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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549**

**FORM 10-Q**

(Mark One)

☒ QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

**For the quarterly period ended: September 30, 2020**

☐ TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 000-17363**

**LIFEWAY FOODS, INC.**

*(Exact Name of Registrant as Specified in its Charter)*

**Illinois**

*(State or Other Jurisdiction of  
Incorporation or Organization)*

**36-3442829**

*(I.R.S. Employer  
Identification No.)*

**6431 West Oakton, Morton Grove, IL 60053**

*(Address of Principal Executive Offices, Zip Code)*

**(847) 967-1010**

*(Registrant's Telephone Number, Including Area Code)*

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
<b>Common Stock, no par value</b>	<b>LWAY</b>	<b>Nasdaq Global Market</b>

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically every Interactive Data file required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☒

Smaller reporting company ☒

Emerging growth company ☐

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Number of shares of Common Stock, no par value, outstanding as of November 10, 2020: 15,604,480

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**PART I – FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS.**

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**  
**Consolidated Balance Sheets**  
**September 30, 2020 and December 31, 2019**  
*(In thousands)*

	<b>September 30, 2020 (Unaudited)</b>	<b>December 31, 2019</b>
<b>Current assets</b>		
Cash and cash equivalents	\$ 7,616	\$ 3,836
Accounts receivable, net of allowance for doubtful accounts and discounts and allowances of \$1,410 and \$1,100 at September 30, 2020 and December 31, 2019, respectively	8,159	6,692
Inventories, net	6,472	6,392
Prepaid expenses and other current assets	1,339	1,598
Refundable income taxes	189	681
<b>Total current assets</b>	<b>23,775</b>	<b>19,199</b>
<b>Property, plant and equipment, net</b>	<b>21,082</b>	<b>22,274</b>
<b>Operating lease right-of-use asset</b>	<b>380</b>	<b>738</b>
<b>Intangible assets</b>		
Goodwill and indefinite-lived intangibles	12,824	12,824
Other intangible assets, net	35	152
<b>Total intangible assets</b>	<b>12,859</b>	<b>12,976</b>
<b>Other assets</b>	1,800	1,800
<b>Total assets</b>	<b>\$ 59,896</b>	<b>\$ 56,987</b>
<b>Current liabilities</b>		
Accounts payable	\$ 6,036	\$ 5,282
Accrued expenses	2,890	4,087
Accrued income taxes	176	154
<b>Total current liabilities</b>	<b>9,102</b>	<b>9,523</b>
<b>Line of credit</b>	<b>2,763</b>	<b>2,745</b>
<b>Operating lease liabilities</b>	<b>198</b>	<b>488</b>
<b>Deferred income taxes, net</b>	<b>1,292</b>	<b>922</b>
<b>Other long-term liabilities</b>	<b>35</b>	<b>58</b>
<b>Total liabilities</b>	<b>13,390</b>	<b>13,736</b>
Commitments and contingencies		
<b>Stockholders' equity</b>		
Preferred stock, no par value; 2,500 shares authorized; no shares issued or outstanding at September 30, 2020 and December 31, 2019	—	—
Common stock, no par value; 40,000 shares authorized; 17,274 shares issued; 15,605 and 15,710 outstanding at September 30, 2020 and December 31, 2019, respectively	6,509	6,509
Paid-in capital	2,532	2,380
Treasury stock, at cost	(12,450)	(12,601)
Retained earnings	49,915	46,963
<b>Total stockholders' equity</b>	<b>46,506</b>	<b>43,251</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 59,896</b>	<b>\$ 56,987</b>

See accompanying notes to consolidated financial statements

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Operations**  
**For the three and nine Months Ended September 30, 2020 and 2019**  
*(Unaudited)*  
*(In thousands, except per share data)*

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
<b>Net sales</b>	<b>\$ 26,039</b>	<b>\$ 22,729</b>	<b>\$ 76,441</b>	<b>\$ 70,497</b>
Cost of goods sold	17,710	16,813	53,613	51,223
Depreciation expense	752	743	2,326	2,235
Total cost of goods sold	18,462	17,556	55,939	53,458
<b>Gross profit</b>	<b>7,577</b>	<b>5,173</b>	<b>20,502</b>	<b>17,039</b>
Selling expenses	2,116	2,679	7,411	8,509
General and administrative	2,805	2,710	8,681	9,100
Amortization expense	39	39	117	152
<b>Total operating expenses</b>	<b>4,960</b>	<b>5,428</b>	<b>16,209</b>	<b>17,761</b>
<b>Income (loss) from operations</b>	<b>2,617</b>	<b>(255)</b>	<b>4,293</b>	<b>(722)</b>
Other income (expense):				
Interest expense	(27)	(65)	(96)	(202)
Gain on investments	—	—	4	—
(Loss) gain on sale of property and equipment	—	154	(28)	183
Other income, net	—	77	2	82
Total other income (expense)	(27)	166	(118)	63
<b>Income (loss) before provision for income taxes</b>	<b>2,590</b>	<b>(89)</b>	<b>4,175</b>	<b>(659)</b>
Provision (benefit) for income taxes	764	(17)	1,223	(58)
<b>Net income (loss)</b>	<b>\$ 1,826</b>	<b>\$ (72)</b>	<b>\$ 2,952</b>	<b>\$ (601)</b>
<b>Earnings (loss) per common share:</b>				
Basic	\$ 0.12	\$ (0.00)	\$ 0.19	\$ (0.04)
Diluted	\$ 0.12	\$ (0.00)	\$ 0.19	\$ (0.04)
<b>Weighted average common shares:</b>				
Basic	15,602	15,740	15,595	15,761
Diluted	15,642	15,740	15,621	15,761

See accompanying notes to consolidated financial statements

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Stockholders' Equity**  
**(Unaudited)**  
**(In thousands)**

	Common Stock				Paid-In Capital	Retained Earnings	Total Equity
	Issued Shares	\$	In treasury Shares	\$			
<b>Balance, January 1, 2019</b>	<b>17,274</b>	<b>\$ 6,509</b>	<b>(1,460)</b>	<b>\$ (12,970)</b>	<b>\$ 2,303</b>	<b>\$ 46,563</b>	<b>\$ 42,405</b>
Cumulative impact of change in accounting principles, net of tax	—	—	—	—	—	(53)	(53)
Issuance of common stock in connection with stock-based compensation	—	—	41	351	142	—	493
Treasury stock purchased	—	—	(82)	(205)	—	—	(205)
Stock-based compensation	—	—	—	—	218	—	218
Net loss	—	—	—	—	—	(388)	(388)
<b>Balance, March 31, 2019</b>	<b><u>17,274</u></b>	<b><u>\$ 6,509</u></b>	<b><u>(1,501)</u></b>	<b><u>\$ (12,824)</u></b>	<b><u>\$ 2,663</u></b>	<b><u>\$ 46,122</u></b>	<b><u>\$ 42,470</u></b>
Issuance of common stock in connection with stock-based compensation	—	—	62	527	(548)	—	(21)
Treasury stock purchased	—	—	(74)	(180)	—	—	(180)
Stock-based compensation	—	—	—	—	115	—	115
Net loss	—	—	—	—	—	(141)	(141)
<b>Balance, June 30, 2019</b>	<b><u>17,274</u></b>	<b><u>\$ 6,509</u></b>	<b><u>(1,513)</u></b>	<b><u>\$ (12,477)</u></b>	<b><u>\$ 2,230</u></b>	<b><u>\$ 45,981</u></b>	<b><u>\$ 42,243</u></b>
Treasury stock purchased	—	—	(54)	(153)	—	—	(153)
Stock-based compensation	—	—	—	—	118	—	118
Net loss	—	—	—	—	—	(72)	(72)
<b>Balance, September 30, 2019</b>	<b><u>17,274</u></b>	<b><u>\$ 6,509</u></b>	<b><u>(1,567)</u></b>	<b><u>\$ (12,630)</u></b>	<b><u>\$ 2,348</u></b>	<b><u>\$ 45,909</u></b>	<b><u>\$ 42,136</u></b>

See accompanying notes to consolidated financial statements

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Stockholders' Equity (continued)**  
**(Unaudited)**  
**(In thousands)**

