TAGLICH BROTHERS
The Standard of Excellence in the Microcap Market
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# *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 $13.03 – (NasdaqGM)**

December 10, 2007

| | FY (12/05)A | FY (12/06) A | *FY (12/07) E* | *FY (12/08) E* |
|---|---|---|---|---|
| Revenue (in millions) | $20.13 | $27.72 | ***$38.52*** | ***$48.23*** |
| Earnings per share (diluted)* | $0.15 | $0.17 | ***$0.21*** | ***$0.26*** |

| | | | |
|---|---|---|---|
| 52-Week range* | $20.75 – $8.51 | Fiscal year ends: | December |
| Shares outstanding a/o 09/30/07* | 16.83 million | Revenue/shares (TTM) * | $2.16 |
| Approximate float* | 4.80 million | Price/Sales (TTM) * | 6.0X |
| Market Capitalization | $219 million | Price/Sales (2008)E* | 4.6X |
| Tangible Book value/shr | $1.52 | Price/Earnings (TTM) * | 62.0X |
| Price/Book* | 8.6X | Price/Earnings (2008)E* | 50.1X |

* All per share figures reflect the 2-1 stock split effective March 9, 2004 and August 16, 2006.

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

***Key investment considerations:***

***We are reiterating our Speculative Buy rating on shares of Lifeway Foods, Inc. (NasdaqGM: LWAY) and lowering our 12-month price target to $14.70 per share based on our sales per share estimate for 2008 (our prior target was $19.20). The reduction in our price target reflects a decline in the Company's share price due to lower gross margin and record high price of milk, which contracted the relative price-to-sales multiple.***

***Our rating is primarily based on momentum from the Helios acquisition, growing awareness of LWAY's Kefir line, its kids Probugs™ Kefir drink, obtaining a foodservice distribution contract, distribution in Mexico, as well as a new smoothie drink called Lifeway Lassi, which is aimed at South Asian consumers in the U.S.***

***On November 15, 2007, Lifeway Foods reported third quarter 2007 revenue of $9.817 million, which was an increase of 31.7% versus $7.457 million in the same period last year. Top line results included sales from the Helios acquisition that amounted to $1.435 million. Net income was $0.468 million or $0.03 per share versus $0.740 million or $0.04 per share in the third quarter of 2006.***

***Based on results so far in 2007, trend analysis of LWAY's base business and Helios operations, and increased distribution and new offerings, we are tweaking our 2007 revenue forecast to $38.520 million (prior was $38.642 million). Our reduced net income forecast (due to the increasing cost structure from the high cost of milk) is $3.499 million or $0.21 per diluted share (prior was $4.561 million or $0.27 per share).***

***We are adjusting our forecast for 2008, which calls for revenue of $48.225 million (prior was $48.910 million) and net income of $4.340 million or $0.26 per share (prior was $6.410 million or $0.38 per share). We believe the year-over-year growth should continue based on current trends and increased consumer awareness, offset by higher operating costs, which should be mitigated by price increases of 10-15% on its catalog of products.***

**** Please view our disclaimer located on page 12.***

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## *The Company*

Lifeway Foods, Inc. (NasdaqGM: LWAY) manufactures a cultured dairy beverage called Kefir and also develops Kefir related products at its two manufacturing facilities in Illinois. The Company's distribution of its twelve Kefir-based products in Illinois is accomplished through approximately 1,200 local stores including major retail chains (i.e., Jewel Food Stores, Dominick's Finer Foods, Treasure Island Food Marts, Whole Foods, and independent retailers), via twelve company owned trucks. Also, over 40 different assorted cream cheese products are distributed under the Cream Cheese Gourmet brand in the Philadelphia and Tri State Metropolitan area. In addition, the Company distributes its products throughout the United States and to some parts of Canada (Ontario and Quebec), utilizing verbal distribution arrangements with a number of distributors. Management believes that verbal arrangements provide the necessary latitude to expand into new markets and establish new relationships on an ongoing basis.

The Company introduced in 2006, a series of innovative new products such as pomegranate Kefir, Greek-style Kefir, and a children's line of organic Kefir products called ProBugs™ in a no-spill pouch in kid-friendly flavors (i.e., Orange Creamy Crawler and Sublime Slime Lime), as well as a line of organic whole milk Kefir. The key group of consumers for the Company's products includes children, women, baby boomers, and Hispanics. With respect to the Hispanic market the Company developed and has had success with its La Fruita product.

In early August 2006, Lifeway Foods acquired Helios Nutrition Limited (including Pride Main Street Dairy, LLC), its top competitor in the Kefir market. Helios held the number two position (versus LWAY's number one position) in terms of the Kefir market and the top position in the organic category. Management has publicly stated that the acquisition is expected to strengthen LWAY's presence in the rapidly growing market for **organic dairy products, as well as provide a steady supply of organic milk through Helios' organic dairy subsidiary.** In addition, it is expected to provide cost efficiencies by pooling the purchase of raw materials.

At the end of June 2007, the Company announced the expansion of its product portfolio to include a new smoothie drink called Lifeway Lassi. This product is designed for Lifeway's core natural and health food markets, people who are familiar with Lassi from Indian restaurants, and the immigrant population from India (where it is a beverage staple). Lifeway Lassi (in mango and strawberry flavors) will be available to consumers in 8-oz 'Grab and Go' containers and distributed through select natural, specialty, and ethnic food stores nationwide. According to Management, Lifeway plans to promote this product through its traditional channels, as well as by sampling it at yoga studios, conferences, and similar events.

According to the June 28, 2007 press release, the Asian Indian community in the U.S. has grown from under 1 million in 1990 to more than 2.3 million in 2005.

<u>*Kefir*</u>

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 Development*

**On November 29, 2007, the Company announced that it will implement a price increase of approximately 10-15% on its full catalog of products.** This price increase will go into effect in December 2007. Julie Smolyansky, Lifeway's CEO, stated in the announcement that the Company's goal is growth in a competitive food industry, as well as building a strong brand and expanding its customer base. Part of this strategy has and will continue to be to maintain a relatively lower price on a per ounce basis when compared to other similar products on the market. However, given the current environment of historically high raw material prices, as well as other rising costs, a price increase is necessary. She reiterated her confidence that given the uniqueness of the Company's Kefir products and dominance in the Kefir market, as well as past price adjustment experiences, and conversations with customers, this price increase should have no negative impact on unit sales.

