Zacks Small-Cap Research

November 15, 2013
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Commtouch Software (CTCH-NASDAQ)

CTCH: Evolving Business Model- OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	N/A
Date of Last Change	09/13/2009
Current Price (11/15/13)	$2.64
Target Price	**$4.50**

OUTLOOK

Commtouch Software a provider of email defense and URL filtering solutions to enterprise customers and OEM distribution partners. The firm's "in the cloud" technology has the ability to analyzes 2.5 billion messages a day, which is far superior to the competition's static solutions which have little chance of catching new outbreaks. The web has more than double the revenue potential of the messaging market

New products are beginning to grow the top-line. We expect the top-line to grow more than 30%. We see value in the shares.

SUMMARY DATA

52-Week High	**$3.87**
52-Week Low	**$2.31**
One-Year Return (%)	**8.20**
Beta	**0.22**
Average Daily Volume (sh)	**35,620**
Shares Outstanding (mil)	**26**
Market Capitalization ($mil)	**$70**
Short Interest Ratio (days)	**0.52**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**N/A**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**17.9**
Earnings Per Share (%)	**2.0**
Dividend (%)	**N/A**
P/E using TTM EPS	**66.0**
P/E using 2013 Estimate	**52.8**
P/E using 2014 Estimate	**22.0**
Zacks Rank	**3**

Risk Level	**Moderate**
Type of Stock	**Small-Growth**
Industry	**Internet-Service**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	5.5 A	5.7 A	5.9 A	6.0 A	23.0 A
2012	5.9 A	5.7 A	5.6 A	6.8 A	24.0 A
2013	7.9 A	8.1 A	8.0 A	8.6 E	32.3 E
2014					38.0 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2011	$0.06 A	$0.06 A	$0.07 A	$0.07 A	$0.26 A
2012	$0.06 A	$0.05 A	$0.03 A	$0.01 A	$0.16 A
2013	$0.00 A	$0.00 A	$0.01 A	$0.03 E	$0.05 E
2014					$0.12 E

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WHATS NEW

This Evolving Business Model Suits Commtouch

On November 14, 2013, Commtouch Software Ltd., the provider of internet security and cloud based services, supplying white label internet cloud-based (SaaS) 'Security as a Service' protection solutions to security OEM's and service providers worldwide, reported financial results for its third quarter and nine months, ended September 30, 2013.

Commtouch reported third quarter 2013 GAAP revenues grew by over 44 percent or $2.461 million year over year to $8.019 million compared to $5.558 million for the comparable quarter of 2012. Sequentially, revenues were flat from the $8.055 million from the first quarter ended June 30, 2013.

The fourth quarter 2012 acquisitions of the company's German and Icelandic operations accounted for the majority of the year-over-year revenue increase. Commtouch closed on the acquisitions of FRISK Software International's antivirus business as of October 1, 2012 and Eleven GmbH as of November 16, 2012.

The acquisition of Eleven accelerated the delivery of the company's "Security-as-a-Service' quality and broadened it, enabling Commtouch to provide more OEM services and private labeled application as well as expanded its European footprint to head offices closer to many of their customers.

Likewise, the integration of the Q4 2012 acquisitions continues to proceed well with the company completing the core portions of the integration of its fourth quarter 2012 acquisitions during the third quarter 2013. Furthermore, the recent streamlining efforts have resulted in margin improvements in the third quarter.

Still, gross margin during the quarter fell year over year to 78.5 percent from 83.5 percent for the three months ended September 30, 2012. However, gross margin improved slightly from the first quarter's 78.2 percent. Gross margin declined primarily related to the acquisition of Eleven which has gross margins of roughly 75 percent and below the gross margin percentages generated by the Commtouch business historically. As the company moves through the integration and streamlining process, management anticipates that it will begin to see a gradual improvement in the gross margin overtime as business efficiencies are realized.

Operating expenses for the third quarter were $6.750 million compared to $4.576 million in the third quarter of 2012 and $6.982 million in the second quarter of 2013. Management expects operating expenses to gradually decrease as the company completes the integration process and begins to realize the benefits of its rationalization efforts in the rest of this year. Nonetheless, Commtouch's recent streamlining efforts have improved the company's cost structure and yielded measurable results with a significant sequential increase in both gross and operating margins

The company reported a GAAP net loss of $914,000 for the third quarter. This was down from net income of $19,000 during the three months ended September 30, 2012 but an improvement from a net loss of $745,000 during the second quarter 2013.