	Common Stock				Paid-In Capital	Retained Earnings	Total Equity
	Issued Shares	\$	In treasury Shares	\$			
<b>Balance, January 1, 2020</b>	17,274	\$ 6,509	(1,564)	\$ (12,601)	\$ 2,380	\$ 46,963	\$ 43,251
Issuance of common stock in connection with stock-based compensation	—	—	27	210	306	—	516
Treasury stock purchased	—	—	(179)	(405)	—	—	(405)
Stock-based compensation	—	—	—	—	62	—	62
Net income	—	—	—	—	—	146	146
<b>Balance, March 31, 2020</b>	<u>17,274</u>	<u>\$ 6,509</u>	<u>(1,716)</u>	<u>\$ (12,796)</u>	<u>\$ 2,748</u>	<u>\$ 47,109</u>	<u>\$ 43,570</u>
Issuance of common stock in connection with stock-based compensation	—	—	34	248	(270)	—	(22)
Stock-based compensation	—	—	—	—	109	—	109
Net income	—	—	—	—	—	980	980
<b>Balance, June 30, 2020</b>	<u>17,274</u>	<u>\$ 6,509</u>	<u>(1,682)</u>	<u>\$ (12,548)</u>	<u>\$ 2,587</u>	<u>\$ 48,089</u>	<u>\$ 44,637</u>
Issuance of common stock in connection with stock-based compensation	—	—	13	98	(98)	—	—
Stock-based compensation	—	—	—	—	43	—	43
Net income	—	—	—	—	—	1,826	1,826
<b>Balance, September 30, 2020</b>	<u>17,274</u>	<u>\$ 6,509</u>	<u>(1,669)</u>	<u>\$ (12,450)</u>	<u>\$ 2,532</u>	<u>\$ 49,915</u>	<u>\$ 46,506</u>

See accompanying notes to consolidated financial statements



**LIFEWAY FOODS, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**  
**(In thousands)**

	<b>Nine months ended September 30,</b>	
	<b>2020</b>	<b>2019</b>
<b><u>Cash flows from operating activities:</u></b>		
<b>Net income (loss)</b>	<b>\$ 2,952</b>	<b>\$ (601)</b>
<b><i>Adjustments to reconcile net income (loss) to operating cash flow:</i></b>		
Depreciation and amortization	2,443	2,387
Non-cash interest expense	17	17
Non-cash rent expense	(38)	—
Bad debt expense	(3)	20
Deferred revenue	(73)	(73)
Stock-based compensation	274	714
Deferred income taxes	369	—
Loss (gain) on sale of property and equipment	28	(183)
Reserve for inventory obsolescence	—	177
<b><i>(Increase) decrease in operating assets:</i></b>		
Accounts receivable	(1,464)	(316)
Inventories	(80)	(1,118)
Refundable income taxes	492	1,921
Prepaid expenses and other current assets	248	(399)
<b><i>Increase (decrease) in operating liabilities:</i></b>		
Accounts payable	756	2,397
Accrued expenses	(595)	53
Accrued income taxes	22	(43)
<b>Net cash provided by operating activities</b>	<b><u>5,348</u></b>	<b><u>4,953</u></b>
<b><u>Cash flows from investing activities:</u></b>		
Purchases of property and equipment	(1,168)	(610)
Proceeds from sale of property and equipment	5	513
Purchase of investments	—	(15)
<b>Net cash used in investing activities</b>	<b><u>(1,163)</u></b>	<b><u>(112)</u></b>
<b><u>Cash flows from financing activities:</u></b>		
Purchase of treasury stock	(405)	(538)
Repayment of line of credit	—	(1,789)
<b>Net cash used in financing activities</b>	<b><u>(405)</u></b>	<b><u>(2,327)</u></b>
<b>Net increase in cash and cash equivalents</b>	<b>3,780</b>	<b>2,514</b>
Cash and cash equivalents at the beginning of the period	3,836	2,998
<b>Cash and cash equivalents at the end of the period</b>	<b><u>\$ 7,616</u></b>	<b><u>\$ 5,512</u></b>
<b><u>Supplemental cash flow information:</u></b>		
Cash paid for income taxes, net of (refunds)	\$ 335	\$ (1,937)
Cash paid for interest	\$ 82	\$ 214
<b><u>Non-cash investing activities</u></b>		
Right-of-use assets recognized at ASU 2016-02 transition	\$ —	\$ 944
Operating lease liability recognized at ASU 2016-02 transition	\$ —	\$ 997
Increase (decrease) in right-of-use assets and operating lease liabilities recognized after ASU 2016-02 transition	\$ (58)	\$ 280
<b><u>Non-cash financing activities</u></b>		
Issuance of common stock under equity incentive plans	\$ 522	\$ —

See accompanying notes to consolidated financial statements

**LIFEWAY FOODS, INC. AND SUBSIDIARIES**  
**Notes to Consolidated Financial Statements**  
**(Unaudited)**  
*(In thousands, except per share data)*

**Note 1 – Basis of Presentation**

Basis of presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the U.S. (“U.S. GAAP”) for interim financial information, and do not include all of the information and disclosures required for complete, audited financial statements. In the opinion of management, these statements include all adjustments necessary for a fair presentation of the results of all interim periods reported herein. The consolidated financial statements and related notes should be read in conjunction with the consolidated financial statements and related notes included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2019. Results of operations for interim periods are not necessarily indicative of the results to be expected for other interim periods or the full year.

A detailed description of our significant accounting policies can be found in our Annual Report on Form 10-K for the fiscal year ended December 31, 2019.

Principles of consolidation

Our consolidated financial statements include the accounts of Lifeway Foods, Inc. and all its wholly owned subsidiaries (collectively “Lifeway” or the “Company”). All significant intercompany accounts and transactions have been eliminated.

**Note 2 – Significant Accounting Policies**

Use of estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates made in preparing the consolidated financial statements include the reserve for promotional allowances, the valuation of goodwill and intangible assets, stock-based and incentive compensation, and deferred income taxes.

Revenue recognition

We sell food and beverage products across select product categories to customers predominantly within the United States (see Note 12, Segments, Products and Customers). We also sell bulk cream, a byproduct of our fluid milk manufacturing process. In accordance with ASC 606, Revenue from Contracts with Customers, we recognize revenue when control over the products transfers to our customers, which generally occurs upon delivery to our customers or their common carriers. The Company adopted this standard at the beginning of fiscal year 2018, with no significant impact to its financial position or results of operations, using the modified retrospective method. The amount of revenue recognized reflects the consideration to which the Company expects to be entitled to receive in exchange for these goods or services, using the five-step method required by ASC 606.

For the Company, the contract is the approved sales order, which may also be supplemented by other agreements that formalize various terms and conditions with customers. The Company applies judgment in determining the customer’s ability and intention to pay, which is based on a variety of factors including the customer’s historical payment experience or, in the case of a new customer, published credit and financial information pertaining to the customer.

Performance obligations promised in a contract are identified based on the goods or services that will be transferred to the customer, which is the delivery of food products which provide immediate benefit to the customer.

We account for product shipping and handling as fulfillment activities with revenues for these activities recorded within net revenue and costs recorded within cost of goods sold. Any taxes collected on behalf of government authorities are excluded from net revenues.

Variable consideration, which typically includes volume-based rebates, known or expected pricing or revenue adjustments, such as trade discounts, allowances for non-saleable products, product returns, trade incentives and coupon redemption, is estimated utilizing the most likely amount method.

Key sales terms, such as pricing and quantities ordered, are established on a frequent basis such that most customer arrangements and related incentives have a one year or shorter duration. As such, we do not capitalize contract inception costs and we capitalize product fulfillment costs in accordance with U.S. GAAP and our inventory policies. We do not have any significant deferred revenue or unbilled receivables at the end of a period. We generally do not receive noncash consideration for the sale of goods, nor do we grant payment financing terms greater than one year.

#### Advertising and promotional costs

Lifeway expenses advertising costs as incurred. For the nine months ended September 30, 2020 and 2019 total advertising expenses were \$1,700 and \$2,650, respectively. For the three months ended September 30, 2020 and 2019 total advertising expenses were \$380 and \$786, respectively.

#### Recent accounting pronouncements

##### Issued but not yet effective

In March 2020, the FASB issued ASU No. 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting. The new guidance provides optional expedients and exceptions for applying generally accepted accounting principles (GAAP) to contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued because of reference rate reform. The guidance is effective prospectively as of March 12, 2020 through December 31, 2022 and interim periods within those fiscal years. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

In December 2019, the FASB issued ASU No. 2019-12, Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes. The new guidance is intended to enhance and simplify various aspects of the accounting for income taxes. The new guidance eliminates certain exceptions to the general approach to the income tax accounting model, and adds new guidance to reduce the complexity in accounting for income taxes. The guidance will be effective for fiscal years beginning after December 15, 2020 and interim periods within those fiscal years. Early adoption of the amendments is permitted, including adoption in any interim period for public business entities for periods for which financial statements have not yet been issued. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, in November 2018 issued an amendment, ASU 2018-19, Codification Improvements to Topic 326, Financial Instruments - Credit Losses, and in November 2019 issued two amendments, ASU 2019-10, Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates, and ASU 2019-11, Codification Improvements to Topic 326, Financial Instruments—Credit Losses. The series of new guidance amends the impairment model by requiring entities to use a forward-looking approach based on expected losses rather than incurred losses to estimate credit losses on certain types of financial instruments, including trade receivables. This may result in the earlier recognition of allowances for losses. The guidance should be applied on either a prospective transition or modified-retrospective approach depending on the subtopic. The guidance will be effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, with early adoption permitted. Management is currently evaluating the impact that the new guidance will have on the consolidated financial statements.