## ***Recent Financials***

For the three-months ended September 30, 2007, versus the three-months ended September 30, 2006:

- Revenue increased to $9.817 million versus $7.457 million. Taglich Brothers' estimates called for revenue of $9.925 million;
- Gross margin declined to 27.71% versus 38.09%;
- Operating expenses increased to $2.140 million versus $1.721 million;
- EBITDA decreased to $0.857 million versus $1.285 million; and
- Net income was $0.468 million or $0.03 per share versus net income of $0.740 million or $0.04 per share. In comparison, Taglich Brothers' estimates called for net income of $1.090 million or $0.06 per share.

The year-over-year revenue increase of 31.7% was attributable to higher sales for the existing Lifeway Foods line, which experienced growth of 27.8% and a contribution from Helios Nutrition, which was only present for the final two months of the same period last year. The organic growth was primarily attributable to increased awareness of the Company's existing drinkable dairy products (i.e., its flagship Kefir product, Organic Kefir, La Fruta, as well as its Probugs™ Kefir drink designed specifically for kids). Sales from Helios Nutrition and its subsidiary, Pride of Main Street Dairy was $1.435 million, consisting of $1.183 million from the Helios brand and $0.251 million from its subsidiary Pride of Main Street Dairy.

Gross margin declined by 1038 basis points versus the same period last year. The plunge in gross margin was primarily related to the increased cost of milk (the Company's largest raw material), which was approximately 110% higher during the quarter compared to the same period last year. According to the third quarter 10-Q filing, the cost of milk during September 2007 was the highest ever recorded. Although the price of milk has slightly dropped during the month of October 2007, Management can make no assurances that the price of milk will continue to decline from its September 2007 record highs. Also, negatively impacting gross margin was the July 2007 minimum wage increase in Illinois.

Operating expenses in the third quarter of 2007 increased by $0.419 million, primarily due to the higher advertising and marketing expenses to build brand awareness. As a percentage of revenue, operating expenses decreased to 21.79% versus 23.08% in the third quarter of 2006. The year-over-year percentage improvement was due to higher top line results, increased operating synergies gained by the consolidation of the Helios acquisition into the Company's overall operations, as well as continuing efforts to maximize efficency through capital investments.

Total other income for the three-month period ended September 30, 2007 was approximately $0.202 million, compared with approximately $0.077 million during the same period in 2006. This increase was primarily attributable to a higher gain on the sale of marketable securities in 2007.

*Balance Sheet as of September 30, 2007*

The Company had cash and cash equivalents of $1.625 million and marketable securities of $6.558 million. This compares to cash and cash equivalents of $1.548 million and marketable securities of $8.491 million as of December 31, 2006. Working capital was $14.259 million versus $13.812 million at the end of 2006. The Company's long-term liabilities stood at $4.424 million, which was a decrease from $5.747 million at the end of 2006. The year-over-year changes in cash, working capital, and long-term liabilities resulted from the August 2006 acquisition of Helios Nutrition, as well as profitable operations during the first nine months of 2007.

The Company's portfolio mix of marketable securities (at fair value as of September 30, 2007) consisted of:

– 25.2% fixed income type securities; and

– 74.8% in equities, mutual funds, preferred securities, and private investments.

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

## *Market Comment*

Lifeway Foods' product portfolio includes cultured dairy products know as Kefir, which includes probiotic functional cultures. The Company's target market is health conscious consumers that are the driving force behind the functional and probiotic foods segment of the Food Industry.

AC Nielsen issued a report entitled "What's Hot around the Globe – Insights on Growth in Food & Beverage Products", in which their analysis concluded that drinkable yogurt topped the list in terms of value growth of 18%, fueled by single-serving products and health trends toward probiotics. This healthy beverage was a strong performer, with double-digit growth in four of the five regions AC Nielsen studied. See chart below (source: December 2006 AC Nielsen report Insights on Growth in Food & Beverage Products):

| Fastest Growing Category | Product Area | Number of Markets Growing/ Measured | Category Growth Rate | Private Label Growth Rate |
|---|---|---|---|---|
| Drinkable Yogurt | Non-Alcoholic Beverages | 40 of 45 | 18% | N/A* |
| Fresh Soup/ Bouillon/ Stock | Ready-To-Eat Meals | 11 of 13 | 18% | 24% |
| Fresh Herbs/ Spices | Cooking Basics | 6 of 7 | 17% | 28% |
| Fresh Fish/ Shellfish/ Seafood | Meat, Fish & Eggs | 10 of 10 | 12% | 16% |
| Alcoholic Cider | Alcoholic Beverages | 9 of 18 | 11% | 7% |
| Fresh Ready to Eat Salads | Fruits & Vegetables | 14 of 14 | 10% | 12% |
| Frozen Meal Starters | Fruits & Vegetables | 3 of 4 | 10% | 15% |
| Baby Formula | Baby Food | 48 of 55 | 10% | 17% |
| Dairy Based Drinks (flavored/unflavored) | Non-Alcoholic Beverages | 32 of 42 | 10% | N/A* |

= Categories over US $1 billion globally

* Private Label data was collected for the combination of Dairy-Based Drinks, Dairy Substitute Drinks and Drinkable Yogurt and cannot be separated into categories for this study.

In a June 2007, issue of Brandweek.com an article entitled "Probiotics Growth Spurt Continues in New Categories", it was stated that the hottest word in food marketing is now probiotics. In the article, Euromonitor International (a provider of market intelligence on industries, countries and consumers) stated that the overall probiotic yogurt category accounted for $294 million in U.S. sales (in 2006) and is projected to grow to $500 million by 2010. Globally, sales doubled during the past half-decade, making probiotic yogurt a $1 billion category.

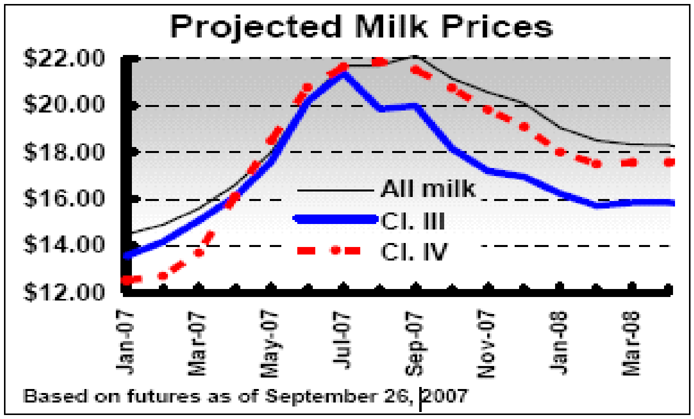
Investors should be cognizant that the two primary drivers for the growth in the Functional Foods Market are:

1) Changing trends in consumer diets towards healthier foods; and
2) Growing proportion of aging populations.