Third quarter 2013 results include an acquisition related earn out adjustment of $0.3 million and reorganization expenses of $0.1 million. Second quarter 2013 results included an acquisition related earn out adjustment of $0.3 million and a $0.1 million net litigation settlement in favor of the company related to contractual issues.

Based on a weighted average number of diluted common shares of 26.384 million, GAAP diluted net loss per share resulted in $0.03 loss per share for the second quarter fiscal 2013. This compares to diluted net income per share of $0.00 on a weighted average number of diluted shares of 24.845 million during

the three months ended September 30, 2012. GAAP diluted net loss per share was $0.03 for the second quarter fiscal 2013 based on a weighted average number of diluted common shares of 26.128 million.

Non-GAAP net income for the third quarter ended September 30, 2013 fell year over year by $422,000 to net income of $322,000 while non-GAAP earnings per diluted share for the third quarter of 2013 fell to $0.01 compared to $0.03 for the three months ended September 30, 2012. Non-GAAP net income was $126,000 during the second quarter of 2013, resulting non-GAAP earnings per diluted share of $0.00 for the quarter.

Cash and equivalents decreased slightly to $3.972 million compared to $4.951 million for the period ended June 30, 2013. After quarter end, the company signed a new credit facility with a U.S. based bank for up to $7.5 million dollars. Net cash usage from operating activities was $1 million for the quarter compared to cash usage of $1.4 million in the third quarter of 2012.

The company has made significant progress on its recent transformation into a provider of comprehensive SecaaS offerings, which was accelerated by its strategic acquisitions and the formal launch of its new cloud-based email Security-as-a-Service offering in early 2013, highlighting the company’s execution on its strategic roadmap and its foundation for future growth.

Commtouch's new Email Security-as-a-Service solution marks a major launch of the company's latest cloud-based offerings and is complemented by new solutions focused on Email Security On-Premise for Service Providers and Mobile Security Services for Android. The e-mail “security-as-a-service” combines permanent protection against e-mail based threats such as spam, phishing and malware with maximum post efficiency and minimum time to market while its new mobile security service for android is the first ever OEM solution that offers cloud assist antivirus and web security services delivered through a single easy to integrate client as the gate for the popular mobile operating system.

Similarly, the new On Premise e-mail security services for service providers delivers additional simplified messaging security and optimization functionality enabling Commtouch to better address the requirements of any service provider that offers e-mail services to end users. The new solution leverages e-mail security technology asset which Commtouch acquired as part of its purchase of Eleven GmbH.

Likewise, during the third quarter, the company made excellent progress in expanding its global sales and marketing organizations to support the rollout of the new cloud-based offerings.

The company has also been gearing up to launch its second major Cloud-based product offering with the release of Commtouch’s new Cloud-based web security solution during the fourth quarter 2013. This offering will focus on web security in the Cloud services, which are easy to provision and use. Those services will be built on the market-leading security detection platforms and will be delivered by the company’s partners as private label services.

Management continues to anticipate revenues for the full year 2013 to be in the range of $32.0 million and $33.0 million. The current outlook would be a year over year increase of approximately 34 percent to 38 percent over fiscal 2012. Furthermore, full year 2013 GAAP net loss is expected to be less than $2.0 million and non-GAAP net income is expected to be greater than $1.5 million.

Looking Forward

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The three recently launched solutions have generated pronounced customer interest with Commtouch winning key customers and hosting clients for its new private label Email Security-as-a-Service product during the second quarter. These initial contracts have the potential to grow substantially as customers begin to roll out services.

Similarly, the company secured its first win for the recently launched Mobile Security for Android solution with a key European partner.

Demand for these new products from both new and existing customers remains robust and validate management's strategy to transform Commtouch from a best-in-class embedded malware detection service provider to a supplier of the complete Cloud-based security-as-a-service solution.

Furthermore, the company has been gearing up to launch its second major Cloud-based product offering with the release of Commtouch's new Cloud-based web security solution during the fourth quarter 2013. This offering will focus on web security in the Cloud services, which are easy to provision and use. Those services will be built on the market-leading security detection platforms and will be delivered by the company's partners as private label services.

Mobile Holds Promise

The Company's GlobalView URL Filtering for Mobile products solution is the industry's first engine for the deployment of the secure web browsing, parental control and compliance applications for Android devices such as smart phones and tablets and is designed to provide real-time protection to end-users while browsing the web from mobile devices.