**Note 3 – Inventories, net**

Inventories consisted of the following:

	September 30, 2020	December 31, 2019
Ingredients	\$ 1,848	\$ 1,942
Packaging	2,223	2,230
Finished goods	2,401	2,220
Total inventories	<u>\$ 6,472</u>	<u>\$ 6,392</u>

**Note 4 – Property, Plant and Equipment, net**

Property, plant and equipment consisted of the following:

	September 30, 2020	December 31, 2019
Land	\$ 1,565	\$ 1,565
Buildings and improvements	17,744	17,332
Machinery and equipment	30,930	30,670
Vehicles	778	778
Office equipment	849	851
Construction in process	455	362
	<u>52,321</u>	<u>51,558</u>
Less accumulated depreciation	(31,239)	(29,284)
Total property, plant and equipment, net	<u>\$ 21,082</u>	<u>\$ 22,274</u>

**Note 5 – Goodwill and Intangible Assets**

Goodwill and indefinite-lived intangible assets consisted of the following:

	September 30, 2020	December 31, 2019
Gross goodwill	\$ 10,368	\$ 10,368
Accumulated impairment losses	(1,244)	(1,244)
Goodwill	<u>9,124</u>	<u>9,124</u>
Brand names	3,700	3,700
Goodwill and indefinite-lived intangible assets	<u>\$ 12,824</u>	<u>\$ 12,824</u>

*Finite-lived Intangible Assets*

Other intangible assets, net consisted of the following:

	September 30, 2020	December 31, 2019
Recipes	\$ 44	\$ 44
Customer lists and other customer related intangibles	4,529	4,529
Customer relationship	985	985
Trade names	2,248	2,248
Formula	438	438
	<u>8,244</u>	<u>8,244</u>
Accumulated amortization	(8,209)	(8,092)
Other intangible assets, net	<u>\$ 35</u>	<u>\$ 152</u>

**Note 6 – Accrued Expenses**

Accrued expenses consisted of the following:

	September 30, 2020	December 31, 2019
Payroll and incentive compensation	\$ 2,092	\$ 3,009
Real estate taxes	320	398
Current portion of operating lease liabilities	181	285
Other	297	395
Total accrued expenses	<u>\$ 2,890</u>	<u>\$ 4,087</u>

**Note 7 – Debt***Line of Credit*

On May 7, 2018, Lifeway entered into an Amended and Restated Loan and Security Agreement (the “Revolving Credit Facility”) with its existing lender. On April 10, 2019, effective March 31, 2019, Lifeway entered into the First Modification to the Amended and Restated Loan and Security Agreement (the “Modified Revolving Credit Facility”) with its existing lender. Under the amendment, the Modified Revolving Credit Facility provides for a revolving line of credit up to a maximum of \$9 million (the “Revolving Loan”) with an incremental facility not to exceed \$5 million (the “Incremental Facility” and together with the Revolving Loan, the “Loans”).

On December 10, 2019, Lifeway entered into the Second Modification to the Amended and Restated Loan and Security Agreement, as amended, (the “Second Modification”) with its existing lender. The Second Modification amends the Amended and Restated Loan and Security Agreement, as amended, by redefining the “Borrowing Base” and further clarifying the definitions of “Eligible Accounts” and “Eligible Inventory.” The “Borrowing Base” under this amendment means, generally, an amount equal to the sum of (a) 85% of the unpaid amount of all eligible accounts receivable, plus (b) 50% of the value of all eligible inventory. The Second Modification also addresses the calculation of interest after the potential discontinuance of LIBOR and its replacement with a replacement benchmark interest rate.

On September 30, 2020, Lifeway entered into the Third Modification to the Amended and Restated Loan and Security Agreement, as amended, (the “Third Modification”) with its existing lender. The Third Modification amends the Amended and Restated Loan and Security Agreement, as amended, by removing the monthly borrowing base reporting requirement effective September 30, 2020, including a covenant to maintain a quarterly minimum working capital financial covenant, as defined, of no less than \$11.25 million each of the fiscal quarters commencing the fiscal quarter ending December 31, 2020 through the expiration date, and eliminating the tier interest pricing structure. The Amended and Restated Loan and Security Agreement continues to provide Lifeway with a revolving line of credit up to a maximum of \$5 million (the “Revolving Loan”) and provides the Borrowers with an incremental facility not to exceed \$5 million (the “Incremental Facility” and together with the Revolving Loan, the “Loans”). The Termination Date of the Revolving Loan was extended to June 30, 2025, unless earlier terminated.

Except as described above, as amended, the Modified Revolving Credit Facility remains substantively unchanged and in full force and effect, including customary representations, warranties, and covenants on the part of Lifeway, including financial covenants requiring us to maintain a fixed charge coverage ratio of no less than 1.25 to 1.00 each of the fiscal quarters ending through the expiration date. The Modified Revolving Credit Facility continues to provide for events of default, including failure to repay principal and interest when due and failure to perform or violation of the provisions or covenants of the agreement, as a result of which amounts due under the Modified Revolving Credit Facility may be accelerated. The loans and all other amounts due and owed under the Revolving Credit Facility and related documents are secured by substantially all of our assets.

As of September 30, 2020, we had \$2,763 net of \$14 of unamortized deferred financing costs, outstanding under the Revolving Credit Facility. We had \$2,223 available for future borrowings as of September 30, 2020.

As amended, all outstanding amounts under the Loans bear interest, at Lifeway’s election, at either the lender Base Rate (the Prime Rate minus 1.00%) or the LIBOR plus 1.95%, payable monthly in arrears. Lifeway is also required to pay a quarterly unused line fee of 0.20% and, in conjunction with the issuance of any letters of credit, a letter of credit fee of 0.20%. Lifeway’s interest rate on debt outstanding under our Revolving Credit Facility as of September 30, 2020 was 2.41%.

We were in compliance with the fixed charge coverage ratio covenant at September 30, 2020.

#### **Note 8 – Leases**

Lifeway has operating leases for two retail stores for its Lifeway Kefir Shop subsidiary and office space which includes fixed base rent payments as well as variable rent payments to reimburse the landlord for operating expenses and taxes. The Company terminated its office space leases in June 2020. The Company also leases certain machinery and equipment with fixed base rent payments and variable costs based on usage. Remaining lease terms for these leases range from less than 1 year to 5 years. Some of our leases include options to extend the leases for up to 5 years and have been included in our calculation of the right-of-use asset and lease liabilities. Lifeway includes only fixed payments for lease components in the measurement of the right-of-use asset and lease liability. Variable lease payments are those that vary because of changes in facts or circumstances occurring after the commencement date, other than the passage of time. There are no residual value guarantees. We do not currently have leases which meet the finance lease classification as defined under ASC 842.

We do not record leases with an initial term of 12 months or less on the balance sheet. Expense for these short-term leases is recorded on a straight-line basis over the lease term. Total lease expense was \$392 and \$552 (including short term leases) for the nine months ended September 30, 2020 and 2019, respectively. Total lease expense was \$81 and \$187 (including short term leases) for the three months ended September 30, 2020 and 2019, respectively.

Lifeway treats contracts as a lease when the contract conveys the right to use a physically distinct asset for a period of time in exchange for consideration, we direct the use of the asset and obtain substantially all the economic benefits of the asset.

Right-of-use assets and lease liabilities are measured and recognized based on the present value of the future minimum lease payments over the lease term at the commencement date. We have elected the practical expedient to combine lease and non-lease components into a single component for all of our leases. For many of our leases such as real estate leases, we are unable to determine an implicit rate; therefore, we use our incremental borrowing rate based on the information available at the commencement date in determining the present value of future payments for those leases. We include options to extend or terminate the lease in the measurement of the right-of-use asset and lease liability when it is reasonably certain that we will exercise such options. Lease expense for minimum lease payments is recognized on a straight-line basis over the lease term.

