

LIFEWAY FOODS INC
Form 10-K
August 14, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2014

£ 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.
(Name of registrant as specified in its charter)

Illinois
(State or other jurisdiction of
incorporation or organization)

36-3442829
(IRS Employer
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
Common Stock, No Par Value	Nasdaq Global Market

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

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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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted 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 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" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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, 2015 (\$19.19 per share as quoted on the Nasdaq Global Market) was \$91,167,353.

As of July 28, 2015, 16,346,017 shares of the registrant's common stock, no par value, were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE:

None.

LIFEWAY FOODS, INC.

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Security Ownership of Certain Beneficial Owners and
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FORWARD LOOKING STATEMENTS

In connection with the “safe harbor” provisions of the Private Securities Litigation Reform Act of 1995, readers of this document and any document incorporated by reference herein, are advised that this document and documents incorporated by reference into this document contain both statements of historical facts and forward looking statements. 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. 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 (“Lifeway” or the “Company”) 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.

This document and any documents incorporated by reference herein also identify important factors which could cause actual results to differ materially from those indicated by forward looking statements. These risks and uncertainties include

price competition;

the decisions of customers or consumers;

the actions of competitors;

changes in the pricing of commodities;

the effects of government regulation;

possible delays in the introduction of new products;

customer acceptance of products and services; 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”.

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. 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 Foods, Inc. (the “Company” or “Lifeway”), an Illinois corporation, commenced operations in February 1986, and was incorporated under the laws of the State of Illinois on May 19, 1986. The Company’s principal business activity is the manufacturing of probiotic, cultured, functional dairy health food products. Lifeway’s primary product is kefir, a dairy beverage similar to but distinct from yogurt, in several flavors and in several packages. In addition to kefir, Lifeway manufactures “Lifeway Farmer Cheese,” a line of various farmer cheeses. Lifeway distributes its products throughout the United States and in London, England. The Company manufactures all of its products distributed in the United States at Company-owned facilities. In the Chicago metropolitan area, Lifeway distributes its products on its own trucks and via distributors. The Company directly distributes its products in the Philadelphia and Tri State metropolitan areas using its own trucks. The Company distributes its products throughout the remainder of the United States via distributors. The Company’s products distributed in London are manufactured and shipped to stores by a third party co-packer. Products sold by the Company to distributors in the United States may be resold by such distributors within or outside of the United States, including in Mexico, Costa Rica and the Caribbean. The Company’s products are also manufactured and distributed in Canada by a third party co-packer.

SUBSIDIARY ENTITIES

On August 3, 2006, the Company acquired all of the issued and outstanding stock of Helios Nutrition, Ltd. (“Helios”). Pride of Main Street Dairy, L.L.C., a Minnesota limited liability company, is 100% owned by Helios.

Starfruit, L.L.C. and Starfruit Franchisor, L.L.C. are both wholly-owned subsidiaries formed on March 26, 2007 and July 15, 2008, respectively, in connection with the Company’s Starfruit cafe activities.

On February 6, 2009, the Company acquired all of the issued and outstanding stock of Fresh Made, Inc., a Pennsylvania corporation (“Fresh Made”).

On October 14, 2010, Lifeway First Juice, Inc., an Illinois corporation and a wholly-owned subsidiary of the Company (“Lifeway First Juice”) acquired substantially all of the assets of First Juice, Inc., a Delaware corporation (“First Juice”). Lifeway First Juice was dissolved on February 10, 2012 and First Juice was dissolved on December 29, 2011.

On July 2, 2013, the Company, through its wholly-owned subsidiary Lifeway Wisconsin, Inc., an Illinois corporation (“Lifeway Wisconsin”) acquired certain assets of Golden Guernsey Dairy Limited Liability Company, a Wisconsin limited liability company (“Golden Guernsey”), including land, a building and equipment used in the milk separation process.

SEGMENTS

The Company has two separate operating segments, the sale of fermented dairy products and three retail locations in Illinois that sell the Company’s fermented dairy products. The Company has determined reportable segments based on how the Company’s 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 performance of the operating segments, has been identified as the Chief Financial Officer and the board of directors that makes strategic decisions. Substantially all of the consolidated revenues of the

Company relate to the sale of fermented dairy products which are produced using the same processes and materials and are sold to consumer retail food sellers through direct delivery and distributors in the United States, delivery by a third-party co-packer in London and Canada, and through delivery by U.S. distributors in Mexico, Costa Rica and the Caribbean. The Company had less than \$1 million in revenues attributable to its retail locations during the year ended December 31, 2014, 2013 or 2012. The Company's annual revenues attributable to its three retail locations are considered not to be material and accordingly the Company has not presented financial information separately for this segment. Substantially all of the consolidated revenues and assets of the Company are within the Unites States.