With substantial increases in mobile vulnerabilities, the mobile security client software market is expected to advance at a CAGR (Compound Annual Growth Rate) of 40 percent from 2010 to 2015.

Correspondingly, the Company continues to build on strategic assets by broadening the use of its cloud security platform and expanding into the mobile space.

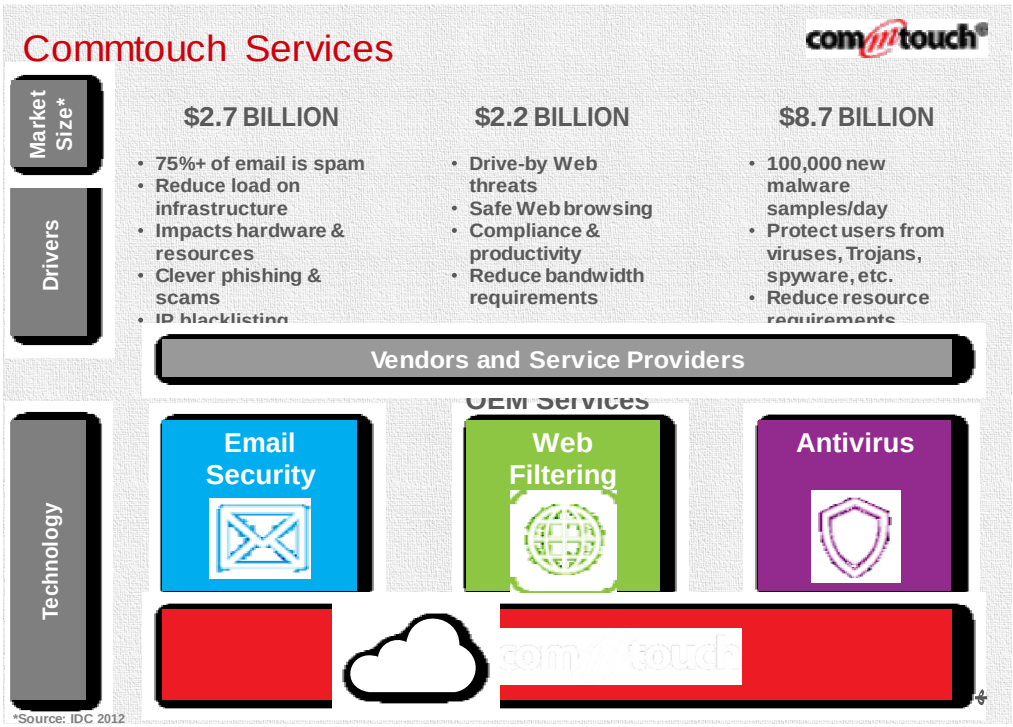
Along the same lines, Commtouch expects to expand its solutions to other leading mobile operating systems besides the Android as well as expand its mobile offerings for other products besides URL filtering.

INVESTMENT THESIS

As Cyber Crime Escalates Commtouch Will Benefit
The recent high profile cyber attacks on government agencies and large companies brought to light what security industry insiders have known for years. Cyber crime and hacking is getting more sophisticated and destructive.

Cyber crime has seen precipitous growth in the last 5-7 years, costing the global economy an estimated $500 Billion annually. While, being one of the main catalyst behind the loss of as many as 500,000 jobs. With a fiscally vulnerable global economy, cyber crimes are only compounding job displacement and unemployment. It is difficult to determine the total affects of Cyber Crimes because corporations and governments that are the victims tend to keep the attacks private.

There are presently 10 Billion vulnerable devices connected to the Internet with an estimated 15 Billion more by 2020. With a growing number of devices (i.e. Smart Phones, Tablets, Lap Tops etc,) cyber crime has become far more ubiquitous and malicious. Gains in cyber crime activity, is the byproduct of the upswing in Internet usage and the increase in new and introverted access to financial information and intellectual property.



The game has changed.
Modern day cyber criminals are using a variety of techniques, to penetrate corporations, governments and individual's sensitive information. Specifically Malware, which is malicious software used to Covertly observe people and institutions, control and subvert systems, and obtain data.. Other popular techniques for compromising information systems include: Directory Traversal, which aims to access files that are stored elsewhere on a hard drive or folder. Cross-site Scripting inserts code into webpages to manipulate website users in order to launch phishing attacks against them. SQL injection is similar, only this aims to insert code into web applications to steal the contents of the database, i.e. credit card numbers, social security numbers or passwords.