Future maturities of lease liabilities were as follows

Year	Operating Leases
Three months ended December 31, 2020	\$ 53
2021	189
2022	145
2023	16
Thereafter	2
Total lease payments	405
Less: Interest	(26)
Present value of lease liabilities	<u>\$ 379</u>

The weighted-average remaining lease term for our operating leases was 2.02 years as of September 30, 2020. The weighted average discount rate of our operating leases was 5.82% as of September 30, 2020. Cash paid for amounts included in the measurement of lease liabilities was \$328 and \$437 the nine months ended September 30, 2020 and 2019, respectively. Cash paid for amounts included in the measurement of lease liabilities was \$56 and \$145 for the three months ended September 30, 2020 and 2019, respectively.

## Note 9 – Commitments and contingencies

### *Litigation*

Lifeway is engaged in various legal actions, claims, audits, and proceedings arising in the normal course of business, including commercial disputes, product liabilities, intellectual property matters and employment-related matters resulting from our business activities.



We record accruals for outstanding legal matters when we believe it is probable that a loss will be incurred and the amount of such loss can be reasonably estimated. We evaluate, on a periodic basis, developments in legal matters that could affect the amount of any accrual and developments that would make a loss contingency both probable and reasonably estimable. If a loss contingency is not both probable and estimable, we do not establish an accrued liability. Currently, none of our accruals for outstanding legal matters are material individually or in the aggregate to our financial position and it is management's opinion that the ultimate resolution of these outstanding legal matters will not have a material adverse effect on our business, financial condition, results of operations, or cash flows. However, if we ultimately are required to make payments in connection with an adverse outcome, it is possible that it could have a material adverse effect on our business, financial condition, results of operations or cash flows.

Lifeway's contingencies are subject to substantial uncertainties, including for each such contingency the following, among other factors: (i) the procedural status of the case; (ii) whether the case has or may be certified as a class action suit; (iii) the outcome of preliminary motions; (iv) the impact of discovery; (v) whether there are significant factual issues to be determined or resolved; (vi) whether the proceedings involve a large number of parties and/or parties and claims in multiple jurisdictions or jurisdictions in which the relevant laws are complex or unclear; (vii) the extent of potential damages, which are often unspecified or indeterminate; and (viii) the status of settlement discussions, if any, and the settlement posture of the parties. Consequently, Lifeway cannot predict with any reasonable certainty the timing or outcome of such contingencies, and we are unable to estimate a possible loss or range of loss.

#### **Note 10 – Income taxes**

For each interim period, Lifeway estimates the effective tax rate expected to be applicable for the full year and applies that rate to income before provision for income taxes for the period. The effective tax rate for the nine months ended September 30, 2020 was 29.3% compared to 8.8% for the nine months ended September 30, 2019. The effective tax rate for the three months ended September 30, 2020 was 29.5% compared to 19.3% for the three months ended September 30, 2019. The increase in effective tax rate for the nine months ended is primarily the result of non-deductible compensation expense related to equity incentive awards and state tax receivables reducing the benefit associated with a pre-tax book loss in 2019, partially offset by a benefit recognized in 2020 due to the enactment of the "Coronavirus Aid, Relief, and Economic Security Act" (the CARES Act). The increase in effective tax rate for the three months ended is also primarily due to the non-deductible compensation expenses related to equity incentive awards and state tax receivables associated with a pre-tax book loss in 2019, but further offset by the adjustment to the valuation allowance recorded for the quarter ended September 30, 2019, which increased the tax benefit associated with our pre-tax book loss for the quarter. Our effective tax rate may change from period to period based on recurring and non-recurring factors including the relative mix of pre-tax earnings (or losses), the underlying income tax rates applicable to various state and local taxing jurisdictions, enacted tax legislation, settlement of tax audits, the impact of non-deductible items, changes in valuation allowances, and the expiration of the statute of limitations in relation to unrecognized tax benefits. We record discrete income tax items such as enacted tax rate changes and completed tax audits in the period in which they occur.

On March 27, 2020, the "Coronavirus Aid, Relief, and Economic Security Act" (the CARES Act) was enacted. The CARES act features several tax provisions and other measures that assist businesses impacted by the economic effects of the COVID-19 pandemic. The significant tax provisions include an increase in the limitation of the tax deduction for interest expense from 30% to 50% of adjusted earnings in 2019 and 2020, a five-year carryback allowance for net operating losses generated in tax years 2018-2020, increased charitable contribution limitations to 25% of taxable income in 2020, and a retroactive technical correction to the 2017 Tax Cuts and Jobs Act that makes qualified improvement property placed in service after December 31, 2017 eligible for bonus depreciation. The Company has recorded a \$245 income tax benefit related to the net operating loss carryback provisions of the CARES Act for the nine months ended September 30, 2020.

Unrecognized tax benefits were \$93 and \$63 at September 30, 2020 and 2019, respectively. The Company believes that an adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If a tax audit is resolved in a manner inconsistent with its expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs. We do not expect material changes to our unrecognized tax benefits during the next twelve months.

**Note 11 – Stock-based and Other Compensation**

In December 2015, Lifeway stockholders approved the 2015 Omnibus Incentive Plan, which authorized the issuance of an aggregate of 3.5 million shares to satisfy awards of stock options, stock appreciation rights, unrestricted stock, restricted stock, restricted stock units, performance shares and performance units to qualifying employees. Under the Plan, the Board or its Audit and Corporate Governance Committee approves stock awards to executive officers and certain senior executives, generally in the form of restricted stock or performance shares. The number of performance shares that participants may earn depends on the extent to which the corresponding performance goals have been achieved. Stock awards generally vest over a three-year performance or service period. At September 30, 2020, 3.317 million shares remain available under the Omnibus Incentive Plan. While we plan to continue to issue awards pursuant to the Plan at least annually, we may choose to suspend the issuance of new awards in the future and may grant additional awards at any time including issuing special grants of restricted stock, restricted stock units, and stock options to attract and retain new and existing executives.

*Stock Options*

The following table summarizes stock option activity during the nine months ended September 30, 2020:

	<b>Options</b>	<b>Weighted average exercise price</b>	<b>Weighted average remaining contractual life</b>	<b>Aggregate intrinsic value</b>
Outstanding at December 31, 2019	41	\$ 10.42	6.22	\$ —
Granted	—	—	—	—
Exercised	—	—	—	—
Forfeited	—	—	—	—
Outstanding at September 30, 2020	<u>41</u>	<u>\$ 10.42</u>	<u>5.47</u>	<u>\$ —</u>
Exercisable at September 30, 2020	<u>41</u>	<u>\$ 10.42</u>	<u>5.47</u>	<u>\$ —</u>

As of December 31, 2019, all outstanding options were vested and there was no remaining unearned compensation expense. For the nine months and three months ended September 30, 2019, total pre-tax stock-based compensation expense recognized in the consolidated statements of operations was \$0. For the nine months and three months ended September 30, 2019, no tax-related benefits were recognized.

*Restricted Stock Awards*

A Restricted Stock Award (“RSA”) represents the right to receive one share of common stock in the future. RSAs have no exercise price. The grant date fair value of the awards is equal to our closing stock price on the grant date. The following table summarizes RSA activity during the nine months ended September 30, 2020.

	<b>RSA's</b>
Outstanding at December 31, 2019	47
Granted	57
Shares issued upon vesting	(13)
Forfeited	(13)
Outstanding at September 30, 2020	<u>78</u>
Weighted average grant date fair value per share outstanding	<u>\$ 3.06</u>

We expense RSA's over the service period. For the nine months ended September 30, 2020 and 2019 total pre-tax stock-based compensation expense recognized in the consolidated statements of operations was \$51 and \$82, respectively. For the nine months ended September 30, 2020 and 2019 tax-related benefits of \$14 and \$22, respectively, were also recognized. For the three months ended September 30, 2020 and 2019 total pre-tax stock-based compensation expense recognized in the consolidated statements of operations was \$28 and \$30, respectively. For the three months ended September 30, 2020 and 2019 tax-related benefits of \$8 were also recognized. As of September 30, 2020, the total remaining unearned compensation related to non-vested RSA's was \$166, which is expected to be amortized over the weighted-average remaining service period of 1.35 years.

#### *Long-Term Incentive Plan Compensation*

Lifeway established long-term incentive-based compensation programs for fiscal year 2017 (the "2017 Plan") and for fiscal year 2019 (the "2019 Plan") for certain senior executives and key employees (the "participants"). Under the 2017 Plan, long-term incentive compensation is based on Lifeway's achievement of certain sales and adjusted EBITDA performance levels versus respective targets established by the Board for the fiscal year. Under the 2019 Plan, long-term equity incentive compensation is based on Lifeway's achievement of four strategic milestones over a three-year period from Fiscal 2019 through Fiscal 2021.