PRODUCTS

Lifeway's primary product is kefir, which, like the better-known product of yogurt, is a fermented dairy product. Kefir has a slightly effervescent quality, with a taste similar to yogurt and a consistency similar to buttermilk. It is a product distinct from yogurt because it incorporates the unique microorganisms of kefir as the cultures to ferment the milk. Lifeway's Kefir is intended for use as a breakfast meal or a snack, or as a base for lower-calorie dressings, dips, soups or sauces. Kefir contains a unique mixture of several live microorganisms and nutrients such as proteins, minerals and vitamins. Kefir is a good source of calcium, protein and B Vitamins. In addition, because the fermentation process does not produce a highly sour-tasting product, the end product has fewer calories than some similar products in the dairy category. Lifeway currently sells (1) drinkable kefir in bottles, (2) ProBugs, drinkable kefir in pouches marketed to children, and (3) frozen kefir. In addition to kefir, Lifeway produces cheese based on a cultured soft cheese.

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

	2014	2013	2012
Drinkable Kefir other than ProBugs	\$ 110,297,098	\$ 90,441,363	\$ 73,003,926
Lifeway Farmer Cheese	10,266,319	9,388,067	9,777,033
ProBugs	7,867,980	7,126,630	4,628,990
Frozen Kefir	1,784,319	2,010,034	2,344,058
Total sales	\$ 130,215,716	\$ 108,966,094	\$ 89,754,007

Lifeway intends to continue to develop new products based on kefir and Farmer Cheese. There is no assurance that such products or any other new products can be developed successfully or marketed profitably.

DISTRIBUTION

With its seventeen Company-owned trucks, Lifeway distributes its products directly and extensively in the State of Illinois, primarily in the Chicago metropolitan area. Lifeway also directly distributes its products in the Philadelphia and Tri State metropolitan area.

In addition to the Chicago, Philadelphia and Tri State metropolitan areas, Lifeway's products are distributed to stores throughout the United States, in London, England and in Canada. Substantially all of Lifeway's products are distributed within the United States. Lifeway has verbal distribution arrangements with various distributors throughout the United States. Lifeway believes these verbal distribution arrangements allow management the necessary latitude to expand into new areas and markets and establish new relationships with distributors on an ongoing basis. Products sold by the Company to distributors in the United States may be resold by such distributors within or outside of the United States. Certain distributors resell the Company's products in Mexico, Costa Rica and the Caribbean. The Company's products distributed in London and Canada are manufactured and shipped to stores by a third party co-packer. Lifeway has not offered any exclusive territories to any distributors.

Distributors are provided Lifeway products at wholesale prices for distribution to their retail accounts. Lifeway believes that the price at which its products are sold to its distributors is competitive with the prices generally paid by distributors for similar products in the markets served. In all areas served, distributors currently deliver the products directly to the refrigerated cases of dairy sections of their retail customers. Each distributor carries a line of Lifeway's products on its trucks, checks the retail stores for space allocated to Lifeway's products, determines inventory requirements of the store and places Lifeway products directly into the retailers' dairy cases. Lifeway believes this method of distribution best serves the needs of each retail store, and is the best available means to ensure consistency and quality of product handling, quality control, flavor selection and favorable retail display. The Company expects customers, either distributors who go into third party retail stores to sell the product they have purchased from us, or

the direct retail customer that may service their own stores, as general good business practice to rotate the perishable products, make or obtain frequent delivery of products, replace damaged, old or substandard packages and have deliveries made directly to the refrigerated case. It is to the benefit of the distributor or retailer, as well as the Company, not to have spoiled, out dated, or substandard product on the shelf. Due to the perishable nature of the product, the Company's distributors and retailers have no right to return any product to the Company.

MARKETING

Lifeway continues to promote the verifiable nutritional profile, purity and good taste of its kefir and kefir-based products. Lifeway primarily advertises its products through local radio stations, which advertisements are directed to both users and non-users of cultured milk products of all kinds. In addition, through newspaper and magazine advertising, Lifeway provides educational information on its products and promotes the common perception that the products may be of particular health benefit, including promoting digestion, and continues to educate the public on the possible health benefits which could be derived from the use of kefir and kefir-based products.

In addition to local radio stations, newspapers and magazines, Lifeway promotes further exposure of its products through the internet (via our website, social media and blogs), catalog advertising and in-store demonstrations, and participation in various trade shows. Lifeway also sponsors several different sporting events in the Chicago metropolitan area as an additional marketing tool.