### *Milk Price Perspective*

The September 2007 Dairy Market Report from the National Milk Producers Federation (an organization that provides a forum through which dairy farmers and their cooperatives formulate policy on national issues that effect milk production and marketing) offers the following comments:

- The market may be seeing a shift associated with a more limited energy-driven food and feed price inflation;
- The U.S. dairy industry has seen strong overseas demand despite high prices, which has been aided by rising incomes and constrained milk production in other countries;
- Modestly lower prices are expected in the next 18 months; and
- The following chart as a projection of future price levels:




Source: September 2007 Dairy Market Report page 4.

The United States Department of Agriculture, in an October 2007 report stated that higher milk production will likely drop prices from 2007 highs. A higher number of milk cows and slightly higher output per cow will be the primary reason for higher milk production for both 2007 and 2008, which in turn should translate into lower milk prices in 2008.

## *Outlook*

We anticipate that the Company is likely to experience a weekly sales run-rate on its core business of approximately $0.653 million for the fourth quarter of 2007. This continues the trend of sequential growth (in the weekly sales run-rate) from the first, second, and third quarters of 2007 of $0.592 million, $0.637 million, and $0.645 million, respectively, of a weekly sales run-rate. On a stand alone basis, the Helios operation should have a weekly run-rate of approximately $0.112 million in the fourth quarter of 2007.

Our belief that the weekly run rate will continue to expand is based primarily on increased orders from existing customers, as well as expanded distribution opportunities (that may include food services such as restaurants, hotels, schools, etc.), the continued rollout of its Probugs™ offering, new foodservices contract, as well as the introduction of a new product (Lifeway Lassi). Lifeway continues to market its products through local radio station, newspaper, and magazines advertisements, as well as gaining additional exposure through the Internet, catalog advertising and promotion, in store demonstration throughout the U.S., and participation in various trade shows.

The Company's CFO publicly commented in the third quarter press release, that Management was proud of the results to date in 2007. Despite record high milk and transportation costs, as well as operating in an environment where most of the other production related costs are increasing, the Company was able to maintain relatively healthy margins. The cost of milk hit a record high in the month of September, and has since dropped slightly in October, a trend Management 'hopes' but cannot assure will continue.

The Company CEO publicly commented in its November 15, 2007 earnings press release, that LWAY has not yet passed to consumers the higher costs that are occurring at the present time; however, if these costs continue to rise, ultimately there will be no choice but to raise prices. **On November 29, 2007, the Company announced that during December 2007, it will implement a price increase of approximately 10-15% on its full catalog of products.**

To reiterate, in an October 22, 2007 report by the United States Department of Agriculture, their forecast stated that a decline in dairy product prices will translate into lower milk prices in 2008. Milk prices should average $18.95 to $19.05 per cwt (abbreviation for hundred-weight) in 2007, with an expected decline to $17.70 to $18.60 per cwt in 2008. At the mid points that would result in approximately a 4.5% year-over-year decline in 2008.

## ***Projections***

Based on public comments made by Management in the Company's press releases and SEC filings, results for the first nine months of 2007, third quarter results that missed our bottom line estimate by $0.03 per diluted share, and a full year contribution from Helios, we are reducing our 2007 revenue estimate to $38.520 million (prior was $38.642 million). If our top line estimate is achieved it would translate into year-over-year growth of 38.96%. Given our revenue estimate and that third quarter results that fell short of our expectation due a contraction of gross margin (primarily due to the increased cost of milk), we are lowering our 2007 forecast for net income to $3.499 million or $0.21 per diluted share (prior was $4.561 million or $0.27 per diluted share).

We are also reducing our forecast for 2008, primarily due to lower gross margin prospects as milk is likely to stay at relatively high levels at the start of 2008, mitigated to some degree by the previously discussed price increases that will take effect during December 2007. Our revised outlook calls for revenue of $48.225 million (prior was $48.910 million) and net income of $4.340 million or $0.26 per diluted share (prior was $6.415 million or $0.38 per share). We believe the year-over-year growth should continue to occur based on current trends, increased consumer awareness, new product introductions such as its Lifeway Lassi product, as well as gross margin expansion during the second half of 2008.

Our forecast for 2007 and 2008 incorporates the following:

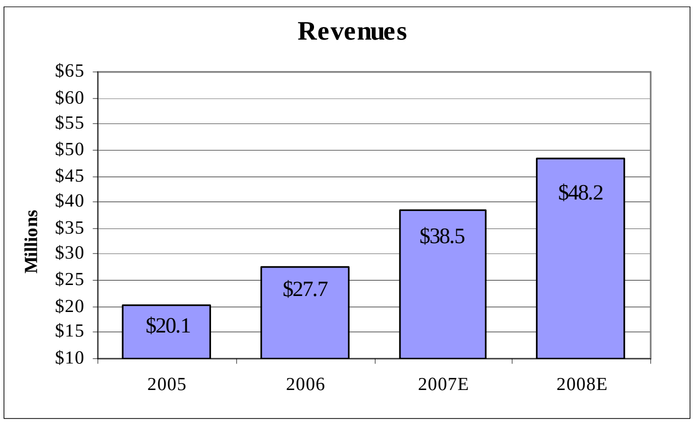
- Distribution agreements with Ralph's Grocery stores in Southern California and ACME Grocery in the Philadelphia and Tri-state area;
- The continued rollout across the U.S. of its ProBugs™ offering;
- Distribution of Lifeway Kefir in Mexico. According to a July 2007 press release, for the first time ever, in a variety of new, upscale supermarkets, through a distributor in Texas the entrance into Mexico occurred. Management stated that while this is by no means the Company's largest account, it is a first step into an important market;
- Completing the integration of the Helios acquisition;
- Initial impact from a May 2007, announcement of its first foodservice distribution contract, as well as the hiring of a professional dedicated to growing this potential revenue stream;
- Increased interest expense for 2007. We anticipate interest expense for 2007 of $0.421 million versus $0.346 million in 2006, primarily due to the acquisition of Helios. In 2008, we estimate interest expense should be reduced to approximately $0.360 million, as a consequent of lower aggregate debt;
- Relatively high energy and raw material cost of resin for its containers and packaging, as well as the relatively high cost of milk, the Company's largest raw material expense;
- Increased capital expenditures that will ultimately double the Company's production capacity (to approximately $100 million in revenue potential). Investors should note that capital expenditures will occur throughout the year with the intent of having the new capacity in place by the start of 2008. During the first nine months of 2007, over $1.140 million of capital expenditures have occurred, as compared to $0.500 million in the same period last year; and
- The continued cost of being a public company (i.e., insurance, legal, and regulatory compliance).