While the early days of virus release were more for notoriety or to be mischievous, today's spammers and hackers are motivated by profit. Most large scale DDOS attacks could be political

(Anonymous taking down a major corporate web site) or nationalistic motivation although they are sometimes used on a smaller scale as part of for-profit criminal activity

According to the market research firm Gartner there are short-term and long-term drivers when considering technology selection for security tools.

Short-term drivers:
• Prioritizing, choosing and maintaining security technologies continue to be top issues for enterprises because companies and government agencies face pressures to demonstrate compliance with the spirit and the letter of the law.

• Security spending is driven by a variety of pressing concerns. The most immediate is the need to "keep the bad guys out" through defensive measures, such as next-generation firewalls.

• Compliance with government regulations, such as SOX, continue to play a significant role in security spending decisions. Investment is often justified because the downside of breaches and failure is so great.

Long-term drivers:
• The need to have security tools in place to protect against malicious attacks and unintentional security incidents, such as leakage of sensitive corporate information, will remain. New risks in mobile and remote workplaces.

• A changing vulnerability and threat landscape and continuing requirements for compliance-related initiatives are driving vulnerability management programs to expand. Vulnerability management consists of a combination of technologies and processes to improve security posture.

• Increased regulations — such as SOX and HIPAA — dealing with reliability will continue to drive additional IT spending across the board, including information security.

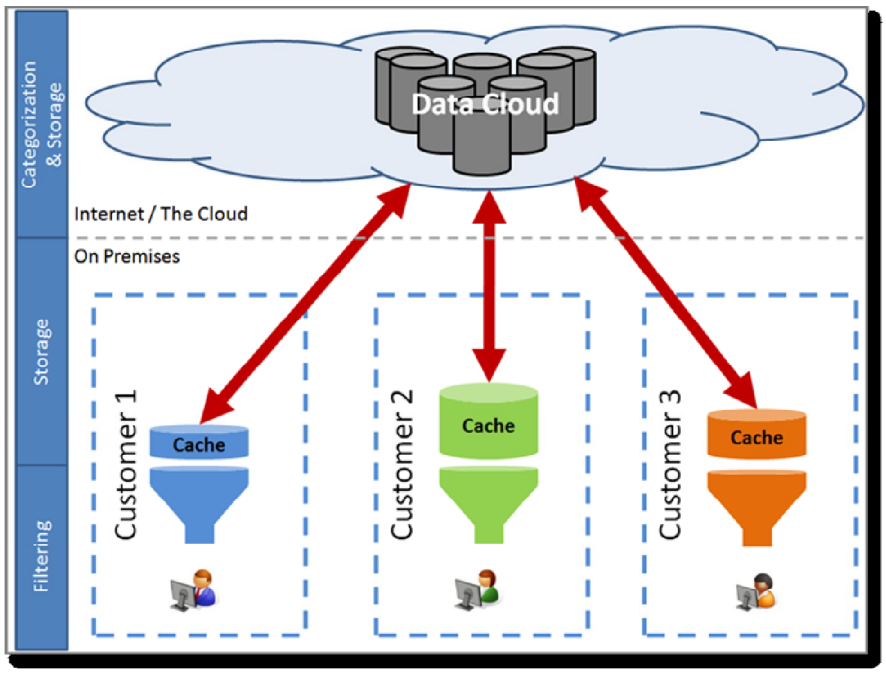
How it works

Commtouch provides GlobalView and patented Recurrent Pattern Detection ((RPD)) technologies.RPD is analytical software that that fingerprints all email traffic (privacy assured) and identifies spam and messages carrying malicious attachments based on their global distribution. Thus, providing instantaneous protection from familiar sequences. This software allows the threat data to be immediately available to millions of users.

RPD is one of the detection engines that powers the Globalview cloud. Globalview also hosts Commtouch's real time IP reputation service and the "zombie feed" (both of which track botnets, bad actors and compromised sites and IPs), content based spam and phishing detection analytics, a real-time URL filtering service with automatic classification engines and many automated functions of the Commtouch antimalware lab. Commtouch leverages these systems across their individual security domains to deliver unique real-time detection value. For instance, if a new spam attack includes a link to a phishing site, the URL is classified as phishing in the URLF service and monitored by and automated service that checks the URL's status on an ongoing basis and keeps the Commtouch AS, IP Reputation, URLF and Antimalware services up to date.