#### *2017 Plan*

Under the 2017 Plan, collectively the participants had the opportunity to earn cash and equity-based incentive compensation in amounts ranging from \$0 to \$11,025 depending on Lifeway's performance levels compared to the respective targets and the participants performance compared to their individual objectives. The equity portion of the incentive compensation is payable in restricted stock that vests one-third in each of the three years from the 2017 grant dates. For the nine months ended September 30, 2020 and 2019, \$49 and \$234 was expensed under the 2017 Plan as stock-based compensation expense in the consolidated statements of operations, respectively. For the three months ended September 30, 2020 and 2019, \$0 and \$54 was expensed under the 2017 Plan as stock-based compensation expense in the consolidated statements of operations, respectively. As of March 31, 2020, there was no remaining expense under the 2017 plan.

#### *2019 Plan*

Under the 2019 Plan, collectively the participants can earn equity-based incentive compensation in amounts ranging from \$0 to \$1,776 depending on Lifeway's performance levels compared to the respective targets. The equity-based incentive compensation is payable in restricted stock that vests 50% of unvested shares in year one, 50% of unvested shares in year two, and 100% of remaining unvested shares in year three from the 2019 grant date. For the nine months ended September 30, 2020 and 2019, \$90 and \$103 was expensed under the 2019 Plan as stock-based compensation expense in the consolidated statements of operations, respectively. For the three months ended September 30, 2020 and 2019, \$1 and \$35 was expensed under the 2019 Retention Award as stock-based compensation expense in the consolidated statements of operations, respectively.

#### *2019 Retention Award*

During Q1 2019, we awarded a special retention grant (the "2019 Retention Award") of restricted stock to certain senior executives and key employees (the "participants"). The equity-based incentive compensation is payable in restricted stock that vests one-third in March 2019, one-third in March 2020 and one-third in March 2021. For the nine months ended September 30, 2020 and 2019, \$73 and \$265 was expensed under the 2020 Retention Award as stock-based compensation expense in the consolidated statements of operations, respectively. For the three months ended September 30, 2020 and 2019, \$15 and \$54 was expensed under the 2019 Retention Award as stock-based compensation expense in the consolidated statements of operations, respectively.

As of September 30, 2020, the total remaining unearned compensation related to the 2019 Retention Award was \$29, of which \$15 and \$14 is expected to be recognized in 2020 and 2021, respectively, subject to vesting.

#### *Retirement Benefits*

Lifeway has a defined contribution plan which is available to substantially all full-time employees. Under the terms of the plan, we match employee contributions under a prescribed formula. For the nine months ended September 30, 2020 and 2019 total contribution expense recognized in the consolidated statements of operations was \$307 and \$269, respectively. For the three months ended September 30, 2020 and 2019 total contribution expense recognized in the consolidated statements of operations was \$93 and \$88, respectively.

#### **Note 12 – Segments, Products and Customers**

Lifeway's primary product is drinkable kefir, a cultured dairy product. Lifeway Kefir is tart and tangy, high in protein, calcium and vitamin D. Thanks to our exclusive blend of kefir cultures, each cup of kefir contains 12 live and active cultures and 15 to 20 billion beneficial CFU (Colony Forming Units) at the time of manufacture.

We manufacture (directly or through co-packers) our products under our own brand, as well as under private labels on behalf of certain customers. In addition to our core drinkable kefir products, we offer several lines of products developed through our innovation and development efforts. These include Kefir Cups, a strained, cupped version of our kefir; and Organic Farmer Cheese Cups, a cupped version of our soft cheeses, both served in resealable 5 oz. containers. We also offer Skyr, a strained cupped Icelandic yogurt; Plantiful, a plant-based probiotic beverage made from organic and non-GMO pea protein with 10 vegan kefir cultures; a line of probiotic supplements for adults and children; and a soft serve kefir mix.

Our product categories are:

- Drinkable Kefir, sold in a variety of organic and non-organic sizes, flavors, and types, including low fat, non-fat, whole milk, protein, and BioKefir (a 3.5 oz. kefir with additional probiotic cultures).
- European-style soft cheeses, including farmer cheese in resealable cups.
- Cream and other, which consists primarily of cream, a byproduct of making our kefir.
- ProBugs, a line of kefir products designed for children.
- Other Dairy, which includes Cupped Kefir and Icelandic Skyr, a line of strained kefir and yogurt products in resealable cups.
- Frozen Kefir, available in soft serve and pint-size containers.

Lifeway has determined that it has one reportable segment based on how our chief operating decision maker manages the business and in a manner consistent with the internal reporting provided to the chief operating decision maker. The chief operating decision maker, who is responsible for allocating resources and assessing our performance, has been identified collectively as the Chief Executive Officer, the Chief Operating Officer, the Chief Financial Officer, and Chairperson of the board of directors. Substantially all of our consolidated revenues relate to the sale of cultured dairy products that we produce using the same processes and materials and are sold to consumers through a common network of distributors and retailers in the United States.

Net sales of products by category were as follows for the nine months ended September 30:

	2020		2019	
	\$	%	\$	%
Drinkable Kefir other than ProBugs	\$ 61,155	80%	\$ 54,126	77%
Cheese	9,619	13%	8,348	12%
Cream and other	2,120	3%	3,359	5%
ProBugs Kefir	1,946	2%	2,050	3%
Other dairy	1,171	1%	1,334	2%
Frozen Kefir (a)	430	1%	1,280	1%
Net Sales	<u>\$ 76,441</u>	<u>100%</u>	<u>\$ 70,497</u>	<u>100%</u>

(a) Includes Lifeway Kefir Shop sales

Net sales of products by category were as follows for the three months ended September 30:

	2020		2019	
	\$	%	\$	%
Drinkable Kefir other than ProBugs	\$ 21,152	81%	\$ 17,513	77%
Cheese	3,105	12%	2,791	12%
Cream and other	688	3%	913	4%
ProBugs Kefir	629	2%	590	3%
Other dairy	363	1%	432	2%
Frozen Kefir (a)	102	1%	490	2%
Net Sales	<u>\$ 26,039</u>	<u>100%</u>	<u>\$ 22,729</u>	<u>100%</u>

(a) Includes Lifeway Kefir Shop sales

**Significant Customers** – Sales are predominately to companies in the retail food industry located within the United States. Two major customers accounted for approximately 21% and 22% of net sales for the nine months ended September 30, 2020 and 2019, respectively. Two major customers accounted for approximately 22% and 21% of net sales for the three months ended September 30, 2020 and 2019, respectively.

### Note 13 – Related Party Transactions

Lifeway obtains consulting services from the Chairperson of its board of directors. Fees earned by the Chairperson are included in general and administrative expenses in the accompanying consolidated statements of operations and were \$750 during each of the nine months ended September 30, 2020 and 2019. Fees earned are included in general and administrative expenses in the accompanying consolidated statements of operations and were \$250 during each of the three months ended September 30, 2020 and 2019.

Lifeway is also a party to a royalty agreement with the Chairperson of its board of directors under which we pay the Chairperson a royalty based on the sale of certain Lifeway products, not to exceed \$50 in any fiscal month. Royalties earned by the Chairperson are included in selling expenses in the accompanying consolidated statements of operations and were \$450 and \$441 during the nine months ended September 30, 2020 and 2019, respectively. Royalties earned are included in selling expenses in the accompanying consolidated statements of operations and were \$150 and \$143 during the three months ended September 30, 2020 and 2019.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in this Form 10-Q is provided as a supplement to, and should be read in conjunction with, our audited consolidated financial statements, the accompanying notes, and the MD&A included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2019 (the "Form 10-K"). Unless otherwise specified, any description of "our", "we", and "us" in this MD&A refer to Lifeway Foods, Inc. and our subsidiaries.

### *Cautionary Statement Regarding Forward-Looking Statements*

In addition to historical information, this quarterly report contains "forward-looking" statements within the meaning of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. These statements may be identified by the use of words such as "anticipate," "from time to time," "intend," "plan," "ongoing," "realize," "should," "may," "could," "believe," "future," "depend," "expect," "will," "result," "can," "remain," "assurance," "subject to," "require," "limit," "impose," "guarantee," "restrict," "continue," "become," "predict," "likely," "opportunities," "effect," "change," "predict," and "estimate," and similar terms or terminology, or the negative of such terms or other comparable terminology. Examples of forward-looking statements include, among others, statements we make regarding:

- Expectations of the effect on our financial condition of claims, litigation, environmental costs, contingent liabilities and governmental and regulatory investigations and proceedings;
- Strategy for acquisitions, customer retention, growth, product development, market position, financial results and reserves; Estimates of the amounts of sales allowances and discounts to our customers and consumers;
- Our belief that we will maintain compliance with our loan agreements and have sufficient liquidity to fund our business operations.