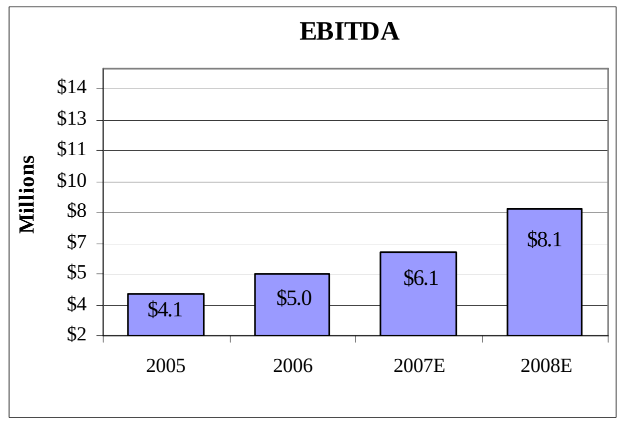
We have adjusted the following from our prior forecast, based on the previously discussed operating trends:

- Gross margin in 2007 to 34.01% from 38.51%. This compares to 38.38% for all of 2006 and 29.93% for the fourth quarter of 2006 (which includes a full quarter of costs from Helios). While, first and second quarter 2007 experienced gross margin of 39.60% and 39.41%, respectively, third quarter gross margin fell to 27.71%. We are using the results from the third quarter of 2007 as a starting point and have modestly modeled in improvement during the fourth quarter and first half of 2008, with a larger improvement occurring during the second half of 2008. We believe that the price increase starting during December 2007 should help moderate the contraction of gross margin. Also, investors should note that it is the record high cost of milk that should moderate going forward that has caused us to reevaluate our overall gross margin forecast. Our 2008 forecast for gross margin is 33.15% versus our prior forecast of 39.56%; and

- SG&A expenses, as a percentage of revenues, in 2007 to 21.02% from 20.79%. Our revised forecast for 2008 calls for SG&A expenses, as a percentage of revenues to 18.48% versus our prior expectation of 18.51%. This compares to 23.12% for all of 2006 and 20.12% for the fourth quarter of 2006 (which includes a full quarter of costs from Helios).

The chart below shows our revenue and EBITDA projections:




Source: Company Filings and Taglich Brothers Estimates

## *Risks*

*Commodities*

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

*Regulation*

Lifeway is subject to regulation by federal, state and local governmental authorities regarding the distribution and sale of food products. Management believes that the Company is currently in compliance with all material government permits, licenses, qualifications, and approvals for its operations; however, there can be no assurance that it will be able to maintain its existing licenses and permits. In addition, the Company believes that it is currently in compliance with all applicable environmental laws. Also, the products exported to Canada are subject to strict quotas imposed by the Trade Control Policy Division of the Department of Foreign Affairs and International Trade of Canada. Management believes that the Company is in compliance with all applicable Canadian regulations.

*Groupe Danone SA Relationship*

According to an 8-K filed with the SEC on January 3, 2007, the Company entered into a fifth extension of the stockholders' agreement with Danone Foods, Inc. (the terms of the non-compete period and standstill period of the stockholders' agreement expire on December 31, 2007, which was originally entered into on October 1 1999. In the filing, on January 3, 2007, LWAY and DS Waters, L.P. an affiliate of Danone Foods, Inc. entered into the fifth extension of the stockholders' agreement and all Lifeway shares held by Danone Foods, Inc., were transferred to DS Waters on November 10, 2005. Also, included in the agreement was a non-compete provision, with the specific exclusion of Stonyfield Farms, Inc., an affiliate of Danone Foods, Inc. and DS Waters. Investors should be aware that Stonyfield Farms is not in direct competition with LWAY, since it does not produce Kefir. However, the competitive landscape could increase as yogurt products (especially in the natural and organic categories) could increase the general competitive landscape in the future. **According to SEC filings, as of December 31, 2006, Danone owned approximately 20.1% of LWAY's common shares.**

*Legal Issue*
Lifeway is from time to time engaged in other litigation matter arising in the ordinary course of business none of which presently is expected to have a material adverse effect on its business results or operations.

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

*Growth Management*
LWAY has returned to growing revenues in excess of 25% annually. As a result, the Company will need to meet the challenges associated with growth, such as management of raw materials and increased production staff. If Lifeway Foods is not successful in meeting these challenges, revenue growth may slow in future periods.

*Integration of Acquisitions*
Acquisitions involve numerous risks that include difficulties in the assimilation of the acquired operations (i.e., technology and product(s)), the diversion of Management's attention, entering markets in which the Company has limited or no direct experience, as well as the potential loss of key employees of the acquired company. Achieving and maintaining anticipated benefits of an acquisition will depend in part upon whether the integration of the acquired assets is accomplished in an efficient and effective manner. Therefore, in the event Lifeway makes an acquisition (such as the Helios Nutrition), no assurance can be given that it will be successful in terms of improving bottom line results.

*Management Control*
Ludmila Smolyansky, who is Chairperson of the Board of Directors of Lifeway Foods, beneficially owns or controls approximately 44.98% of common shares outstanding, as of September 10, 2007.

As a result, she has the ability to substantially influence matters submitted to stockholders for approval, including election or removal of a member of the Board of Directors, amendment to the Company's certificate of incorporation or bylaws, adoption of measures that could delay or prevent a change in control or impede a merger, takeover, or other business combination, and adoption of stock-based compensation plans. Accordingly, this could have a negative impact if her interests do not coincide with other shareholders on a particular issue.

