

Lifeway Foods, Inc.
Form 10-K
April 15, 2019

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2018

Commission file number: 000-17363

LIFEWAY FOODS, INC.

(Name of registrant as specified in its charter)

Illinois **36-3442829**
*(State or other jurisdiction of (IRS Employer
incorporation or organization) Identification No.)*

6431 West Oakton St., Morton Grove, Illinois 60053

(Address of principal executive offices) (Zip Code)

(847) 967-1010

(Registrant’s telephone number, including area code)

Securities registered under Section 12(b) of the Exchange Act:

Title of Each Class	Name of each exchange on which registered
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Common Stock, No Par Value	Nasdaq Global Market
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Securities registered under Section 12(g) of the Exchange Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 such files). Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting 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
<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input checked="" type="radio"/>	<input type="radio"/>

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the stock was last sold as of June 30, 2018 (\$5.03 per share as quoted on the Nasdaq

Global Market) was \$22,411,859.

As of March 15, 2019, 15,762,801 shares of the registrant's common stock, no par value, were outstanding.

Portions of the Registrant's Proxy Statement for the Annual Meeting of Shareholders to be held on June 20, 2019, are incorporated by reference into Part III.

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FORWARD LOOKING STATEMENTS

In connection with the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995, readers are advised that this document, any document incorporated by reference herein, and other documents we file with the SEC, contain forward looking statements. In addition, we, or others on our behalf, may make forward looking statements in press releases or written statements, or in our communications and discussions with investors and analysts in the normal course of business through meetings, webcasts, phone calls, and conference calls. Forward looking statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those indicated by the forward looking statements. These statements use words, variations of words, and negatives of words such as "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," "future," "predict," and "estimate." Examples of forward looking statements include, but are not limited to, (i) projections of revenues, income or loss, earnings or losses per share, capital expenditures, dividends, capital structure and other financial items, (ii) statements of Lifeway Foods, Inc.'s (the “Company”, “Lifeway”, “we”, or “our”) plans and objectives, including the introduction of new products, or estimates or predictions of actions by customers, suppliers, competitors or regulatory authorities, (iii) statements of future economic performance, and (iv) statements of assumptions underlying other statements and statements about Lifeway or its business.

These 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;

- disruptions to our supply chain, or our manufacturing and distribution capabilities, including those due to cybersecurity threats; and

the other risks and uncertainties that are set forth in Item 1, “Business”, Item 1A “Risk Factors” and Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” 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 Securities and Exchange Commission (“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.

PART I

ITEM 1 BUSINESS

OVERVIEW

Lifeway was co-founded in 1986 by Michael and Ludmila Smolyansky shortly after their emigration from Russia to the United States. Mr. and Mrs. Smolyansky were the first to successfully introduce kefir to the U.S. consumer on a commercial scale, initially catering to ethnic consumers in the Chicago, Illinois metropolitan area. In the over thirty years that have followed, Lifeway has grown to become the largest producer and marketer of kefir in the U.S. and an important player in the broader market spaces of probiotic-based products and natural, “better for you” foods.

PRODUCTS

Our 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. As of December 31, 2018, Lifeway offered approximately 20 varieties of our kefir products including more than 60 flavors. 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, BioKefir (a 3.5 oz. kefir with additional probiotic cultures), and Kefir with Oats.

- 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 in drinkable and frozen formats, 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 both bars and pint-size containers.

Net sales of products by category were as follows for the years ended December 31:

In thousands	2018		2017	
	\$	%	\$	%
Drinkable Kefir other than ProBugs	\$78,523	76%	\$90,514	76%
Cheese	11,486	11%	11,516	10%
Cream and other	5,276	5%	6,527	5%
Cupped Kefir and Skyr	3,836	4%	4,138	4%
ProBugs Kefir	2,795	3%	4,537	4%
Frozen Kefir (a)	1,434	1%	1,661	1%
Net Sales	\$103,350	100%	\$118,893	100%

(a) Includes Lifeway Kefir Shop sales

Product innovation and new product development

Lifeway is committed to maintaining its positions as the leading producer of kefir and a recognized leader in the market for probiotic products. We routinely evaluate opportunities for new product flavors and formulations, improved package design, new product configurations and other innovation opportunities. Beyond our core drinkable kefir products, we have an ongoing effort to extend the strength of the Lifeway brand and leverage the capabilities of the Lifeway organization into categories both inside and outside of the dairy aisle, including into non-food categories and into additional channels, such as gyms and fitness studios. In 2018, we continued to focus relatively more of our personnel, financial resources, and management attention on product innovations, packaging innovations, and growth opportunities than in prior years. As noted above, these product innovation and development efforts have led to additional revenue opportunities from our cupped kefir and cupped cheese, probiotic supplements, and non-dairy based probiotic beverage lines like Plantiful. We expect that these efforts will continue to diversify our revenue sources in 2019. New items introduced or expanded through our innovation efforts were offset by lower volumes of our core drinkable kefir products in 2018.

Lifeway considers research and development of new products to be a significant part of our overall business philosophy. Where possible, we leverage our existing staff and facilities to conduct our innovation, research, and development efforts, rather than maintaining a dedicated research and development staff and facilities or relying solely on third parties.

PRODUCTION

Manufacturing

During 2018 and 2017, approximately 98% of our revenue was derived from products manufactured at our own facilities. We currently operate the following manufacturing and distribution facilities:

- Morton Grove, Illinois, which produces drinkable kefir, drinkable ProBugs kefir, Kefir Cups, and cheese products;
- Waukesha, Wisconsin, which produces drinkable kefir products and from which we store and distribute products;

Niles, Illinois, which stores and serves as a distribution point for products, including those manufactured by co-packers;

· Philadelphia, Pennsylvania, which produces drinkable kefir, cheese, and butter products.

We own these manufacturing facilities, and all our fixed assets associated with manufacturing, storage, and distribution of our products are located in the United States.

Co-Packers

In addition to the products manufactured in our own facilities, independent manufacturers (“co-packers”) manufacture some of our products. We have co-packer agreements to manufacture drinkable kefir in European markets our frozen kefir products, and our probiotic supplements. During 2018 and 2017, approximately 2% of our revenue was derived from products manufactured by co-packers. Our co-packers are audited regularly by our staff and are required to follow our specifications and Good Manufacturing Practices (GMPs). Additionally, the co-packers are required to ensure our products are manufactured in accordance with our quality and safety specifications and that they are compliant with all applicable laws and regulations.

SALES AND DISTRIBUTION

Sales Organization

We sell our products primarily through our direct sales force, brokers, and distributors. Our sales organization strives to cultivate strong, collaborative relationships with our customers that facilitate favorable shelf placement for our products, which we believe will drive sales volumes when combined with our marketing efforts and our brand strength. Our relationships with food brokers provide additional retail customer coverage as a supplement to our direct sales force.

Distribution inside the United States

Lifeway's products reach the consumer through four primary "route-to-market" pathways:

- Retail-direct;

- Distributor;

- Direct store delivery ("DSD");

- Retail sales.