Forward looking statements are based on management's beliefs, assumptions, estimates and observations of future events based on information available to our management at the time the statements are made and include any statements that do not relate to any historical or current fact. These statements are not guarantees of future performance and they involve certain risks, uncertainties and assumptions that are difficult to predict. Actual outcomes and results may differ materially from what is expressed, implied or forecast by our forward-looking statements due in part to the risks, uncertainties, and assumptions that include:

- The actions of our competitors and customers, including those related to price competition;
- The decisions of customers or consumers;
- Our ability to successfully implement our business strategy;
- Changes in the pricing of commodities
- The effects of government regulation;
- The impact of the COVID-19 outbreak on our business, suppliers, consumers, customers, and employees;
- Disruptions to our supply chain, or our manufacturing and distribution capabilities, including those due to cybersecurity threats and the COVID-19 outbreak; and
- Such other factors as discussed throughout Part I, Item 1 "Business"; Part I, Item 1A "Risk Factors"; and Part II, Item 7 "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended December 31, 2019 and that are described from time to time in our filings with the SEC.

These factors are not necessarily all of the important factors that could cause actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors could also have material adverse effects on future results. We intend these forward-looking statements to speak only at the date made. Except as otherwise required to be disclosed in periodic reports required to be filed by public companies with the SEC pursuant to the SEC's rules, we have no duty to update these statements, and we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

## Recent Developments

### COVID-19 Pandemic Impact

In December 2019, a novel coronavirus disease ("COVID-19") was first reported and subsequently characterized by the World Health Organization ("WHO") as a pandemic in March 2020. In an effort to reduce the global transmission of COVID-19, various policies and initiatives have been implemented by governments around the world, including orders to close businesses not deemed "essential", shelter-in-place orders enacted by state and local governments, and the practice of social distancing measures when engaging in essential activities. Lifeway has seen increased orders from retail customers in response to increased consumer demand for food at home in response to government mandated social distancing and shelter in place orders in the United States and the immune boosting quality of our products.

Local, state, and national governments continue to emphasize the importance of food supply during this pandemic and asked that food manufacturers and retailers remain open to meet the needs of our communities. The health and safety of our employees throughout this pandemic is paramount, and we have taken numerous steps to keep our employees safe including enhanced sanitation protocols, implementation of social distancing measures at our manufacturing operations, masks and personal protective equipment for employees across our facilities, preventative temperature screenings across all manufacturing locations, the rollout of new benefits that help support our employees and their families, and remote work arrangements for administrative support functions to comply with shelter-in-place orders. In addition, a cross-functional task force has been established to monitor and coordinate the Company's response to COVID-19.

During the first quarter of 2020, Management, anticipating the spread of COVID-19 and its effects, implemented a plan to mitigate effects of COVID-19 on supply and transportation of materials used to make and package our products, staffing, and transportation of our products to customers. Management's proactive planning allowed the Company to avoid disruption to its manufacturing facilities and production, transportation, and sales and to meet the increased demand without delay. The Company has full production capacity available at all locations at this time and does not anticipate manufacturing or staffing disruptions in the near term.

## Results of Operations

### Three Months Ended September 30, 2020 Compared to Three Months Ended September 30, 2019

	September 30,		Change	
	2020	2019	\$	%
<b>Net sales</b>	<b>\$ 26,039</b>	<b>\$ 22,729</b>	<b>\$ 3,310</b>	<b>14.6%</b>
Cost of goods sold	\$ 17,710	\$ 16,813	\$ (897)	
Depreciation expense	752	743	(9)	
<b>Total cost of goods sold</b>	<b>\$ 18,462</b>	<b>\$ 17,556</b>	<b>\$ (906)</b>	<b>(5.2%)</b>
<b>Gross profit</b>	<b>\$ 7,577</b>	<b>\$ 5,173</b>	<b>\$ 2,404</b>	<b>46.5%</b>
<i>Gross Profit % to net sales</i>	<i>29.1%</i>	<i>22.8%</i>		
<b>Selling expenses</b>	<b>\$ 2,116</b>	<b>\$ 2,679</b>	<b>\$ 563</b>	<b>21.0%</b>
<i>Selling expenses % to net sales</i>	<i>8.1%</i>	<i>11.8%</i>		
<b>General and administrative expenses</b>	<b>\$ 2,805</b>	<b>\$ 2,710</b>	<b>\$ (95)</b>	<b>(3.5%)</b>
<i>General and administrative % to net sales</i>	<i>10.8%</i>	<i>11.9%</i>		
<b>Amortization expense</b>	<b>\$ 39</b>	<b>\$ 39</b>	<b>\$ 0</b>	<b>0.0%</b>
<b>Total operating expenses</b>	<b>\$ 4,960</b>	<b>\$ 5,428</b>	<b>\$ 468</b>	<b>8.6%</b>
<i>Total operating expense % to net sales</i>	<i>19.0%</i>	<i>23.9%</i>		
<b>Income (loss) from operations</b>	<b>\$ 2,617</b>	<b>\$ (255)</b>	<b>\$ 2,872</b>	<b>(1,126.3%)</b>
<i>Income (loss) from operations % to net sales</i>	<i>10.1%</i>	<i>(1.1%)</i>		





## **Net Sales**

Net sales finished at \$26,039 for the three-month period ended September 30, 2020, an increase of \$3,310 or 14.6% versus prior year. The net sales increase was primarily driven by higher volumes of our branded drinkable kefir, partially offset by lower cream revenues associated with a decline in the market price of butter fat.

## **Gross Profit**

Gross profit as a percentage of net sales was 29.1% during the three-month period ended September 30, 2020. Gross profit percentage was 22.8% in the prior year. The increase versus the prior year was primarily due to the impact of favorable milk pricing, and to a lesser extent favorable freight costs. Additionally, depreciation expense increased reflecting our continued investment in manufacturing improvements.

## **Selling Expenses**

Selling expenses decreased by \$563 or 21.0% to \$2,116 during the three-month period ended September 30, 2020 from \$2,679 during the same period in 2019. The decrease versus prior year primarily reflects a reduction in advertising and marketing expense, such as trade shows and other marketing events which were postponed due to COVID-19 and the lower planned spending on in-store demonstrations in 2020 compared to 2019. Selling expenses as a percentage of net sales were 8.1% during the three-month period ended September 30, 2020 compared to 11.8% for the same period in 2019.

## **General and Administrative Expenses**

General and administrative expenses increased \$95 or 3.5% to \$2,805 during the three-month period ended September 30, 2020 from \$2,710 during the same period in 2019.

## **Provision for Income Taxes**

The provision for income taxes includes federal, state and local income taxes. The provision for income taxes was \$764 during the three months ended September 30, 2020, compared to a benefit for income taxes of \$17 during the same period in 2019.

Our effective income tax rate for the three months ended September 30, 2020 was 29.5% compared to 19.3% in the same period last year. The increase in effective tax rate is primarily due to non-deductible compensation expense related to equity incentive awards and adjustments to state income tax receivables in the quarter ended September 30, 2019. However, the increase in the effective tax rate for these two items was partially offset by an adjustment to the valuation allowance recorded for the quarter ended September 30, 2019, which increased the tax benefit associated with our pre-tax book loss for the quarter. The valuation allowance was released in the quarter ended September 30, 2019 and a valuation allowance was not required for the three months ended September 30, 2020. The Company consistently reflects non-deductible officer compensation expense, non-deductible compensation expense related to equity incentive awards and separate state tax rates from year to year. Although similar items were reflected in 2019, the percentage effect is different due to the difference in pre-tax income in 2020 compared to the pre-tax loss in 2019.

Our effective tax rate may change from period to period based on recurring and non-recurring factors including the relative mix of pre-tax earnings (or losses), the underlying income tax rates applicable to various state and local taxing jurisdictions, enacted tax legislation, settlement of tax audits, the impact of non-deductible items, changes in valuation allowances, and the expiration of the statute of limitations in relation to unrecognized tax benefits. We record discrete income tax items such as enacted tax rate changes and completed tax audits in the period in which they occur.