*Marketable Securities*
At September 30, 2007, the fair value of the Company's marketable securities available for sale was $6.558 million. In the Company's 10-K filing, Management stated investments in equity securities, mutual funds, and corporate bonds consist of investments in common stock and debt securities of companies in various industries.

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

*Trading Volume*
Liquidity has the potential to be a concern. Based on our calculations average daily-volume during 2003 increased to 4,451 shares from 1,943 shares in 2002. During 2004, average volume increased significantly to 154,399 shares traded a day. In 2005, average volume declined to 43,400 shares traded a day. During 2006, average daily volume has declined to 30,756 shares traded a day and rebounded during the first eleven months of 2007 to 69,887 shares traded daily. Average daily volume remains relatively low; therefore, investors need to be aware that by nature a thinly traded equity can have significant price volatility.

## ***Conclusion***

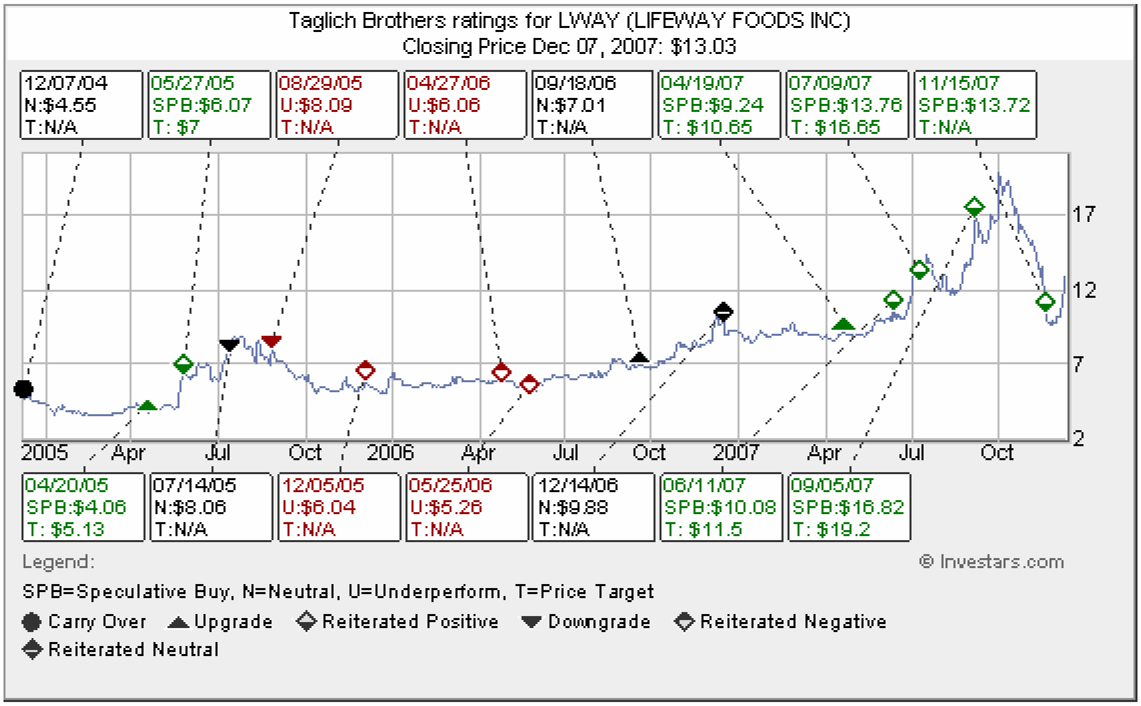
**We are reiterating our Speculative Buy rating on shares of Lifeway Foods, Inc. (NasdaqGM: LWAY) and lowering our twelve-month price target of $14.70 per share based on our sales per share estimates for 2008.** Our prior twelve-month price target was $19.20. The reduction in our price target reflects a decline in gross margin, as well as the record high price of milk. While increased expenses are likely to occur, it has not diminished the Company's ability to grow top line results. Also, we have incorporated in our outlook, the price increase that will begin during December 2007, believing that it should not materially impact top line growth. Additionally, it should help alleviate increasing input costs (i.e., milk prices).

Our rating is primarily based on momentum that is occurring from the Helios acquisition, a growing awareness of Lifeway's flagship Kefir line, its kids Kefir drink, called Probugs™, securing its first foodservice distribution contract (which occurred on May 18, 2007), and distribution in Mexico, as well as introduction of a new smoothie drink called Lifeway Lassi, which is aimed at South Asian consumers in the U.S.

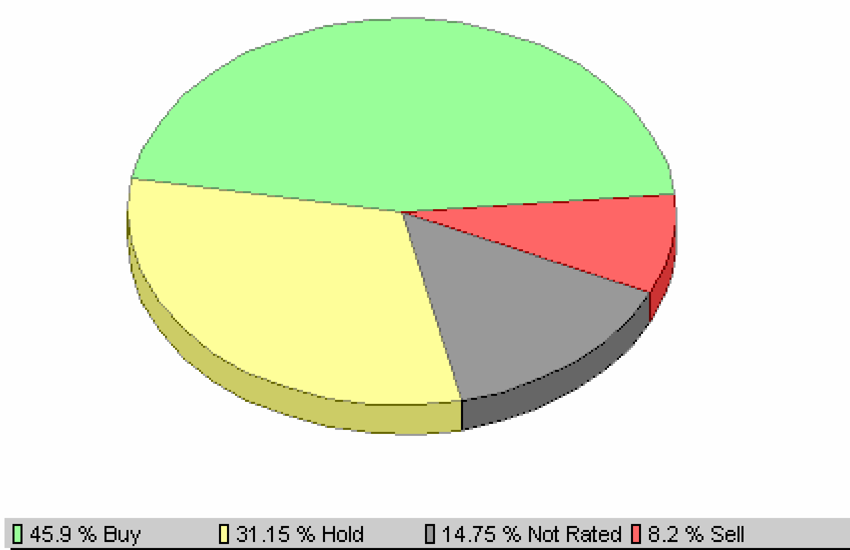
We obtained our price target from the following valuation model, discounted by 15% to account for microcap risk and Company specific risks mentioned earlier:

- A 6.0X price to sales multiple, which is the Company's current trailing-twelve month multiple, applied to our net sales estimate of $2.86 per share for 2008.