Under the retail-direct channel, we sell our products to the retailer that either the retailer's carrier picks up or Lifeway ships through third party carriers for delivery to those retailers' distribution centers. In turn, our retailers then deliver the products to their respective stores. Customers in this route-to-market grouping include Kroger, Walmart and Costco. Under the retail direct model, optimal product merchandising, assortments and product presentation are attended to by the retailer with limited support from Lifeway's broker network. Sales to our retail-direct customers represent approximately 50% of our total net sales for the year ended 2018.

Under the distributor channel, we sell our products to distributors that either the distributor's carrier picks up or Lifeway ships through third party carriers for delivery to those distributors' designated warehouses. In turn, our

distributors then sell and ship our products to their retail customers. Our distributors often use a DSD model of their own to make deliveries directly to individual stores, but they also make deliveries to retailers' distribution centers. Our distributor customers include United Natural Foods (UNFI), KeHE Distributors, and C&S Wholesale Grocers. The distributor attends to optimal product merchandising, assortments, and product presentations at the retail end of the channel, with support from Lifeway's direct sales force and broker network. Sales to our distributor customers represent approximately 44% of our total net sales for year ended 2018.

Under the direct store delivery (DSD) route to market, we distribute our products directly to the retailer using a fleet of Company-owned vehicles and a team of Lifeway merchandisers who engage face-to-face with store management to ensure optimal product assortments and presentations. We operate our DSD model in the Chicago, Illinois metropolitan area only. Sales to our DSD customers represent approximately 4% of our total net sales for the year ended 2018.

In the Chicago, Illinois metropolitan area, Lifeway operates three retail stores and a food truck under its Lifeway Kefir Shop subsidiary. The Lifeway Kefir Shop sells its frozen and drinkable kefir products, as well as certain Lifeway products, through these retail outlets. Sales through these retail outlets represent less than 1% of net sales for the year ended 2018.

Distribution outside of the U.S.

Substantially all of Lifeway's products are distributed within the United States; however, certain of our distributors sell our products to retailers in Mexico, Costa Rica, portions of South America, and the Caribbean. Additionally, Lifeway products reach consumers in the United Kingdom, Ireland, Norway, Sweden, and the Middle East under third party co-manufacturing agreements and in-country broker and distributor arrangements. Sales outside the United States represents less than 1% of net sales for the year ended 2018.

Channel- and Market-Specific Distribution and Broker Representation Arrangements

Lifeway's generally standardized agreements with independent distributors and food brokers allow us the latitude to establish new relationships as the opportunities and needs arise. Where appropriate given the relationship, market, and business opportunity, we offer exclusive channels, markets, and/or territories to our distributors and brokers.

We provide our independent distributors with products at wholesale prices for distribution to their retail accounts. Lifeway believes that the prices at which we sell our products to distributors are competitive with the prices generally paid by distributors for similar products in the markets served. Due to the perishable nature of our products and the costs associated with moving product back through the channel, we do not offer return privileges to any of our distributors or channel customers; however, from time to time we do provide our customers with allowances for non-saleable product.

Lifeway engages independent food brokers generally on a commission basis, subject in some cases to a minimum commission guarantee. The commissions vary based on the scope of services provided and customers served. Our brokers represent our products to a variety of prospective buyers. These buyers could be specialty stores, retail grocery chains, wholesalers, foodservice operators and distributors, drug chains, mass merchandisers, industrial users, schools and universities, or military installations. With support from our direct sales force, brokers may provide other value-added services. These may include scheduling and coordinating promotions, merchandising, centralized ordering, and data collection services.

MARKETING

We use a combination of sales incentives, trade promotions, and consumer promotions to market our products.

Sales Incentives and Trade Promotion Allowances

Lifeway offers various sales incentives and trade promotional programs to its retailer and distributor customers from time to time in the normal course of business. These sales incentives and trade promotion programs typically include rebates, in-store display and demo allowances, allowances for non-saleable product, coupons, and other trade promotional activities. Trade promotions support price features, displays, and other merchandising of our products by our retail and distributor customers. We record these arrangements as a reduction to net sales in our consolidated statements of operations.

Consumer Promotions and Marketing Campaigns

We engage in an ongoing and wide variety of marketing and media campaigns - primarily digital and social media, print advertising in some newspapers and magazines, and, to a lesser extent, targeted television advertising. We complement these marketing and media efforts by sponsoring cultural and community events, and various festivals, as well as participating in industry-related trade shows and in-store promotional events. Our consumer marketing efforts also include cooperative advertising programs with our retail customers and various couponing campaigns, online consumer relationship programs, and other similar forms of promotions.

Our marketing efforts are aimed at stimulating demand with new and existing consumers by elevating awareness and consumption of kefir and probiotics, as well as enhancing our brand equity. Our awareness marketing seeks to promote the verifiable nutritional profile, purity, benefits, and good taste of our kefir.

COMPETITION

Lifeway competes with a limited number of other domestic kefir producers and consequently faces a small amount of direct competition for kefir products. However, Lifeway's kefir-based products compete with other dairy products, notably spoonable and drinkable yogurt, and, increasingly, with non-dairy probiotic products that incorporate kefir cultures but are not kefir. Many of our competitors are well-established and have significantly greater financial resources than Lifeway to promote their products.

SUPPLIERS

We purchase our ingredients such as raw milk, pectin, and fruit purees from unaffiliated suppliers. In addition, we purchase significant quantities of packaging materials to package our products and natural gas and electricity to operate our facilities. Purchases are made through purchase orders or contracts, and price, delivery terms, and product specifications vary. Although the prices for our principal inputs can fluctuate based on economic, weather, and other conditions, Lifeway believes it has ready access to multiple suppliers for all ingredient, packaging, and other input requirements.

MAJOR CUSTOMERS

During the year ended December 31, 2018, two customers, United Natural Foods, Inc. (UNFI) and one other customer, represented approximately 12% and 9% of our total net sales. These customers collectively accounted for approximately 17% of net accounts receivable as of December 31, 2018.

SEGMENTS

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 Company performance, has been identified collectively as the Chief Financial Officer, the Chief Operating Officer, the Chief Executive 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.

DANONE SA

Since October 1999, Danone SA, through subsidiaries (collectively “Danone”), has been the beneficial owner of approximately 22% of the outstanding common stock of Lifeway. Lifeway and Danone are parties to a Stockholders’ Agreement dated October 1, 1999, which as amended provides Danone the right to designate one director nominee, provides Danone with anti-dilutive rights relating to certain future offerings and issuances of capital stock, and grants Danone limited registration rights.

INTELLECTUAL PROPERTY

We own more than seventy five domestic and international trademarks and service marks. In addition, we own numerous registered and unregistered copyrights, registered domain names, and proprietary trade secrets, trade dress, technology, know-how, processes, and other proprietary rights that are not registered. Depending on the jurisdiction, trademarks are generally valid as long as they are in use and/or their registrations are properly maintained and they have not been found to have become generic. Registrations of trademarks can also generally be renewed indefinitely as long as the trademarks are in use. We also have licenses to use certain trademarks inside and outside of the United States and to certain product formulas, all subject to the terms of the agreements under which such licenses are granted. Lifeway's policy is to pursue registration of intellectual property whenever appropriate. We protect our intellectual property rights by relying on a combination of trademark, copyright, trade dress, trade secret and other intellectual property laws, and domain name dispute resolution systems; as well as licensing agreements, third-party confidentiality, nondisclosure, and assignment agreements; and by policing third-party misuses of our intellectual property. We regard the Lifeway family of trademarks and other intellectual property as having substantial value and as being an important factor in the marketing of our products. The loss of such protection would have a material adverse impact on our operations and share price.

