17%	32.91%	21.92%
Net Income	23.37%	30.23%	10.61%	34.78%	23.79%

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

	<u>FY1998A</u>	<u>FY1999A</u>	<u>Q3 2000A</u>	<u>F2000E</u>
<i>Cash Flows from Operating Activities</i>				
Net Income	\$ 763	\$ 682	\$ 649	\$ 879
Depreciation and amortization	391	441	466	625
Amortization of discounts on securities	-	(7)	-	-
Gain on sale of marketable securities	(35)	(7)	(237)	(237)
Issuance of common stock in exchange for services rendered	31	-	-	-
Decrease in allowance for doubtful accounts	(48)	-	-	-
Deferred income taxes	<u>115</u>	<u>54</u>	<u>12</u>	<u>16</u>
	1,217	1,165	890	1,283
<i>Changes In:</i>				
Accounts receivable	19	(118)	(119)	(115)
Other receivables	(1)	(41)	(7)	(10)
Inventories	(237)	8	199	185
Prepaid expenses and other assets	(4)	12	-	-
Accounts payable	119	(34)	79	75
Accrued expenses	(262)	26	119	120
Net Changes in Working Capital	<u>(366)</u>	<u>(148)</u>	<u>271</u>	<u>255</u>
<b>Net cash Provided by Operations</b>	<b><u>850</u></b>	<b><u>1,017</u></b>	<b><u>1,161</u></b>	<b><u>1,538</u></b>
<i>Cash Flows from Investing Activities</i>				
Purchase of marketable securities	(305)	(1,846)	(2,501)	(2,501)
Sale of marketable securities	218	646	2,576	2,576
Purchase of property, plant and equipment	<u>(593)</u>	<u>(794)</u>	<u>(810)</u>	<u>(850)</u>
<b>Net cash used in Investing</b>	<b><u>(680)</u></b>	<b><u>(1,994)</u></b>	<b><u>(734)</u></b>	<b><u>(775)</u></b>
<i>Cash Flows from Financing Activities</i>				
Repayment of notes payable	(92)	(96)	(68)	91
Proceeds from issuance of common stock	-	5,138	-	-
Stock issuance costs	-	(52)	-	-
<b>Net cash provided by Financing</b>	<b><u>(92)</u></b>	<b><u>4,990</u></b>	<b><u>(68)</u></b>	<b><u>91</u></b>
Net change in Cash	78	4,013	359	854
Cash Beginning of Period	<u>551</u>	<u>628</u>	<u>4,641</u>	<u>4,641</u>
Cash End of Period	<u><u>\$ 628</u></u>	<u><u>\$ 4,641</u></u>	<u><u>\$ 5,000</u></u>	<u><u>\$ 5,495</u></u>