Finally, the AV ((Anti-virus)) or Antimalware services, based off of Commtouch's proprietary detection and remediation technology, is designed to combat modern malware threats and provides maximum results with high scanning speeds, low resource requirements and superior detection.

Products and services such as these help to increase revenue for organizations by enhancing their security analysis and detection capabilities far beyond the expertise of most OEMs and service providers. The solutions based on Commtouch services and technology help end customers mitigate the threat from Spam, malware and malicious web sites, threats which can lead to costly incidents that diminish quarterly profits



The OEM Business Model

The OEM model has inherent advantages. Among them high margins, marketing risk to the end-customer is reduced, 90% of OEM's renew, and the firm has the ability to cross sell. Further, market consolidation, such as IBM's acquisition of Cobion, will strengthen Commtouch's hold on the market since other OEM venders are unlikely to buy from competitors.

Time Period	Impact
0 months	Contract is signed
3-6 months	Integration, first cash
12-18 months	Revenues begin to accelerate
18-24 months	Full revenue potential reached

Internet

In the 4th quarter of 2008 Commtouch introduced its URL filtering services. Where the firm once only monitored email/messaging space, it now has footprints in the more lucrative space of filtering web sites. The firm's technology analyzes and categorizes the source of URLs being accessed by such customers, mainly in order to prevent 1) the possibility of malware attacks being propagated by malicious URLs, 2) access to non-business related websites by employees and 3) access by children to inappropriate websites.

WORLD INTERNET USAGE AND POPULATION STATISTICS						
World Regions	Population (2009 Est.)	Internet Users Dec. 31, 2000	Internet Users Latest Data	Penetration (% Population)	Growth 2000-2009	Users % of Table
Africa	991,002,342	4,514,400	65,903,900	6.70%	1359.90%	3.90%
Asia	3,808,070,503	114,304,000	704,213,930	18.50%	516.10%	42.20%
Europe	803,850,858	105,096,093	402,380,474	50.10%	282.90%	24.20%
Middle East	202,687,005	3,284,800	47,964,146	23.70%	1360.20%	2.90%
North America	340,831,831	108,096,800	251,735,500	73.90%	132.90%	15.10%
Latin America/caribbean	586,662,468	18,068,919	175,834,439	30.00%	873.10%	10.50%
Oceania/Austraila	34,700,201	7,620,480	20,838,019	60.10%	173.40%	1.20%
World Total	**6,767,805,208**	**360,985,492**	**1,668,870,408**	**24.70%**	**362.30%**	**100.00%**

*source: World Internet Stats

In our opinion the internet is still growing and has a relatively low 24.7% penetration rate compared to the population. Especially if one considers Asia which has approximately 56% of the world's population yet remains only 18.5% penetrated. Another trend to consider in assessing the Commtouch growth rate is the explosion of handheld devices such as IPhones and Blackberries. There are in effect more and more devices being connected and each new connection is a new risk element in the chain.

Service Providers: The Next Growth Leg

Customer loss, operational cost increases, brand damage and even potential lawsuits are just some of the possible consequences service providers face as a result of spam emanating from their networks. Because the problem differs significantly from that of inbound spam, the potential hazards of outbound spam require a distinctive approach to protect service providers against this rapidly growing threat.

Commtouch messaging security solutions rely on its patented Recurrent Pattern Detection™ (RPD) technology, which analyzes billions of messages per day to identify outbreaks the moment they occur. In order to provide accurate protection from outbound spam, Commtouch has enabled local RPD technology within the Outbound Spam Engine. Outbound email is scanned by the Outbound Spam Engine for globally recurring patterns, locally recurring patterns and replies to scams. This allows the engine to track a sender's traffic statistics, such as mails per period of time and spam/ham ratio. Once a sender reaches a certain threshold set by the service provider, the Commtouch Engine blocks the spam and alerts the service provider with the sender address. Samples of the blocked emails are also provided for analysis.

Benefits Include:

- Secures service provider's reputation – Blocking outbound spam at the right time will prevent the network from being blocked and will improve the reputation of the service provider.

- Saves money –Reduces expenses associated with resolving blocked IPs, handling angry customers, and increasing existing hardware and support staff.