REGULATION

Lifeway is subject to extensive regulation by federal, state, and local governmental authorities. In the United States, agencies governing the manufacture, marketing, and distribution of our products include, among others, the Federal Trade Commission ("FTC"), the United States Food & Drug Administration ("FDA"), the United States Department of Agriculture ("USDA"), the United States Environmental Protection Agency ("EPA"), the Occupational Safety and Health Administration ("OSHA"), and their state and local equivalents. Under various statutes, these agencies prescribe, among other things, the requirements and standards for quality, safety, and representation of our products to consumers. We are also subject to federal laws and regulations relating to our products and production. For example, as required by the National Organic Program ("NOP"), we rely on third parties to certify certain of our products and production locations as organic. Additionally, our facilities are subject to various laws and regulations regarding the release of material into the environment and the protection of the environment in other ways.

Internationally, we are subject to the laws and regulatory authorities of the foreign jurisdictions in which we manufacture and sell our products, including the Food Standards Agency in the United Kingdom; the National Service of Health, Food Safety and Agro-Food Quality (known by its Spanish-language acronym “SENASICA”) and the Federal Commission for the Protection from Sanitary Risks (“COFEPRIS”) in Mexico; the Food Safety Authority in Ireland; and the European Food Safety Authority, which supports the European Commission, as well as individual country, province, state, and local regulations.

MILK INDUSTRY REGULATION

Our primary raw material is conventional and organic raw milk. Raw milk primarily contains raw skim milk, in addition to a small percentage of butterfat and other components. The federal government establishes minimum prices for raw milk purchased in federally regulated areas. Some states have established their own rules for determining minimum prices. The federal government announces prices for raw milk each month. While we are subject to federal government regulations that establish minimum prices for milk, the prices we pay producers of organic raw milk are generally well above such minimum prices, as organic milk production is generally costlier, and organic milk therefore commands a price premium. In addition to the prices for raw milk, we also pay producer (“over-order”) premiums, federal order administration costs, and other related charges that vary by milk product, location, and supplier.

FOOD SAFETY

Lifeway takes appropriate precautions to ensure the safety of our products. In addition to routine inspections by state and federal regulatory agencies, including the USDA and FDA, we have instituted Company-wide quality systems that address topics such as supplier control; ingredient, packaging, and product specifications; preventive maintenance; pest control; and sanitation. Each of our facilities also has in place a hazard analysis critical control points (“HACCP”) plan that identifies critical pathways for contaminants and mandates control measures that must be used to prevent, eliminate or reduce relevant food-borne hazards. To the extent that the federal Food Safety Modernization Act applies to Lifeway’s business, we develop food safety plans and implement preventive measures to protect against food contamination. We also maintain a product recall plan, including lot identifiability and traceability measures that allow us to act quickly to reduce the risk of consumption of any product that we suspect may pose a health issue.

We maintain various types of insurance, including product liability coverage, which we believe to be sufficient to cover potential product liabilities.

We have also implemented the Safe Quality Food (“SQF”) program at all of our facilities. SQF is a fully integrated food safety and quality management protocol designed specifically for the food sector. The SQF Code, based on universally accepted CODEX Alimentarius, HACCP guidelines and the Global Food Safety Initiative (“GFSI”) standards, offers a comprehensive methodology to manage food safety and quality simultaneously. Safe Quality Food or SQF certification provides an independent and external validation that a product, process or service complies with international, regulatory and other specified standards. Our Waukesha and Morton Grove facilities are SQF certified at the highest level of such certification.

SEASONALITY

Lifeway’s business is not seasonal.

EMPLOYEES

As of December 31, 2018, we employed approximately 322 employees, approximately 108 of which were members of a union bargaining unit.

AVAILABLE INFORMATION

Lifeway maintains a corporate website for investors at www.lifewayfoods.com and it makes available, free of charge, through this website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports that we file with or furnish to the SEC as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

ITEM 1A RISK FACTORS

In evaluating and understanding us and our business, you should carefully consider the risks described below, in conjunction with all of the other information included in this Annual Report on Form 10-K, including “Management’s Discussion and Analysis of Financial Condition and Results of Operations” contained in Part II, Item 7 and “Quantitative and Qualitative Disclosures About Market Risk” contained in Part II, Item 7A. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we are unaware of, or that we currently believe are not material, may become important factors that adversely affect our business. If any of the events or circumstances described in the following risk factors actually occurs, our business, financial condition, results of operations, and future prospects could be materially and adversely affected.

Our product categories face a high level of competition, which could negatively impact our sales and results of operations.

We face significant competition for limited retailer shelf space in each of our product categories. Competition in our product categories is based on product innovation, product quality, price, brand recognition and loyalty, effectiveness of marketing, promotional activity, and our ability to identify and satisfy consumer tastes and preferences. We believe that our brands have benefited in many cases from being the first to introduce products in their categories, and their success has attracted competition from other food and beverage companies that produce branded products, as well as from private label competitors. Some of our competitors, such as Danone, General Mills, Dean Foods, Chobani, Hain Celestial Group, and Nestle, have substantial financial and marketing resources. These competitors and others may be able to introduce innovative products more quickly or market their products more successfully than we can, which could cause our growth rate to be slower than we anticipate and could cause sales to decline.

We also compete with producers of non-dairy products, such as Millennium Products and PepsiCo, that have lower ingredient and production-related costs. As a result, these competing producers may be able to offer their products to customers at a lower price point. This could cause us to lower our prices, resulting in lower profitability or, in the alternative, cause us to lose market share if we fail to lower prices. Furthermore, private label competitors are generally able to sell their products at lower prices because private label products typically have lower marketing costs than their branded counterparts. If our products fail to compete successfully with other branded or private label offerings, demand for our products and our sales volumes could be negatively impacted.

Additionally, due to high levels of competition, certain of our key retailers may demand price concessions on our products or may become more resistant to price increases for our products. Increased price competition and resistance to price increases have had, and may continue to have, a negative effect on our results of operations.

We may not be able to successfully implement our business strategy for our brands on a timely basis or at all.

We believe that our future success depends, in part, on our ability to implement our strategy of leveraging our existing brands with our current and new products to maintain our market position in our product categories; drive increased sales; acquire or establish new brands; and create strategic alliances including potential joint ventures. Our ability to implement this strategy depends, among other things, on our ability to:

- enter into distribution and other strategic arrangements with third-party retailers and other potential distributors of our products;
- compete successfully in the product categories in which we choose to operate;
- introduce timely, new, cost-effective, and appealing products and innovate successfully within our existing product categories;
- develop and maintain consumer interest in and demand for our brands considering prevailing consumer tastes and preferences;
- increase our brand recognition and loyalty;

- enter into strategic arrangements with third-party suppliers to obtain necessary raw materials;
- identify suitable acquisition candidates or joint venture partners and accurately assess their value, growth potential, strengths, weaknesses, contingent and other liabilities, and potential profitability;
- negotiate acquisitions and joint ventures on terms acceptable to us; and
- integrate acquired brands, products, or joint ventures into our company and our business strategy.