Section 162(m) of the Internal Revenue Code (the “Code”) limits the deductibility of compensation paid to certain of our executives. Under the Tax Cuts and Jobs Act (the “Act”) amendments to Section 162(m), no tax deduction in taxable years beginning after December 31, 2017 is allowed for compensation paid to any covered employee to the extent that the total compensation for that covered employee exceeds \$1,000,000 in any taxable year. Although the Act eliminated the prior tax deduction under Section 162(m) for performance-based executive compensation, it included a transition rule under which the changes to Section 162(m) will not apply to awards made to our covered employees who had the right to participate in our 2015 Omnibus Incentive Plan pursuant to written binding contracts in effect as of November 2, 2017, as long as those contracts have not subsequently been modified in any material respect. Accordingly, subject to further guidance from the Treasury Department and the Internal Revenue Service (“IRS”), the performance-based compensation paid to our executives under our Omnibus Plan remained eligible for the Section 162(m) exemption in 2019. Beginning in 2020, compensation exceeding the threshold for covered employees is non-deductible for income tax purposes.

Income taxes are discussed in Note 10 in the Notes to the Consolidated Financial Statements.

***Nine months ended September 30, 2020 Compared to Nine months ended September 30, 2019***

	September 30,		Change	
	2020	2019	\$	%
<b>Net sales</b>	<u>\$ 76,441</u>	<u>\$ 70,497</u>	<u>\$ 5,944</u>	<u>8.4%</u>
Cost of goods sold	\$ 53,613	\$ 51,223	\$ (2,390)	
Depreciation expense	2,326	2,235	(91)	
<b>Total cost of goods sold</b>	<u>\$ 55,939</u>	<u>\$ 53,458</u>	<u>\$ (2,481)</u>	<u>(4.6%)</u>
<b>Gross profit</b>	<u>\$ 20,502</u>	<u>\$ 17,039</u>	<u>\$ 3,463</u>	<u>20.3%</u>
<i>Gross Profit % to net sales</i>	26.8%	24.2%		
<b>Selling expenses</b>	<u>\$ 7,411</u>	<u>\$ 8,509</u>	<u>\$ 1,098</u>	<u>12.9%</u>
<i>Selling expenses % to net sales</i>	9.7%	12.1%		
<b>General &amp; administrative expenses</b>	<u>\$ 8,681</u>	<u>\$ 9,100</u>	<u>\$ 419</u>	<u>4.6%</u>
<i>General &amp; administrative % to net sales</i>	11.4%	12.9%		
<b>Amortization expense</b>	<u>\$ 117</u>	<u>\$ 152</u>	<u>\$ 35</u>	<u>23.0%</u>
<b>Total operating expenses</b>	<u>\$ 16,209</u>	<u>\$ 17,761</u>	<u>\$ 1,552</u>	<u>8.7%</u>
<i>Total operating expense % to net sales</i>	21.2%	25.2%		
<b>Income (loss) from operations</b>	<u>\$ 4,293</u>	<u>\$ (722)</u>	<u>\$ 5,015</u>	<u>(694.6%)</u>
<i>Income (loss) income from operations % to net sales</i>	5.6%	(1.0%)		

## **Net Sales**

Net sales finished at \$76,441 for the nine-month period ended September 30, 2020, an increase of \$5,944 or 8.4% versus prior year. The net sales increase was primarily driven by higher volumes of our branded drinkable kefir, partially offset by lower cream revenues associated with a decline in the market price of butter fat.

## **Gross Profit**

Gross profit as a percentage of net sales increased to 26.8% during the nine-month period ended September 30, 2020 from 24.2% during the same period in 2019. The increase versus the prior year was primarily due to the impact of favorable milk pricing, and to a lesser extent favorable freight costs, partially offset by an increase in salaries associated with hourly commitment award wage premiums incurred during 2020 due to COVID-19. Additionally, depreciation expense increased reflecting our continued investment in manufacturing improvements.

## **Selling Expenses**

Selling expenses decreased by \$1,098 or 12.9% to \$7,411 during the nine-month period ended September 30, 2020 from \$8,509 during the same period in 2019. The decrease versus prior year primarily reflects a reduction in advertising and marketing expense, such as trade shows and other marketing events which were postponed due to COVID-19 and the lower planned spending on in-store demonstrations in 2020 compared to 2019. Selling expenses as a percentage of net sales were 9.7% during the nine-month period ended September 30, 2020 compared to 12.1% for the same period in 2019.

## **General and Administrative Expenses**

General and administrative expenses decreased \$419 or 4.6% to \$8,681 during the nine-month period ended September 30, 2020 from \$9,100 during the same period in 2019. The decrease is primarily a result of lower compensation expense due to organizational changes made in 2019 and lower incentive compensation, partially offset by increased professional fee expense.

## **Provision for Income Taxes**

The provision for income taxes includes federal, state and local income taxes. The provision for income taxes was \$1,223 during the nine months ended September 30, 2020, compared to a benefit for income taxes of \$58 during the same period in 2019.

Our effective income tax rate for the nine months ended September 30, 2020 was 29.3% compared to 8.8% in the same period last year. The increase in effective tax rate is primarily the result of non-deductible compensation expense related to equity incentive awards and state tax receivables reducing the benefit associated with a pre-tax book loss in 2019, partially offset by a benefit recognized in 2020 due to the enactment of the "Coronavirus Aid, Relief, and Economic Security Act" (the CARES Act). The Company consistently reflects non-deductible officer compensation expense, non-deductible compensation expense related to equity incentive awards and separate state tax rates from year to year. Although similar items were reflected in 2019, the percentage effect is substantially different due to the difference in pre-tax income in 2020 compared to the pre-tax loss in 2019.

Our effective tax rate may change from period to period based on recurring and non-recurring factors including the relative mix of pre-tax earnings (or losses), the underlying income tax rates applicable to various state and local taxing jurisdictions, enacted tax legislation, settlement of tax audits, the impact of non-deductible items, changes in valuation allowances, and the expiration of the statute of limitations in relation to unrecognized tax benefits. We record discrete income tax items such as enacted tax rate changes and completed tax audits in the period in which they occur.

Section 162(m) of the Internal Revenue Code (the “Code”) limits the deductibility of compensation paid to certain of our executives. Under the Tax Cuts and Jobs Act (the “Act”) amendments to Section 162(m), no tax deduction in taxable years beginning after December 31, 2017 is allowed for compensation paid to any covered employee to the extent that the total compensation for that covered employee exceeds \$1,000,000 in any taxable year. Although the Act eliminated the prior tax deduction under Section 162(m) for performance-based executive compensation, it included a transition rule under which the changes to Section 162(m) will not apply to awards made to our covered employees who had the right to participate in our 2015 Omnibus Incentive Plan pursuant to written binding contracts in effect as of November 2, 2017, as long as those contracts have not subsequently been modified in any material respect. Accordingly, subject to further guidance from the Treasury Department and the Internal Revenue Service (“IRS”), the performance-based compensation paid to our executives under our Omnibus Plan remained eligible for the Section 162(m) exemption in 2019. Beginning in 2020, compensation exceeding the threshold for covered employees is non-deductible for income tax purposes.

Income taxes are discussed in Note 10 in the Notes to the Consolidated Financial Statements.

## **Liquidity and Capital Resources**

### ***Cash Flow***

At this time, the COVID-19 pandemic has not materially impacted on our operations. We expect to meet our foreseeable liquidity and capital resource requirements through anticipated cash flows from operations; our revolving credit facility; and cash and cash equivalents to ensure the continuation of the Company as a going concern. The success of our business and financing strategies will continue to provide us with the financial flexibility to take advantage of various opportunities as they arise. Given the dynamic nature of COVID-19, we will continue to assess our liquidity needs while continuing to manage our discretionary spending and investment strategies.

### ***Sources and Uses of Cash***

Lifeway had a net increase in cash and cash equivalents of \$3,780 during the nine-month period ended September 30, 2020 compared to a net increase in cash and cash equivalents of \$2,514 in the same period in 2019. The drivers of the year over year change are as follows:

Net cash provided by operating activities was \$5,348 during the nine-month period ended September 30, 2020 compared to net cash provided by operating activities of \$4,953 in the same period in 2019. The increase in cash provided by operating activities is primarily due to the increase in cash generated through higher revenues and reduced expenses in 2020, offset by the change in working capital.

Net cash used in investing activities was \$1,163 during the nine-month period ended September 30, 2020 compared to net cash used in investing activities of \$112 in the same period in 2019. The higher level of net cash used in investing activities in 2020 reflects higher capital spending in 2020 and the impact of \$474 in net proceeds related to the sale of our Skokie, IL facility during Q3 2019. Capital spending was \$1,168 during the nine-month period ended September 30, 2020 compared to \$610 in 2019. Our capital spending is focused in three core areas: growth, cost reduction, and facility improvements. Growth capital spending supports new product innovation and enhancements. Cost reduction and facility improvements support manufacturing efficiency, safety and productivity.