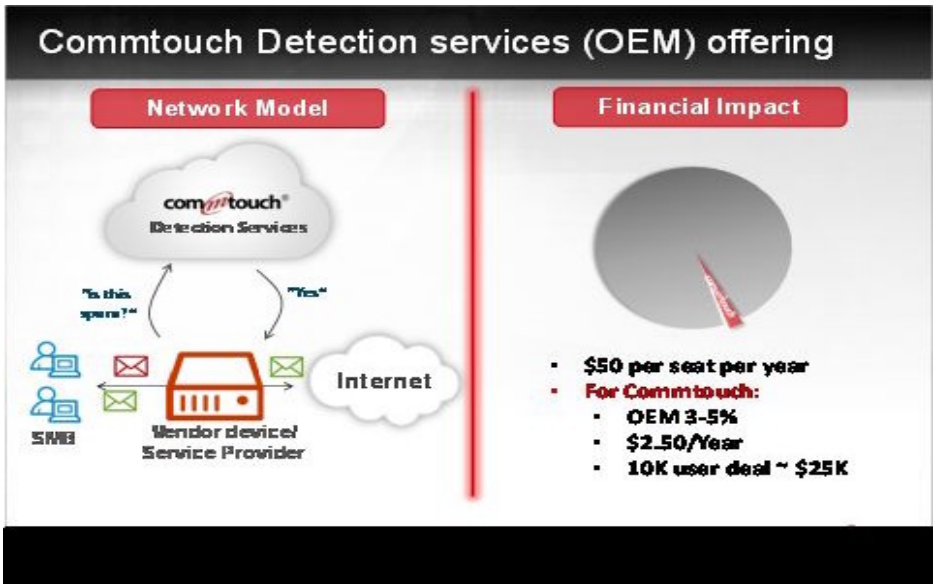
- Improves customer satisfaction – Commtouch's near zero false positive rate allows customers to benefit from a high level of service with no disruptions while protecting them from scams.

- Differentiates service offering – A unique anti-scam component adds valuable protection for customers.

Strategic Moves

The company ended 2012 with renewed revenue growth and tremendous progress, which was accelerated by its strategic acquisitions and the formal launch of its new cloud-based email Security-as-a-Service offering in early 2013. Commtouch's new Email Security-as-a-Service solution marks a major launch of the Company's latest cloud-based offerings and is complemented by new solutions focused on Email Security and Mobile Security Services for Android. Offerings such as these will lead to increased margins and amplify long term profits. These endeavors demonstrate the Company's execution on its strategic roadmap and its foundation for future growth.

Commtouch's e-mail "security-as-a-service" combines permanent protection against e-mail based threats and its new mobile security service for android is the first ever OEM solution that offers cloud assist antivirus and URL filtering in one lite weight package. The Demand for these services from new and existing customers has grown tenfold for the organization since the inception of the full-scale security service.



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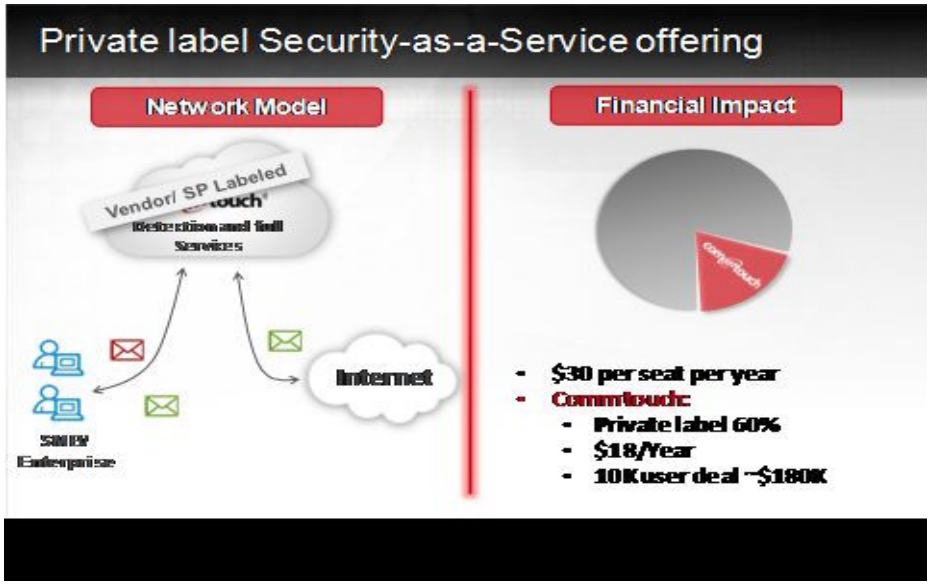