Investors need to be aware that during December 2006, Lifeway Foods was able to enter into a fifth extension of the stockholders' agreement with Danone Foods, Inc. According to the SEC filing, LWAY and DS Waters, L.P. an affiliate of Danone Foods, Inc. entered into the fifth extension of the stockholders', standstill, and non-compete agreements, which will now expire on December 31, 2007.




Taglich Brothers Current Ratings Distribution




**Investment Banking Services for Companies Covered in the Past 12 Months**

| Rating | # | % |
|---|---|---|
| Buy | 0 | 0 |
| Hold | 2 | 11.76% |
| Sell | 0 | 0 |
| Not Rated | 0 | 0 |

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. 2005 Year End | Dec. 2006 Year End | Mar. 2007 1st Qtr End | Jun. 2007 2nd Qtr End | Sept. 2007 3rd Qtr End |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| Current assets: | | | | | |
| Cash and cash equivalents | $ 4,354 | $ 1,548 | $ 1,013 | $ 1,014 | $ 1,625 |
| Marketable securities | 7,479 | 8,491 | 8,561 | 8,425 | 6,558 |
| Investment, at cost | - | - | - | - | 500 |
| Accounts receivable, net | 2,518 | 3,943 | 4,588 | 4,602 | 4,846 |
| Other receivables | 56 | 71 | 50 | 40 | 46 |
| Inventories | 1,717 | 2,522 | 2,883 | 3,511 | 4,061 |
| Prepaid income taxes | 12 | 268 | 159 | 73 | 126 |
| Prepaid expenses and other assets | 9 | 12 | 10 | 13 | 13 |
| Deferred income taxes | 143 | 32 | - | - | 226 |
| **Total current assets** | **16,287** | **16,887** | **17,264** | **17,679** | **18,000** |
| Property, plant and equipment, net | 7,751 | 8,581 | 8,555 | 8,819 | 9,176 |
| **Total assets** | **$ 24,465** | **$ 32,999** | **$ 33,270** | **$ 33,874** | **$ 34,471** |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | | | | |
| Current liabilities: | | | | | |
| Current maturities of notes payable | 532 | 1,131 | 1,129 | 1,130 | 1,435 |
| Accounts payable | 426 | 1,463 | 1,239 | 1,527 | 1,865 |
| Accrued expenses | 355 | 480 | 341 | 387 | 441 |
| Taxes payable | - | - | 31 | 32 | - |
| **Total current liabilities** | **1,314** | **3,074** | **2,740** | **3,076** | **3,741** |
| Long-term liabilities | 2,903 | 5,747 | 5,202 | 4,843 | 4,424 |
| Deferred income taxes | 349 | 450 | 454 | 467 | 510 |
| **Stockholders' equity:** | | | | | |
| Common stock, no par value; authorized 10,000,000 shares | 6,509 | 6,509 | 6,509 | 6,509 | 6,509 |
| Paid-in capital | 91 | 1,081 | 1,081 | 1,087 | 1,104 |
| Stock subscription receivable | - | - | - | - | - |
| Retained earnings | 14,423 | 17,319 | 18,454 | 19,850 | 20,318 |
| Accumulated other comprehansive income, net of tax | (100) | 154 | 241 | 127 | (53) |
| Treasury stock, at cost | (1,025) | (1,334) | (1,411) | (2,086) | (2,082) |
| **Total stockholders' equity** | **19,899** | **23,728** | **24,874** | **25,488** | **25,796** |
| **Total liabilities and stockholders' equity** | **$ 24,465** | **$ 32,999** | **$ 33,270** | **$ 33,874** | **$ 34,471** |

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

| | FY2005A | FY2006A | **FY2007E** | **FY2008E** |
|---|---|---|---|---|
| Sales | $ 20,132 | $ 27,721 | **$ 38,520** | **$ 48,225** |
| Cost of goods sold | 12,123 | 17,082 | **25,418** | **32,240** |
| **Gross Profit** | 8,009 | 10,639 | **13,102** | **15,985** |
| *Gross Margins* | 39.78% | 38.38% | **34.01%** | **33.15%** |
| Operating Expenses: | | | | |
| Sales | 2,354 | 3,065 | **3,568** | **3,780** |
| General and administrative | 2,253 | 3,343 | **4,531** | **5,170** |
| Total Operating Expenses | 4,607 | 6,409 | **8,098** | **8,950** |
| *EBITDA* | 4,052 | 4,990 | **6,068** | **8,135** |
| **Operating Income** | 3,401 | 4,230 | **5,003** | **7,035** |
| *Operating Margin* | 16.90% | 15.26% | **12.99%** | **14.59%** |
| Other Income (Expense) | | | | |
| Interest income | 323 | 388 | **319** | **240** |
| Interest expense | (101) | (346) | **(421)** | **(360)** |
| Gain on sale of marketable securities | 445 | 357 | **663** | **-** |
| Other | 14 | 1 | **1** | **-** |
| Rental income | - | 11 | **38** | **20** |
| Total Other Income (Expense) | 682 | 411 | **599** | **(100)** |
| **Pre-Tax Income** | 4,083 | 4,642 | **5,603** | **6,935** |
| *Pre-Tax Margins* | 20.28% | 16.74% | **14.54%** | **14.38%** |
| Income Tax Expense (Benefit) | 1,535 | 1,745 | **2,104** | **2,595** |
| *Tax Rate* | 37.58% | 37.60% | **37.55%** | **37.42%** |
| **Net Income** | $ 2,548 | $ 2,897 | **$ 3,499** | **$ 4,340** |
| **EPS -- Fully Diluted*** | $ 0.15 | $ 0.17 | **$ 0.21** | **$ 0.26** |
| Avg Shares Out-Fully Diluted* | 16,809 | 16,830 | **16,857** | **16,846** |
| Percent of Revenue | | | | |
| Cost of Revenues | 60.22% | 61.62% | 65.99% | 66.85% |
| Selling expenses | 11.69% | 11.06% | 9.26% | 7.84% |
| General and Administrative expenses | 11.19% | 12.06% | 11.76% | 10.72% |
| YEAR / YEAR GROWTH | | | | |
| Total Revenues | 23.36% | 37.70% | 38.96% | 25.20% |
| Net Income | 24.19% | 13.66% | 20.80% | 24.03% |