If we fail to execute these and other important elements of our business strategy, our business and results of operations could be adversely affected.

One key element of our business strategy is to introduce timely, new, cost-effective, and appealing products and to innovate successfully within our existing product categories. New items introduced through our innovation efforts partially offset lower volumes in 2018 of our core drinkable kefir products. However, consumer tastes and preferences change rapidly, and evolve over time. Factors that may affect consumer tastes and preferences include:

- dietary trends and increased attention to nutritional values, such as the sugar, fat, protein, fiber or calorie content of different foods and beverages;
- concerns regarding the health effects of specific ingredients and nutrients, such as sugar, other sweeteners, dairy, soybeans, nuts, oils, vitamins, fiber and minerals;
- concerns regarding the public health consequences associated with obesity, particularly among young people;
- decisions by yogurt and non-dairy beverage manufacturers to mislabel their products as “kefir” in order to benefit from our branding and marketing efforts, a marketing ploy that can cause significant confusion and misunderstanding among consumers; and
- increased awareness of the environmental and social effects of food processing.

Our future investments may not produce the results we expect when we expect them for a variety of reasons including those described herein. Our future product development and innovation will be reliant on our ability to identify and develop potential new growth opportunities. This process is inherently risky and will result in investments in substantial time and resources for which we do not achieve any return or value. Successful product development and innovation is also affected by our ability to launch new or improved products successfully and on a timely and cost-effective basis.

We may have to pay cash, incur debt, or issue equity, equity-linked, or debt securities to fund our business strategy, or may be unable to fund that strategy. Any of these events could adversely affect our financial results and our business. We could experience similar effects if we invest resources in a strategy that ultimately proves unsuccessful. If, due to a failure of our strategy or any other reason, consumer demand for our products declines, our sales volumes, results of operations, and our business could be negatively affected, and we may not be able to create or sustain growth or successfully implement our business strategy.

The consolidation of our customers or the loss of any of our largest customers could negatively impact our sales and results of operations.

Customers, such as supermarkets and food distributors, continue to consolidate. This consolidation has produced larger, more sophisticated organizations with increased negotiating and buying power that are able to resist price increases or demand increased promotional programs, as well as operate with lower inventories, decrease the number of brands that they carry and increase their emphasis on private label products, all of which could negatively impact our business. The consolidation of retail customers also increases the risk that a significant adverse impact on their business could have a corresponding material adverse impact on our business.

Two of our customers together accounted for 21% of our net sales in the fiscal year ended December 31, 2018. Where we enter into written agreements with our customers, they are generally terminable after short notice periods by the customer. In addition, our customers sometimes award contracts based on competitive bidding, which could result in lower profits for contracts we win and the loss of business for contracts we lose. The loss of any large customer, the reduction of purchasing levels, or the cancellation of any business from a large customer for an extended period of time could negatively affect our sales and results of operations.

We rely on sales made by or through our independent distributors to customers. Distributors purchase directly for their own account for resale. The loss of, or business disruption at, one or more of these distributors may harm our business. If we are required to obtain additional or alternative distribution agreements or arrangements in the future, we cannot be certain that we will be able to do so on satisfactory terms or in a timely manner. Our inability to enter into satisfactory distribution agreements may inhibit our ability to implement our business plan or to establish markets necessary to expand the distribution of our products successfully.

We are subject to the risk of product contamination and product liability claims, which could harm our reputation, force us to recall products and incur substantial costs.

The sale of food products for human consumption involves the risk of injury to consumers. Such injuries may result from tampering by unauthorized third parties, inadvertent mislabeling, product contamination or spoilage including the presence of foreign objects, substances, chemicals, other agents, or residues introduced during the storage, processing, handling or transportation phases. We also may be subject to liability if our products or production processes violate applicable laws or regulations, including environmental, health, and safety requirements, or in the event our products cause injury, illness, or death.

Under certain circumstances, we may be required to recall or withdraw products, suspend production of our products, or cease operations, which may lead to a material adverse effect on our business. In addition, customers may cancel orders for such products as a result of such events. Even if a situation does not necessitate a recall or market withdrawal, and even if we and each of our co-packers and suppliers comply in all material respects with all applicable laws and regulations, we may become subject to claims or lawsuits relating to such matters. Even if a product liability claim is unsuccessful or is not fully pursued, the negative publicity surrounding any assertion that our products caused illness or physical harm, including the risk of reputational harm being magnified and/or distorted through the rapid dissemination of information over the Internet, including through news articles, blogs, chat rooms, and social media, could adversely affect our reputation with existing and potential customers and consumers and our corporate and brand image. Moreover, claims or liabilities of this type might not be covered by our insurance or by any rights of indemnity or contribution that we may have against others. We maintain product liability insurance in an amount that we believe to be adequate. However, we cannot be sure that we will not incur claims or liabilities for which we are not insured or that exceed the amount of our insurance coverage. A product liability judgment against us or a product recall could have a material adverse effect on our business, consolidated financial condition, results of operations or liquidity.

We rely on independent certification for several of our products and facilities.

We rely on independent certification, such as certifications of our products as “organic”, or “gluten-free,” to differentiate our products from others. The loss of any independent certifications could adversely affect our market position as a probiotic-based products and natural, “better for you” foods company, which could harm our business. We rely on independent SQF certification at some of our facilities, a certification that some of our customers require us to maintain.

We must comply with the requirements of independent organizations or certification authorities in order to label our products as certified. For example, we can lose our “organic” certification if a manufacturing plant becomes contaminated with non-organic materials, or if it is not properly cleaned after a production run. In addition, all organic raw materials must be certified organic. Our products could lose their organic certifications if our raw material suppliers lose their organic certifications. Similarly, we could lose our SQF certification if we do not meet the requirements of the SQF Code. The loss of these certifications could cause us to lose customers that require Lifeway products and/or facilities to carry some or all of them, which could negatively affect our sales and results of operations.

Increases in the cost of raw milk could reduce our gross margin and profit.

Conventional and organic raw milk, our primary raw material, is an agricultural commodity that is subject to price fluctuations. Although both conventional and organic milk prices in fiscal 2018 were relatively consistent with the prior year, there can be no assurance that such prices will remain at these levels in the future. The supply and price of raw milk may be impacted by, among other things, weather, natural disasters, real or perceived supply shortages, lower dairy and crop yields, general increases in farm inputs and costs of production, political and economic conditions, labor actions, government actions, and trade barriers. Increases in the market price for raw milk or over-order premiums charged by producers may also impact our ability to enter into purchase commitments at a fixed price. There can be no assurance that our purchasing practices will mitigate future price risk. As a result, increases in the cost of raw milk could have an adverse impact on our profitability.