Management is undertaking a range of initiatives designed to optimize the integration, synergies and streamlining of its recent acquisition with a focused commitment to bottom line profitability. The Company also remains committed to investing in its enhanced sales and marketing platform to fully leverage the value for innovative new "securities-as-a-service" offerings among customers worldwide. The recently launched solutions have generated pronounced initial customer interest setting the stage for strong revenue growth in 2014. By moving from a product-based company to a servicebased company, Commtouch will increase its long-term cash flow. The increase in cash flow would be derived from signing multiyear service contracts with multi-national organizations. These relationships have already begun to develop with existing customers like Microsoft, Fujitsu and Google.

Additionally, the Company's focus remains on increasing its market share in the fast growing market for cloud based e-mails, web and anti-virus solutions. This includes a significant launch of its new upcoming cloud based web security solution, which is on-track for release during the second half of 2013.

VALUATION

CTCH remains well positioned to achieve solid revenue growth and operating leverage as, virus problems become more complex given the company's competitive advantage led by innovation and the OEM business model. The firm has four things that separate it from the pack in our opinion.

- A technologically superior product.
- A service based OEM business model that assures recurring revenues and high margins with less end market risk.
- A strong balance sheet with low debt.
- A growth platform in URL filtering that looks to be double the size of the message market.

The intrinsic value is essentially a sum of the company's future earnings, minus any long-term debt. Dividing the intrinsic value by the number of shares outstanding yields an intrinsic stock price. We used the following inputs:

- A 10-year period with an earnings growth rate of 10.0% (average forecast) and a discount rate of 12.45%.

- A continuing period assumed to go on forever, with earnings growing at 5% and a discount rate of 12.23%.

With these inputs we arrive at a target price of $4.50.

RISKS

- The company is headquartered in Israel and faces political risk.

- Future growth depends on the adoption rate of technology and a delay could result in revenues and earnings dropping below expectations.

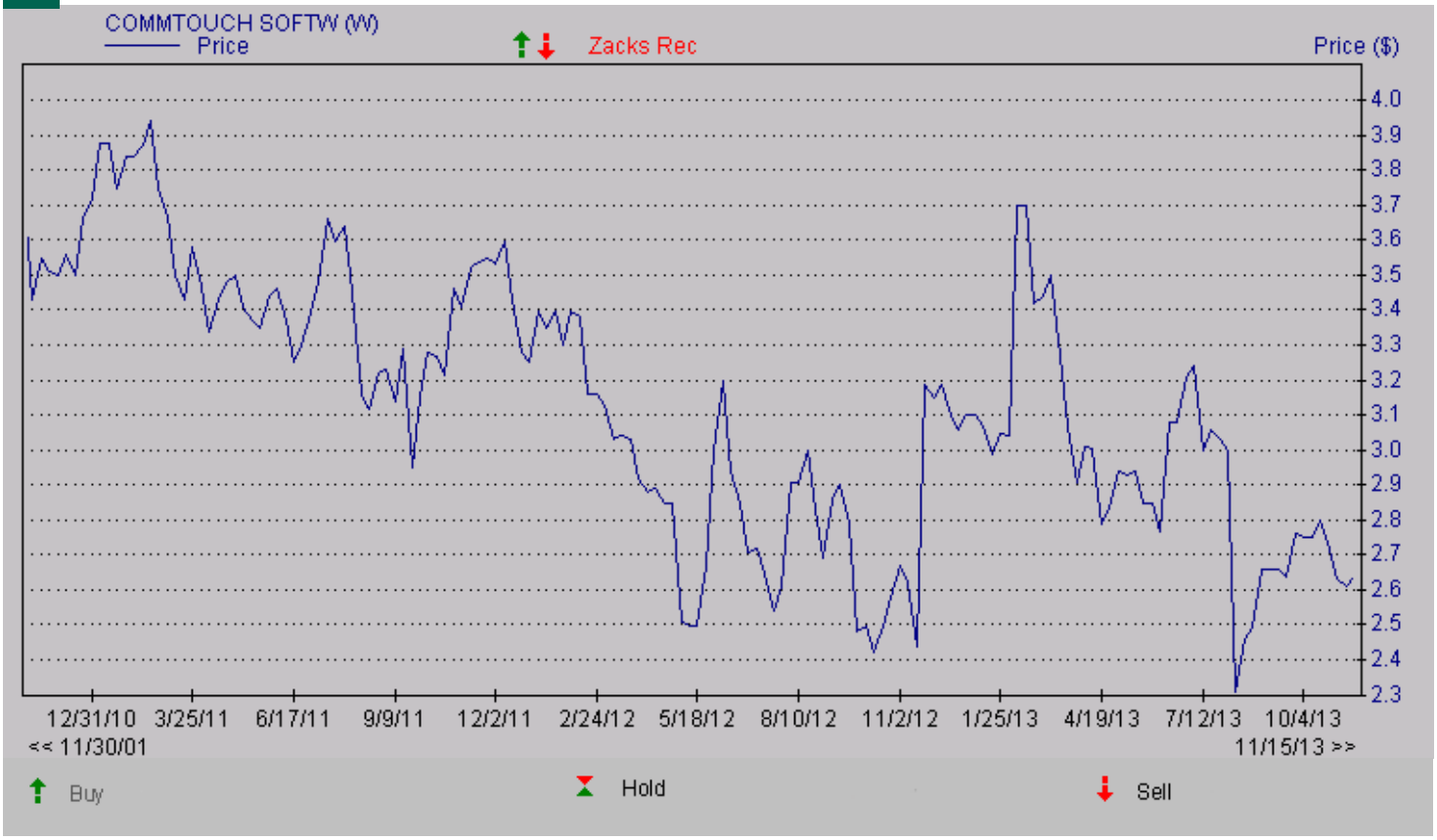
- The Nature of the business forces the firm to stay ahead of hackers and spammers. While these law breakers were thought of as jokesters in the past, they are more and more motivated by profit and greed.