COMPETITION

Although Lifeway faces a small amount of direct competition for kefir products, Lifeway's kefir-based products compete with all other yogurt and other dairy products. Many producers of yogurt and other dairy products are well-established and have significantly greater financial resources than Lifeway to promote their products.

SUPPLIERS

Lifeway purchases its raw materials, such as milk, sugar and fruit from unaffiliated suppliers, and is not limited or contractually bound to any supplier. Lifeway has ready access to multiple suppliers for all of its raw materials and packaging requirements. Prior to making any purchase, Lifeway determines which supplier can offer the lowest price for the highest quality of product. The raw and packaging materials purchased by Lifeway are considered commodity items and are widely available on the open market. Lifeway owns and operates the means of production of all of its products except that the Company has a co-packer that produces products for distribution in London, England and in Canada.

MAJOR CUSTOMERS

The Company's sales are predominately to companies in the retail food industry located within the United States of America. Two major customers collectively accounted for approximately 28% of gross sales for the year ended December 31, 2014. These customers accounted for approximately 23% of accounts receivable as of December 31, 2014. In 2014, one distributor, United Natural Foods, Inc., represented approximately 21% of the Company's total sales and one retail customer represented approximately 7% of the Company's total sales.

TRANSACTIONS WITH GROUPE DANONE SA

On October 1, 1999, Lifeway and certain members of the Smolyansky family sold shares of restricted common stock to Danone. Later in 1999, Danone purchased additional shares of common stock from certain individuals, including shares purchased in transactions with certain Company affiliates, including Lifeway's founder Michael Smolyansky, Val Nikolenko, former Vice President of Production, and Pol Sikar, a director, and his affiliates. As a result of these transactions, Danone became the beneficial owner of approximately 20% of the outstanding common stock of Lifeway. In addition Lifeway and Danone are parties to a Stockholders' Agreement dated October 1, 1999, as amended through extensions of certain provisions pursuant to which the parties agreed, among other things, that they would not compete with each other with respect to certain kefir products. Pursuant to the Stockholders' Agreement, Lifeway also granted certain limited rights to Danone, which include a right to nominate one director, anti-dilutive rights relating to future offerings and limited registration rights. The Stockholders' Agreement also provides that

Danone may not own more than 20% of the outstanding common stock of Lifeway as a result of direct or indirect acquisition of shares during the standstill period. Danone's interest as of December 31, 2014 was approximately 21.1% due to reductions in Lifeway's shares outstanding, primarily due to share repurchases by Lifeway. The terms of the non-compete obligation and the standstill period each expired on December 31, 2010. The remaining provisions of the Stockholders' Agreement are in full force and effect.

PATENTS, TRADEMARKS, LICENSES, ROYALTY AGREEMENTS

All trademark registrations have been granted by the United States Patent and Trademark Office (“USPTO”), unless otherwise noted below. Each trademark registration may be renewed upon expiration. Lifeway intends to make all timely filings as required for all trademarks listed.

Mark/Reg. No.	Goods/Services	Date of Registration	Expiration of Registration
ProBug Design 1, Reg. No. 3266378	dairy-based beverages; dairy-based food beverages; kefir; soy-based food beverage used as milk substitute	July 17, 2007	July 17, 2017
ProBug Design 2, Reg. No. 3263130	dairy-based beverages; dairy-based food beverages; kefir; soy-based food beverage used as milk substitute	July 10, 2007	July 10, 2017
Penelope ProBug Design, Reg. No. 3408792	dairy-based beverages; dairy-based food beverages; kefir; soy-based food beverage used as milk substitute	April 8, 2008	April 8, 2018
BA3APHBIII (a Stylized presentation of “bazarny” in Cyrillic characters), Reg. No. 3590660	cultured milk products, excluding ice cream, ice milk and frozen yogurt; cheeses and cottage cheese	March 17, 2009	March 17, 2019
BAMBINO, Reg. No. 2770522	cheeses, cottage	October 7, 2003	October 7, 2023

	cheeses and other dairy products, excluding ice cream, ice milk, and frozen yogurt		
BAZARNY, Reg. No. 3597883	cultured milk products, excluding ice cream, ice milk and frozen yogurt; cheeses and cottage cheese	March 31, 2009	March 31, 2019
BIO KEFIR, Reg. No. 3886709	yogurt, cheeses, cottage cheeses and other milk products, excluding ice cream, ice milk and frozen yogurt	December 7, 2010	December 7, 2020
GOO-BERRY PIE, Reg. No. 3405134	dairy-based beverages; dairy-based food beverages; kefir	April	