In addition, the dairy industry continues to experience periodic imbalances between supply and demand for organic raw milk. Industry regulation and the costs of organic farming compared to costs of conventional farming can impact the supply of organic raw milk in the market. Oversupply levels of organic raw milk can increase competitive pressure on our products and pricing, while supply shortages can cause higher input costs and reduce our ability to deliver product to our customers. Cost increases in raw materials and other inputs could cause our profits to decrease significantly compared to prior periods, as we may be unable to increase our prices to offset the increased cost of these raw materials and other inputs. If we are unable to obtain raw materials and other inputs for our products or offset any increased costs for such raw materials and inputs, our business could be negatively affected.

Reduced availability of raw materials and other inputs, as well as increased costs for them, could adversely affect us.

Our business depends heavily on raw materials and other inputs in addition to conventional and organic raw milk, such as sweeteners, diesel fuel, packaging material, resin, and other commodities. Our raw materials are generally sourced from third-party suppliers, and we are not assured of continued supply, pricing, or exclusive access to raw materials from any of these suppliers. In addition, some of our raw materials are also agricultural products, and therefore subject to the same vulnerabilities described above for raw milk. Other events that adversely affect our third-party suppliers and that are out of our control could also impair our ability to obtain the raw materials and other inputs that we need in the quantities and at the prices that we desire. Such events include problems with our suppliers' businesses, finances, labor relations, costs, production, insurance, and reputation.

The organic ingredients we use in some of our products are less plentiful and available from a fewer number of suppliers than their conventional counterparts. Competition with other manufacturers in the procurement of organic product ingredients may increase in the future if consumer demand for organic products increases.

Interruption of our supply chain could affect our ability to manufacture or distribute products, could adversely affect our business and sales, and/or could increase our operating costs and capital expenditures.

We have several supply agreements with suppliers and co-packers that require them to provide us with specific finished goods, including packaging, kefir, and probiotic supplements. For some of these products, we essentially rely on a single supplier or co-packer as our sole source for the item. The failure for any reason of any such sole source or other co-packer to fulfill its obligations under the applicable agreements with us or the termination or renegotiation of any such sourcing agreement could result in disruptions to our supply of finished goods and have an adverse effect on our results of operations. Additionally, our suppliers and co-packers are subject to risk, including labor disputes, union organizing activities, financial liquidity, inclement weather, natural disasters, supply constraints, and general economic and political conditions that could limit their ability to timely provide us with acceptable products, which could disrupt our supply of finished goods, or require that we incur additional expense by providing financial accommodations to the supplier or co-packer or taking other steps to seek to minimize or avoid supply disruption, such as establishing new arrangements with other providers. A new arrangement may not be available on terms as favorable to us as our existing arrangements, if at all.

Our inability to maintain sufficient internal capacity or establish satisfactory co-packing, warehousing and distribution arrangements could limit our ability to operate our business or implement our strategic plan, and could negatively affect our sales volumes and results of operations.

Disruption of our manufacturing or distribution chains or information technology systems, including disruption due to cybersecurity threats, could adversely affect our business.

The success of our business depends, in part, on maintaining a strong production platform and we rely primarily on internal production resources to fulfill our manufacturing needs. Our ongoing initiatives to expand our production platform and our productive capacity could fail to achieve such objectives and in any case could increase our operating costs beyond our expectations and could require significant additional capital expenditures. If we cannot maintain sufficient production, warehousing, and distribution capacity, either internally or through third party agreements, we may be unable to meet customer demand and/or our manufacturing, distribution, and warehousing costs may increase, which could negatively affect our business.

Furthermore, damage or disruption to our manufacturing or distribution capabilities due to weather, natural disaster, fire, environmental incident, terrorism, cybersecurity threats and other security breaches, pandemic, strikes, the financial or operational instability of key distributors, warehousing, and transportation providers, or other reasons could impair our ability to manufacture or distribute our products.

We rely on a limited number of production and distribution facilities. A disruption in operations at any of these facilities or any other disruption in our supply chain relating to common carriers, supply of raw materials and finished goods, or otherwise, whether as a result of casualty, natural disaster, power loss, telecommunications failure, cybersecurity threat, terrorism, labor shortages, contractual disputes or other causes, could significantly impair our ability to operate our business and adversely affect our relationship with our customers. Furthermore, our insurance coverage may not be adequate to cover all related costs.

Our information technology systems are also critical to the operation of our business and essential to our ability to successfully perform day-to-day operations. These systems include, without limitation, networks, applications, and outsourced services in connection with the operation of our business. A failure of our information technology systems to perform as we anticipate could disrupt our business and result in transaction errors, processing inefficiencies, and sales losses, causing our business to suffer. In addition, our information technology systems may be vulnerable to damage or interruption from circumstances beyond our control, including fire, natural disasters, systems failures, and cybersecurity threats. Cybersecurity threats in particular are persistent, evolve quickly and include, without limitation, computer viruses, unauthorized attempts to access information, denial of service attacks, and other electronic security breaches. Like our customers, suppliers, subcontractors and other third parties with whom we do business generally, we expect that we will continue to be the subject of cybersecurity threats. In some cases we must rely on the safeguards put in place by the third parties with whom we do business to protect against security threats. We believe we have implemented appropriate measures and controls and have invested in sufficient resources to appropriately identify and monitor these threats and mitigate potential risks, including risks involving our customers and suppliers. However, there can be no assurance that any such actions will be sufficient to prevent cybersecurity breaches, disruptions to mission critical systems, the unauthorized release of sensitive information or corruption of data, or harm to facilities or personnel.

These threats and other events could disrupt our operations, or the operations of our customers, suppliers, subcontractors and other third parties; could require significant management attention and resources; could result in the loss of business, regulatory actions and potential liability; and could negatively impact our reputation among our customers and the public. Any of these outcomes could have a negative impact on our financial condition, results of operations, or liquidity.

Our debt and financial obligations could adversely affect our financial condition, our ability to obtain future financing, and our ability to operate our business.

We have outstanding debt obligations that could adversely affect our financial condition and limit our ability to successfully implement our business strategy. Furthermore, from time to time, we may need additional financing to support our business and pursue our business strategy, including strategic acquisitions. Our ability to obtain additional financing, if and when required, will depend on investor demand, our operating performance, the condition of the capital markets, and other factors. We cannot assure that additional financing will be available to us on favorable terms when required, or at all. If we raise additional funds through the issuance of equity, equity-linked, or debt securities, those securities may have rights, preferences, or privileges senior to those of our common stock, and, in the case of equity and equity-linked securities, our existing stockholders may experience dilution.

As of December 31, 2018, we had outstanding borrowings of approximately \$6.0 million, net of \$55 of unamortized deferred financing costs, which consisted of a revolving line of credit. Our loan agreements contain certain restrictions and requirements that among other things:

- require us to maintain a minimum year-to-date EBITDA in fiscal year 2019, and a quarterly fixed charge coverage ratio;
- limit our ability to obtain additional financing in the future for working capital, capital expenditures and acquisitions, to fund growth or for general corporate purposes;
- limit our future ability to refinance our indebtedness on terms acceptable to us or at all;
- limit our flexibility in planning for or reacting to changes in our business and market conditions or in funding our strategic growth plan; and
- impose on us financial and operational restrictions.