Net cash used in financing activities was \$405 during the nine-month period ended September 30, 2020 compared to net cash used in financing activities of \$2,327 in the same period in 2019. We utilized proceeds from our federal and state income tax refunds to repay \$1,330 on our revolving line of credit during the first quarter of 2019. There have been no borrowings or repayments on our revolving line of credit during 2020.

On November 1, 2017, Lifeway's Board approved an increase in the aggregate amount under our previously announced 2015 stock repurchase program (the "2017 Repurchase Plan Amendment"), by adding to (i.e., exclusive of the shares previously authorized under the 2015 stock repurchase program) the authorization the lesser of \$5,185 or 625 shares. We repurchased 179 shares of common stock at a cost of \$405 during the nine-month period ended September 30, 2020 under the 2017 Repurchase Plan Amendment. We repurchased 210 shares of common stock at a cost of \$538 during the nine-month period ended September 30, 2019 under the 2017 Repurchase Plan Amendment. As of September 30, 2020, there were no shares of common stock that remained available to be purchased under the 2017 Repurchase Plan Amendment. We intend to hold repurchased shares in treasury for general corporate purposes, including issuances under our 2015 Omnibus Incentive Plan. Treasury shares are accounted for using the cost method.

### ***Debt Obligations***

On September 30, 2020, Lifeway entered into the Third Modification to the Amended and Restated Loan and Security Agreement, as amended, (the "Third Modification") with its existing lender. The Third Modification amends the Amended and Restated Loan and Security Agreement, as amended, by removing the monthly borrowing base reporting requirement effective September 30, 2020, including a covenant to maintain a quarterly minimum working capital financial covenant, as defined, of no less than \$11.25 million each of the fiscal quarters commencing the fiscal quarter ending December 31, 2020 through the expiration date, and eliminating the tier interest pricing structure. The Amended and Restated Loan and Security Agreement continues to provide Lifeway with a revolving line of credit up to a maximum of \$5 million (the "Revolving Loan") and provides the Borrowers with an incremental facility not to exceed \$5 million (the "Incremental Facility" and together with the Revolving Loan, the "Loans"). The Termination Date of the Revolving Loan was extended to June 30, 2025, unless earlier terminated.

Except as described above, amended, the Modified Revolving Credit Facility remains substantively unchanged and in full force and effect, including customary representations, warranties, and covenants on the part of Lifeway, including financial covenants requiring us to maintain a fixed charge coverage ratio of no less than 1.25 to 1.00 each of the fiscal quarters ending through the expiration date. The Modified Revolving Credit Facility continues to provide for events of default, including failure to repay principal and interest when due and failure to perform or violation of the provisions or covenants of the agreement, as a result of which amounts due under the Modified Revolving Credit Facility may be accelerated.

As of September 30, 2020, we had \$2,763 net of \$14 of unamortized deferred financing costs, outstanding under the Revolving Credit Facility. We had \$2,223 available for future borrowings as of September 30, 2020.

We are in compliance with all applicable financial debt covenants as of September 30, 2020. See Note 7 to our Consolidated Financial Statements for additional information regarding our indebtedness and related agreements.

### ***Critical Accounting Policies and Estimates***

The preparation of financial statements and related disclosures in conformity with U.S. generally accepted accounting principles and the Company's discussion and analysis of its financial condition and operating results require the Company's management to make judgments, assumptions and estimates that affect the amounts reported. Management bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates, and such differences may be material.

Note 2, “Summary of Significant Accounting Policies” in Part I, Item 1 of this Form 10-Q and in the Notes to Consolidated Financial Statements in Part II, Item 8 of the 2019 Form 10-K, and “Critical Accounting Policies and Estimates” in Part II, Item 7 of the 2019 Form 10-K describe the significant accounting policies and methods used in the preparation of the Company’s condensed consolidated financial statements. There have been no material changes to the Company’s critical accounting policies and estimates since the 2019 Form 10-K.

### ***New Accounting Pronouncements***

Please refer to Note 2 to the accompanying unaudited consolidated financial statements for a discussion of recent accounting pronouncements.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

Not applicable.

### **ITEM 4. CONTROLS AND PROCEDURES.**

#### **Evaluation of Disclosure Controls and Procedures**

We have established disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934 (the “Exchange Act”)) designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms, and such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Management, with the participation of the Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company’s disclosure controls and procedures as of September 30, 2020. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2020.

There were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) during the quarter ended September 30, 2020 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II – OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS.**

From time to time we are engaged in litigation matters arising in the ordinary course of business. While the results of litigation and claims cannot be predicted with certainty, Lifeway believes that no such matter is reasonably likely to have a material adverse effect on our financial position or results of operations.

**ITEM 1A. RISK FACTORS.**

Except for the risk factor disclosed in Part II, Item 1A of the Form 10-Q for the period ended March 31, 2020, which is hereby incorporated by reference into this Part II, Item 1A of this Form 10-Q, there have been no material changes to the Company's risk factors since the 2019 Form 10-K.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.****Issuer Purchases of Equity Securities**

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of a publicly announced program (a)	Approximate Dollar Value of Shares that may yet be Purchased Under the Plans or Programs (\$ in thousands) (a)
1/1/2020 to 1/31/2020	97,739	\$ 2.33	97,739	\$ 4,275
2/1/2020 to 2/29/2020	35,198	\$ 2.49	35,198	\$ 4,188
3/1/2020 to 3/31/2020	45,469	\$ 1.98	45,469	\$ 4,098
4/1/2020 to 4/30/2020	11	\$ 2.01	11	\$ 4,098
<b>Fiscal Year 2020</b>	<b>178,417</b>	<b>\$ 2.27</b>	<b>178,417</b>	<b>\$ 0</b>

(a) During the fourth quarter of 2015, Lifeway publicly announced a share repurchase program. On November 1, 2017, the Board of Directors amended the 2015 stock repurchase program (the "2017 amendment"), by adding to (i.e., exclusive of the shares previously authorized under the 2015 stock program repurchase) the authorization the lesser of \$5,185 or 625 shares. The program has no expiration date. As of September 30, 2020, the Company had reached the amended threshold of 625 shares and therefore no shares of common stock remain available to be purchased under the 2017 Repurchase Plan Amendment.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

None.

**ITEM 4. MINE SAFETY DISCLOSURE.**

Not applicable.

**ITEM 5. OTHER INFORMATION.**

None.

**ITEM 6. EXHIBITS.**

<u>No.</u>	<u>Description</u>	<u>Form</u>	<u>Period Ending</u>	<u>Exhibit</u>	<u>Filing Date</u>
10.1	<a href="#">Third Modification to Amended and Restated Loan and Security Agreement dated as of September 30, 2020 amount Lifeway Foods, Inc., Fresh Made, Inc., The Lifeway Kefir Shop, LLC, Lifeway Wisconsin, Inc., and CIBC Bank USA, as Lender.</a>	8-K	9/30/2020	10.1	10/6/2020
31.1	<a href="#">Rule 13a-14(a)/15d-14(a) Certification of Julie Smolyansky</a>	Filed Herewith			
31.2	<a href="#">Rule 13a-14(a)/15d-14(a) Certification of Eric Hanson</a>	Filed Herewith			
32.1	<a href="#">Section 1350 Certification of Julie Smolyansky</a> *	Furnished Herewith			
32.2	<a href="#">Section 1350 Certification of Eric Hanson</a> *	Furnished Herewith			
99.1	<a href="#">Press release dated November 16, 2020 reporting Lifeway's financial results for the nine months ended September 30, 2020.</a> *	Furnished Herewith			
101	Interactive Data Files	Filed Herewith			

\* The exhibits deemed furnished with this Form 10-Q and are not deemed “filed” for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, nor shall they be deemed incorporated by reference into any filing under the Securities Act or the Exchange Act., whether made before or after the date of the filing of this Form 10-Q and irrespective of any general incorporation language contained in such filing.



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**LIFEWAY FOODS, INC.**

Date: November 16, 2020

By: /s/ Julie Smolyansky  
Julie Smolyansky  
Chief Executive Officer, President, and Director  
(Principal Executive Officer)

Date: November 16, 2020

By: /s/ Eric Hanson  
Eric Hanson  
Chief Financial & Accounting Officer  
(Principal Financial and Accounting Officer)