*** Adjusted for the 2-1 stock split effective March 9, 2004 and August 16, 2006**

Lifeway Foods, Inc.
Quarterly Income Statement Model*
For the Years Ended December 31, 2006
(in thousands)

| | Q1(03/06)A | Q2 (06/06)A | Q3 (09/06)A | Q4 (12/06)A | **FY2006A** |
|---|---|---|---|---|---|
| Sales | $ 6,003 | $ 6,367 | $ 7,457 | $ 7,894 | **$ 27,721** |
| Cost of goods sold | 3,306 | 3,788 | 4,616 | 5,372 | **17,082** |
| **Gross Profit** | 2,697 | 2,580 | 2,840 | 2,521 | **10,639** |
| *Gross Margins* | *44.93%* | *40.52%* | *38.09%* | *31.94%* | **38.38%** |
| Operating Expenses: | | | | | |
| Sales | 583 | 850 | 891 | 742 | **3,065** |
| General and administrative | 708 | 800 | 830 | 1,005 | **3,343** |
| Total Operating Expenses | 1,291 | 1,650 | 1,721 | 1,747 | **6,409** |
| *EBITDA* | 1,550 | 1,078 | 1,285 | 1,076 | **4,990** |
| **Operating Income** | 1,406 | 930 | 1,119 | 774 | **4,230** |
| *Operating Margin* | *23.43%* | *14.61%* | *15.01%* | *9.81%* | **15.26%** |
| Other Income (Expense) | | | | | |
| Interest income | 86 | 122 | 86 | 94 | **388** |
| Interest expense | (50) | (63) | (97) | (136) | **(346)** |
| Gain on sale of marketable securities | (37) | 225 | 89 | 79 | **357** |
| Other | 1 | 3 | (2) | - | **1** |
| Rental income | | - | - | 11 | **11** |
| Total Other Income (Expense) | (0) | 287 | 77 | 48 | **411** |
| **Pre-Tax Income** | 1,406 | 1,217 | 1,196 | 823 | **4,642** |
| *Pre-Tax Margins* | *23.42%* | *19.11%* | *16.04%* | *10.42%* | **16.74%** |
| Income Tax Expense (Benefit) | 511 | 467 | 456 | 311 | **1,745** |
| *Tax Rate* | *36.37%* | *38.36%* | *38.13%* | *37.79%* | **37.60%** |
| **Net Income** | $ 895 | $ 750 | $ 740 | $ 512 | **$ 2,897** |
| **EPS -- Fully Diluted*** | $ 0.05 | $ 0.04 | $ 0.04 | $ 0.03 | **$ 0.17** |
| Avg Shares Out-Fully Diluted* | 16,792 | 16,800 | 16,860 | 16,866 | **16,830** |
| Percent of Revenue | | | | | |
| Cost of Revenues | 55.07% | 59.48% | 61.91% | 68.06% | 61.62% |
| Selling expenses | 9.71% | 13.34% | 11.94% | 9.40% | 11.06% |
| General and Administrative expenses | 11.80% | 12.56% | 11.14% | 12.73% | 12.06% |
| YEAR / YEAR GROWTH | | | | | |
| Total Revenues | 28.91% | 25.53% | 43.54% | 51.58% | 37.70% |
| Net Income | 23.34% | 34.70% | 32.38% | -27.63% | 13.66% |

*** Adjusted for the 2-1 stock split effective March 9, 2004 and August 16, 2006**

Lifeway Foods, Inc.
Quarterly Income Statement Model
For the Years Ended December 31, 2007
(in thousands)

| | Q1(03/07)A | Q2 (06/07)A | Q3 (09/07)A | Q4 (12/07)E | **FY2007E** |
|---|---|---|---|---|---|
| Sales | $ 9,022 | $ 9,715 | $ 9,817 | $ 9,965 | **$ 38,520** |
| Cost of goods sold | 5,450 | 5,886 | 7,097 | 6,985 | **25,418** |
| **Gross Profit** | 3,572 | 3,829 | 2,721 | 2,980 | **13,102** |
| *Gross Margins* | *39.60%* | *39.41%* | *27.71%* | *29.90%* | **34.01%** |
| Operating Expenses: | | | | | |
| Sales | 770 | 912 | 965 | 920 | **3,568** |
| General and administrative | 1,001 | 1,156 | 1,174 | 1,200 | **4,531** |
| Total Operating Expenses | 1,771 | 2,068 | 2,140 | 2,120 | **8,098** |
| *EBITDA* | 2,047 | 2,029 | 857 | 1,135 | **6,068** |
| **Operating Income** | 1,801 | 1,761 | 581 | 860 | **5,003** |
| *Operating Margin* | *19.97%* | *18.13%* | *5.92%* | *8.63%* | **12.99%** |
| Other Income (Expense) | | | | | |
| Interest income | 66 | 98 | 85 | 70 | **319** |
| Interest expense | (110) | (109) | (102) | (100) | **(421)** |
| Gain on sale of marketable securities | 15 | 439 | 209 | | **663** |
| Rental income | 9 | 10 | 10 | 10 | **38** |
| Total Other Income (Expense) | (20) | 438 | 202 | (20) | **599** |
| **Pre-Tax Income** | 1,781 | 2,199 | 783 | 840 | **5,603** |
| *Pre-Tax Margins* | *19.74%* | *22.64%* | *7.97%* | *8.43%* | **14.54%** |
| Income Tax Expense (Benefit) | 646 | 804 | 315 | 340 | **2,104** |
| *Tax Rate* | *36.26%* | *36.54%* | *40.18%* | *40.49%* | **37.55%** |
| **Net Income** | $ 1,135 | $ 1,396 | $ 468 | $ 500 | **$ 3,499** |
| **EPS -- Fully Diluted** | $ 0.07 | $ 0.08 | $ 0.03 | $ 0.03 | **$ 0.21** |
| Avg Shares Out-Fully Diluted | 16,895 | 16,876 | 16,825 | 16,830 | **16,857** |
| Percent of Revenue | | | | | |
| Cost of Revenues | 60.40% | 60.59% | 72.29% | 70.10% | 65.99% |
| Selling expenses | 8.54% | 9.39% | 9.83% | 9.23% | 9.26% |
| General and Administrative expenses | 11.09% | 11.89% | 11.96% | 12.04% | 11.76% |
| YEAR / YEAR GROWTH | | | | | |
| Total Revenues | 50.29% | 52.58% | 31.66% | 26.24% | 38.96% |
| Net Income | 26.90% | 86.08% | -36.73% | -2.38% | 20.80% |