Our ability to meet our debt service obligations will depend on our future performance, which will be affected by the other risk factors described in this Annual Report on Form 10-K. If we do not generate enough cash flow to pay our debt service obligations, we may be required to refinance all or part of our existing debt, sell our assets, borrow more money or raise equity. There is no guarantee that we will be able to take any of these actions on a timely basis, on terms satisfactory to us, or at all.

Our notes bear interest at variable rates. If market interest rates increase, it will increase our debt service requirements, which could adversely affect our cash flow.

Our loan agreements also contain provisions that restrict our ability to:

- borrow money or guarantee debt;
- create liens;

- make specified types of investments and acquisitions;

- pay dividends on or redeem or repurchase stock;

- enter into new lines of business;

- enter into transactions with affiliates; and

- sell assets or merge with other companies.

These restrictions on the operation of our business could harm our ability to execute on our business strategy by, among other things, limiting our ability to take advantage of financing, merger and acquisition opportunities, and other corporate opportunities. Various risks, uncertainties, and events beyond our control could affect our ability to comply with these covenants. Unless cured or waived, a default would permit lenders to accelerate the maturity of the debt under the credit agreement and to foreclose upon the collateral securing the debt.

Loss of our key management or other personnel, or an inability to attract such management and other personnel, could negatively impact our business.

We depend on the skills, working relationships, and continued services of key personnel, including our experienced senior management team. We also depend on our ability to attract and retain qualified personnel to operate and expand our business. If we lose one or more members of our senior management team, or if we fail to attract talented new employees, our business and results of operations could be negatively affected.

Employee strikes and other labor-related disruptions may adversely affect our operations.

We have a union contract governing the terms and conditions of employment for a significant portion of our workforce. Although we believe union relations since the union's certification as the exclusive bargaining representative of this portion of our workforce have been amicable, there is no assurance that this will continue in the future or that we will not be subject to future union organizing activity. There are potential adverse effects of labor disputes with our own employees or by others who provide warehousing, transportation, and distribution, both domestic and foreign, of our raw materials or other products. Strikes or work stoppages or other business interruptions could occur if we are unable to renew collective bargaining agreements on satisfactory terms or enter into new agreements on satisfactory terms, which could impair manufacturing and distribution of our products or result in a loss of sales, which could adversely impact our business, financial condition, or results of operations. The terms and conditions of existing, renegotiated, or new collective bargaining agreements could also increase our costs or otherwise affect our ability to fully implement future operational changes to enhance our efficiency or to adapt to changing business needs or strategy.

Our intellectual property rights are valuable, and any inability to protect them could reduce the value of our products and brands.

We consider our intellectual property rights, particularly our trademarks, but also our copyrights, registered domain names, and proprietary trade secrets, technology, know-how, processes and other proprietary rights to be a significant and valuable aspect of our business. We attempt to protect our intellectual property rights by relying on a combination of trademark, copyright, trade dress, trade secret, and other intellectual property laws, and domain name dispute resolution systems; as well as licensing agreements, third-party confidentiality, nondisclosure, and assignment agreements; and by policing third-party misuses of our intellectual property. Our failure to obtain or maintain adequate protection of our intellectual property rights, or any change in law or other changes that serve to lessen or remove the current legal protections of our intellectual property, may diminish our competitiveness and could materially harm our business.

We also face the risk of claims that we have infringed third parties' intellectual property rights. Any claims of intellectual property infringement, even those without merit, could be expensive and time consuming to defend, cause us to cease making, licensing, or using products that incorporate the challenged intellectual property, require us to redesign or rebrand our products or packaging, divert management's attention and resources, or require us to enter into royalty or licensing agreements to obtain the right to use a third party's intellectual property. Any royalty or licensing agreements, if required, may not be available to us on acceptable terms or at all. Additionally, a successful claim of infringement against us could result in our being required to pay significant damages, enter into costly license or royalty agreements, or stop the sale of certain products, any of which could have a negative effect on our results of operations.

Litigation or legal proceedings could expose us to significant liabilities and have a negative impact on our reputation.

We are or may become party to various claims and legal proceedings in the ordinary course of our business. These claims and legal proceedings may include lawsuits or claims relating to contracts, intellectual property, product recalls, product liability, the marketing and labeling of products, employment matters, environmental matters, regulatory compliance, or other aspects of our business. Even when not merited, the defense of these claims and legal proceedings may divert our management's attention, and we may incur significant expenses in defending these claims and proceedings. In addition, we may be required to pay damage awards or settlements or become subject to injunctions or other equitable remedies, which could have a material adverse effect on our financial position, cash flows, or results of operations. The outcome of litigation is often difficult to predict, and the outcome of pending or future claims and legal proceedings may have a material adverse effect on our financial position, cash flows, or results of operations. We evaluate these claims and legal proceedings to assess the likelihood of unfavorable outcomes and to estimate, if possible, the amount of potential losses. Based on these assessments and estimates, we establish reserves or disclose the relevant litigation claims or legal proceedings, as appropriate. These assessments and estimates are based on the information available to management at the time and involve a significant amount of management judgment. Actual outcomes or losses may differ materially from our current assessments and estimates. If actual outcomes or losses differ materially from our current assessments and estimates or additional claims or legal proceedings are initiated, we could be exposed to significant liabilities.

Our business is subject to various food, environmental, and health and safety laws and regulations, which may increase our compliance costs, subject us to liabilities, or otherwise adversely affect our business.

Our business operations are subject to numerous requirements in the United States relating to food safety, production, and marketing, as well as the protection of the environment, and health and safety matters. The food production and marketing industry is subject to a variety of federal, state, local, and foreign laws and regulations, including food safety requirements related to the ingredients, manufacture, processing, storage, marketing, advertising, labeling, and distribution of our products, as well as those related to worker health and workplace safety. Our activities, both in and outside of the United States, are subject to extensive regulation. We are regulated by, among other federal and state authorities, the FDA, USDA, the U.S. Federal Trade Commission (“FTC”), and the U.S. Departments of Commerce, and Labor, as well as by similar authorities in the foreign countries in which we do business. Environmental laws including the Clean Air Act, the Clean Water Act, the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, and the National Organic Standards of the U.S. Department of Agriculture, as well as similar state and local statutes and regulations in the United States and in each of the foreign countries in which we do business apply to our business operations as well. These laws and regulations govern, among other things, air emissions and the discharge of wastewater and other pollutants, the use of refrigerants, the handling and disposal of hazardous materials, and the cleanup of contamination in the environment.

In addition, the marketing and advertising of our products could make us the target of claims relating to alleged false or deceptive advertising under federal, state, and foreign laws and regulations, and we may be subject to initiatives that limit or prohibit the marketing and advertising of our products to children.

We are also subject to federal laws and regulations relating to our organic products and production. For example, as required by the National Organic Program (“NOP”), we rely on third parties to certify certain of our products and production locations as organic. Regulations and formal and informal positions taken by the NOP pursuant to the Organic Foods Production Act of 1990, which created the NOP, are subject to continued review and scrutiny.

Changes in these laws or regulations or the introduction of new laws or regulations could increase our compliance costs, increase other costs of doing business for us, our customers, or our suppliers, or restrict our actions, which could adversely affect our results of operations. In some cases, new laws and regulations or other federal and state regulatory initiatives could interrupt distribution of our products or force changes in our production processes and our products. Governmental regulations also affect taxes and levies, healthcare costs, energy usage, immigration, and other labor issues, all of which may have a direct or indirect effect on our business or those of our customers or suppliers. These costs could negatively affect our results of operations and financial condition. Further, if we are found to be in violation of applicable laws and regulations in these areas, we could be subject to civil remedies, including third-party claims for property damage or personal injury, fines, injunctions, recalls, clean up costs, and other civil sanctions, as well as potential criminal sanctions, any of which could have a material adverse effect on our business.

The Smolyansky family controls a majority of our common stock and has the ability to control the outcome of matters submitted for stockholder approval.

A majority of our common stock is controlled by members of the Smolyansky family, and collectively, they have the ability to control the outcome of stockholder votes, including the election of all of our directors and the approval or rejection of any merger, change of control, or other significant corporate transaction. No person interested in acquiring Lifeway will be able to do so without obtaining the consent of the Smolyansky family. We believe that having the Smolyansky family as a significant part of a long-term-focused, committed, and engaged stockholder base provides us with an important strategic advantage, particularly in a business with a mature, well-recognized brand. This advantage could be eroded or lost, however, should Smolyansky family members cease, collectively, to be controlling stockholders of Lifeway. We desire to remain independent and family-owned, and we believe the Smolyansky family shares these interests. However, the Smolyansky family's interests may not always be aligned with other stockholders' interests. By exercising their control, the Smolyansky family could cause Lifeway to take actions that are at odds with the investment goals of institutional, short-term, non-voting, or other non-controlling investors, or that have a negative effect on our stock price.

Because the Smolyansky family, collectively, controls a majority of our common stock (approximately 50.4%), we are considered a “controlled company” under Nasdaq Listing Rules. Controlled companies are exempt from Nasdaq listing standards that require a board composed of a majority of independent directors, a fully independent nominating/corporate governance committee, and a fully independent compensation committee. Our Board of Directors has determined that Lifeway will avail itself of these exemptions, though we currently maintain a Board composed of a majority of independent directors. In reliance on the controlled company exemptions described above, we have chosen to combine our audit, compensation, and nominating committees into an Audit and Corporate Governance Committee comprised of a majority of the Board’s independent directors to eliminate unnecessary redundancies in our independent committee structure given the size of our Board. The Committee fulfills the Board’s delegated audit, compensation, and nominating duties. As a result of our use of controlled company exemptions, our corporate governance practices differ from those of non-controlled companies, which are subject to all of the Nasdaq corporate governance requirements.

We have identified a material weakness in our internal control over financial reporting, and our business and stock price may be adversely affected if we have other material weaknesses or significant deficiencies in our internal control over financial reporting.

Maintaining effective internal control over financial reporting is necessary for us to produce reliable financial statements. We have identified a material weakness in our internal control over financial reporting related to our controls over the review of the step one goodwill impairment evaluation performed by third party valuation experts. A description of the material weakness can be found in Item 9A of this report. As a result of this material weakness, management concluded that our disclosure controls and procedures and internal control over financial reporting were not effective as of December 31, 2018.

Unless and until this material weakness has been remediated, or should new material weaknesses arise or be discovered in the future, material misstatements could occur and go undetected in our interim or annual consolidated financial statements and we may be required to restate our financial statements. In addition, we may experience delays in satisfying our reporting obligations or to comply with SEC rules and regulations, which could result in investigations and sanctions by regulatory authorities. Any of these results could adversely affect our business and the value of our common stock.

ITEM 1B UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2 PROPERTIES

We operate the following facilities:

Location	Owned / Leased	Principal Use
Morton Grove, Illinois	Owned	Production of kefir and cheese, principal executive offices
Waukesha, Wisconsin	Owned	Production of kefir, administrative offices
Niles, Illinois	Owned	Distribution center, administrative offices
Philadelphia, Pennsylvania	Owned	Production of kefir and cheese, administrative offices
Chicago, Illinois	Leased	3 Retail stores
Chicago, Illinois	Leased	Administrative offices
New York, New York	Leased	Administrative offices

Lifeway believes that its facilities are adequate for its current needs and that suitable additional space will be available on commercially acceptable terms as required. We believe that we have adequate insurance coverage for all of our properties.

ITEM 3 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 4 MINE SAFETY DISCLOSURES

None

PART II

ITEM 5 MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is listed on the Nasdaq Global Market under the symbol “LWAY.” Trading commenced on March 29, 1988. As of March 15, 2019, there were approximately 150 holders of record of Lifeway’s Common Stock.

Common stock price

The following table shows the high and low sale prices per share of our common stock as reported on the Nasdaq Global Market for each quarter during the two most recent fiscal years:

	Common Stock Price Range	
	2017	
	Low	High
First Quarter	\$10.31	\$11.83
Second Quarter	\$9.12	\$10.58
Third Quarter	\$8.15	\$9.62
Fourth Quarter	\$7.79	\$10.56
	2018	
	Low	High
First Quarter	\$5.99	\$8.40
Second Quarter	\$4.79	\$6.48
Third Quarter	\$2.66	\$4.63
Fourth Quarter	\$1.88	\$3.39

Dividend Policy

Lifeway does not routinely declare and pay dividends. From time to time however our Board of Directors may declare and pay dividends depending on our operating cash flow, financial condition, capital requirements and such other factors as the Board of Directors may deem relevant.

There were no dividends declared or paid in fiscal 2018 or 2017.

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)
8/1/2017 to 8/31/2017	85,665	\$ 10.54	–	\$ 1,220
9/1/2017 to 9/30/2017	31,348	\$ 9.06	31,348	\$ 936
10/1/2017 to 10/31/2017	12,818	\$ 9.23	12,818	\$ 818
11/1/2017 to 11/30/2017 (a)	10,390	\$ 10.37	10,390	\$ 5,895
12/1/2017 to 12/31/2017	7,325	\$ 10.03	7,325	\$ 5,822
Fiscal Year 2017	147,546	\$ 10.07	61,881	\$ 5,822
1/1/2018 to 1/31/18	106,441	\$ 8.22	106,441	\$ 5,007
2/1/2018 to 2/28/2018	24,486	\$ 7.21	24,486	\$ 4,830
4/1/2018 to 4/30/2018	15,433	\$ 6.09	15,433	\$ 4,736
6/1/2018 to 6/30/2018	4,143	\$ 5.46	4,143	\$ 4,714
8/1/2018 to 8/31/2018	1,332	\$ 3.96	1,332	\$ 4,709
9/1/2018 to 9/30/2018	40,364	\$ 3.35	40,364	\$ 4,573
11/1/2018 to 11/30/2018	17,228	\$ 2.99	17,228	\$ 4,522
12/1/2018 to 12/31/2018	8,305	\$ 2.25	8,305	\$ 4,503
Fiscal Year 2018	217,732	\$ 6.33	217,732	\$ 4,503

During the fourth quarter of 2015, Lifeway publicly announced a share repurchase program. On November 1, 2017, the our Board of Directors amended the 2015 stock repurchase program (the “2017 amendment”), by adding (a) 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.