Lifeway Foods, Inc.
Quarterly Income Statement Model
For the Years Ended December 31, 2008
(in thousands)

| | Q1(03/08)E | Q2 (06/08)E | Q3 (09/08)E | Q4 (12/08)E | **FY2008E** |
|---|---|---|---|---|---|
| Sales | $ 11,365 | $ 12,185 | $ 12,300 | $ 12,375 | **$ 48,225** |
| Cost of goods sold | 7,725 | 8,175 | 8,240 | 8,100 | **32,240** |
| **Gross Profit** | 3,640 | 4,010 | 4,060 | 4,275 | **15,985** |
| *Gross Margins* | *32.03%* | *32.91%* | *33.01%* | *34.54%* | **33.15%** |
| Operating Expenses: | | | | | |
| Sales | 925 | 930 | 950 | 975 | **3,780** |
| General and administrative | 1,225 | 1,280 | 1,300 | 1,365 | **5,170** |
| Total Operating Expenses | 2,150 | 2,210 | 2,250 | 2,340 | **8,950** |
| *EBITDA* | 1,765 | 2,075 | 2,085 | 2,210 | **8,135** |
| **Operating Income** | 1,490 | 1,800 | 1,810 | 1,935 | **7,035** |
| *Operating Margin* | *13.11%* | *14.77%* | *14.72%* | *15.63%* | **14.59%** |
| Other Income (Expense) | | | | | |
| Interest income | 60 | 60 | 60 | 60 | **240** |
| Interest expense | (90) | (90) | (90) | (90) | **(360)** |
| Rental income | 5 | 5 | 5 | 5 | **20** |
| Total Other Income (Expense) | (25) | (25) | (25) | (25) | **(100)** |
| **Pre-Tax Income** | 1,465 | 1,775 | 1,785 | 1,910 | **6,935** |
| *Pre-Tax Margins* | *12.89%* | *14.57%* | *14.51%* | *15.43%* | **14.38%** |
| Income Tax Expense (Benefit) | 555 | 665 | 660 | 715 | **2,595** |
| *Tax Rate* | *37.89%* | *37.47%* | *36.97%* | *37.44%* | **37.42%** |
| **Net Income** | $ 910 | $ 1,110 | $ 1,125 | $ 1,195 | **$ 4,340** |
| **EPS -- Fully Diluted** | $ 0.05 | $ 0.07 | $ 0.07 | $ 0.07 | **$ 0.26** |
| Avg Shares Out-Fully Diluted | 16,835 | 16,840 | 16,850 | 16,860 | **16,846** |
| Percent of Revenue | | | | | |
| Cost of Revenues | 67.97% | 67.09% | 66.99% | 65.46% | 66.85% |
| Selling expenses | 8.14% | 7.63% | 7.72% | 7.88% | 7.84% |
| General and Administrative expenses | 10.78% | 10.50% | 10.57% | 11.03% | 10.72% |
| YEAR / YEAR GROWTH | | | | | |
| Total Revenues | 25.97% | 25.42% | 25.29% | 24.19% | 25.20% |
| Net Income | -19.85% | -20.48% | 140.31% | 139.12% | 24.03% |

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

| | FY2004A | FY2005A | FY2006A | 9 Mos.2007A |
|---|---|---|---|---|
| *Cash Flows from Operating Activities* | | | | |
| Net Income | $ 2,052 | $ 2,548 | $ 2,896 | $ 3,000 |
| Depreciation and amortization | 670 | 651 | 759 | 789 |
| Amortization of discounts on securities | - | - | - | - |
| Gain on sale of marketable securities | (354) | (445) | (356) | (662) |
| Loss on marketable securities classified as trading | 16 | (14) | (1) | (2) |
| Issuance of common stock in exchange for services rendered | 95 | 52 | 29 | 28 |
| Decrease in allowance for doubtful accounts | - | - | 45 | (41) |
| Deferred income taxes | 46 | (100) | 33 | 12 |
| | 2,525 | 2,692 | 3,405 | 3,125 |
| *Changes In:* | | | | |
| Accounts receivable | (224) | (494) | (1,190) | (863) |
| Other receivables | 94 | 16 | (15) | 25 |
| Inventories | (94) | (811) | (586) | (1,539) |
| Prepaid income taxes | 48 | 247 | (256) | 142 |
| Prepaid expenses and other assets | (6) | (2) | 35 | (1) |
| Accounts payable | (154) | (215) | 639 | 402 |
| Accrued expenses | 12 | 159 | 125 | (39) |
| Taxes payable | - | - | - | - |
| Net Changes in Working Capital | (325) | (1,100) | (1,248) | (1,873) |
| **Net cash Provided by Operations** | 2,200 | 1,592 | 2,158 | 1,252 |
| | | | | |
| *Cash Flows from Investing Activities* | | | | |
| Purchase of marketable securities | (6,266) | (6,461) | (7,510) | (4,408) |
| Sale of marketable securities | 6,097 | 5,810 | 7,285 | 6,653 |
| Investment in cost method securities | - | - | - | (500) |
| Acquisition of Ilya's Farms, Inc., net of assets acquired | (512) | - | - | - |
| Acquisition of Helios, net of cash acquired | - | - | (2,552) | - |
| Purchases of organizational costs | - | - | - | (6) |
| Purchase of property, plant and equipment | (330) | (4,917) | (680) | (1,143) |
| **Net cash used in Investing** | (1,011) | (5,567) | (3,456) | 596 |
| | | | | |
| *Cash Flows from Financing Activities* | | | | |
| Repayment of notes payable | (28) | (37) | (859) | (1,319) |
| Proceeds from issuance of common stock | 15 | - | - | - |
| Proceeds from note payable | - | 3,000 | - | 300 |
| Purchase of treasury stock | - | (402) | (649) | (753) |
| Loan costs | - | (7) | - | - |
| **Net cash provided by Financing** | (13) | 2,555 | (1,507) | (1,771) |
| | | | | |
| Net change in Cash | 1,175 | (1,419) | (2,806) | 77 |
| Cash Beginning of Period | 4,598 | 5,773 | 4,354 | 1,548 |
| | | | | |
| Cash End of Period | $ 5,773 | $ 4,354 | $ 1,548 | $ 1,625 |