ITEM 6 SELECTED FINANCIAL DATA

Not applicable

ITEM 7 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of the financial condition and results of operations for the years ended December 31, 2018 and December 31, 2017 should be read in conjunction with the audited consolidated financial statements and the notes to those statements that are included elsewhere in this report on Form 10-K. In addition to historical information, the following discussion contains certain forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. These statements relate to our future plans, objectives, expectations and intentions. These statements may be identified by the use of words such as "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," "future," "predict," and "estimate," and similar terms or terminology, or the negative of such terms or other comparable terminology. Although we believe the expectations expressed in these forward-looking statements are based on reasonable assumptions within the bounds of our knowledge of our business, our actual results could differ materially from those discussed in these statements. Factors that could contribute to such differences include, but are not limited to, those discussed in the "Risk Factors" section in Part I, Item 1A. We undertake no obligation to update publicly any forward-looking statements for any reason even if new information becomes available or other events occur in the future.

Results of Operations**Comparison of Year Ended December 31, 2018 to Year Ended December 31, 2017 (in 000's)**

	December 31,		Change	
	2018	2017	\$	%
Net sales	\$ 103,350	\$ 118,893	\$(15,543)	(13.1%)
Cost of goods sold	\$ 74,646	\$ 85,757	\$ 11,111	–
Depreciation expense	2,846	2,440	(406)	
Total cost of goods sold	\$ 77,492	\$ 88,197	\$ 10,705	12.1%
Gross profit	\$ 25,858	\$ 30,696	\$(4,838)	(15.8%)
Gross Profit % to net sales	25.0%	25.8%		
Selling expenses	\$ 13,477	\$ 16,595	\$ 3,118	18.8%
Selling expenses % to net sales	13.0%	14.0%		
General & administrative expenses	\$ 13,616	\$ 13,955	\$ 339	2.4%
General & administrative % to net sales	13.2%	11.7%		
Goodwill impairment	1,244	–	(1,244)	(100.0%)
Amortization expense	\$ 631	\$ 672	\$ 41	6.1%
Total operating expenses	\$ 28,968	\$ 31,222	\$ 2,254	7.2%
Total operating expense % to net sales	28.0%	26.3%		
Income (loss) from operations	\$(3,110)	\$(526)	\$(2,584)	(491.3%)
Income (loss) from operations % to net sales	(3.0%)	(0.4%)		

Net Sales

Net sales finished at \$103,350 for the year ended December 31, 2018, a decrease of \$15,543 or 13.1% versus prior year. The decline was primarily due to volume/mix of 16.6%, partially offset by lower spend in trade promotion and allowances of 1.7%, and partially offset by pricing gains of 1.8%. The decline in volume/mix was primarily driven by volume softness in our branded drinkable and ProBugs kefir, partially offset by the incremental volume of new item

introductions. The volume decline reflects lower consumption of our products that is consistent with the overall volume decline in dairy and cultured dairy product categories.

Pricing primarily includes the favorable impact of a second quarter 2018 price increase to recover higher input costs. This increase was partially offset by the lapping of a price reduction driven by the shift in delivery method for select customers in the first quarter 2017. The favorable promotional activity reflects lower trade spending, partially offset by the increased redemptions on our 2018 coupon program.

Gross Profit

Gross profit as a percentage of net sales was 25.0% during the year ended December 31, 2018. Gross profit percentage was 25.8% in the prior year. The decline versus the prior year was primarily due to the unfavorable impact of operating leverage that arises from lower net sales relative to fixed costs, increased trade promotion investment, and higher freight and fixed costs, partially offset by an increase in pricing and a reduction in variable costs. Additionally, depreciation expense increased reflecting the continued investment in manufacturing improvements. We incurred \$139k of direct labor severance expense in 2018 to reduce expense and create efficiencies in our manufacturing process.

Selling Expenses

Selling expenses decreased by \$3,118 or 18.8% to \$13,477 during the year ended December 31, 2018. The decrease versus prior year, primarily reflects a change in media spending to reduce programs with lower efficiency. The primary driver was a reduction in television advertising spend in 2018 compared to the prior year, and to a lesser extent lower broker commissions and marketing spending. The reduction was partially offset by severance expense. We incurred \$274 of selling severance expense in 2018 to align our organizational structure and reduce expenses.

General and administrative expenses

General and administrative expenses were slightly lower for the year ended December 31, 2018 finishing at \$13,616, 2.4% below the prior year. This reflects decreased incentive compensation and bad debt expense, partially offset by severance expense. We incurred \$431 of general and administrative severance expense in 2018 to align our organizational structure and reduce expenses.

As noted in the sections above, we incurred a total of \$845 of severance expense during fiscal year 2018, primarily in the fourth quarter.

Goodwill Impairment

During the fourth quarter of fiscal 2018, we recorded a goodwill impairment charge of \$1,244. There were no goodwill impairment charges recorded during fiscal 2017. See Note 5, Goodwill and Intangible Assets, in the Notes to the Consolidated Financial Statements included in Item 8 of this Form 10-K.

Provision for Income Taxes

The provision for income tax includes federal, state and local income taxes. Benefit for income taxes was \$225 during the year ended December 31, 2018, compared to a benefit for income taxes of \$458 during the same period in 2017.

Our effective income tax rate (ETR) was 6.8% and 57.0% of pre-tax loss for the years ended December 31, 2018 and 2017, respectively. The lower effective tax rate was primarily due to the reduction in the federal statutory tax rate and the 2018 impairment of goodwill that was not deductible for tax purposes.

On December 22, 2017, the Tax Cuts and Jobs Act (the “Act”) was signed into law. The Act significantly changed U.S. income tax law by, among other things, reducing the U.S. federal income tax rate from 35% to 21%, transitioning from a global tax system to a modified territorial tax system, eliminating the domestic manufacturing deduction, reducing the dividend received deduction, and limiting the tax deductions for interest expense and executive compensation.

Section 162(m) of the Code limits the deductibility of compensation paid to certain of our executives. Under the Act’s 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”), we expect that performance-based compensation paid to our executives under our Omnibus Plan will remain eligible for the Section 162(m) exemption in 2019.

Income taxes are discussed in Note 9 in the Notes to the Consolidated Financial Statements.

Net loss

We reported a net loss of \$(3,086) or \$(0.19) per basic and diluted common share for the year ended December 31, 2018 compared to net loss of \$(346) or \$(0.02) per basic and diluted common share in the same period in 2017.

Liquidity and Capital Resources

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. 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.

Sources and Uses of Cash

Lifeway had a net decrease in cash and cash equivalents of \$1,980 during the year ended December 31, 2018 compared to a net decrease in cash and cash equivalents of \$3,834 in the same period in 2017. The drivers of the year over year change are as follows:

Net cash provided by operating activities was \$2,417 during the year ended December 31, 2018 compared to net cash provided by operating activities of \$3,808 in the same period in 2017. The decline in cash provided by operating activities primarily results from lower net income.

Net cash used in investing activities was \$2,720 during the year ended December