PROJECTED INCOME STATEMENT

INCOME STATEMENT ($ Millions)	Sep-12 Q3 12	Dec-12 Q4 12	Mar-13 Q1 13	Jun-13 Q2 13	Sep-13 Q3 13	Dec-13 Q4 13 E	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013 E	FY 2014 E
REVENUE												
Net Revenue	**5.6**	**6.8**	**7.7**	**8.1**	**7.9**	**8.6**	**15.2**	**18.2**	**23.0**	**24.0**	**32.3**	**38.0**
Sequential Growth		*21%*	*14%*	*4%*	*-1%*	*8%*						
OPERATING EXPENSES												
Cost of Revenues	0.86	1.21	1.58	1.60	1.48	1.60	2.2	2.8	3.9	4.0	6.3	7.8
% of Revenue	*15.4%*	*17.9%*	*20.4%*	*19.9%*	*18.6%*	*18.6%*						
Gross Profit -	**4.70**	**5.57**	**6.15**	**6.46**	**6.47**	**7.00**	**13.0**	**15.4**	**19.1**	**19.9**	**26.1**	**30.3**
Proforma Gross Margin	*83.9%*	*82.1%*	*79.6%*	*80.1%*	*81.4%*	*81.4%*	*85.4%*	*84.6%*	*83.2%*	*83.2%*	*80.7%*	*79.6%*
R&D + Engg	1.38	2.18	2.21	2.12	2.02	2.25	2.7	3.1	5.0	6.1	8.6	9.0
% of Revenue	*24.6%*	*32.1%*	*28.5%*	*26.3%*	*25.4%*	*26.2%*	*17.4%*	*17.0%*	*21.9%*	*25.3%*	*26.6%*	*23.7%*
SG&A	2.55	3.59	4.18	4.11	4.00	4.00	6.3	6.8	7.8	10.5	16.3	18.0
% of Revenue	*45.5%*	*52.9%*	*54.1%*	*51.1%*	*50.3%*	*46.5%*	*41.3%*	*37.6%*	*33.8%*	*43.7%*	*50.4%*	*47.4%*
GW Amort, Restructuring, other							-	-				
% of Revenue												
Total Operating Expenses	3.93	5.76	6.39	6.23	6.01	6.25	8.9	9.9	13	17	25	27
% of Revenue	*70.2%*	*85.0%*	*82.7%*	*77.4%*	*75.7%*	*72.7%*	*58.7%*	*54.6%*	*56%*	*69%*	*77%*	*71%*
Operating Income -	**0.77**	**-0.2**	**-0.2**	**0.2**	**0.5**	**0.8**	**4.05**	**5.46**	**6.33**	**3.41**	**1.19**	**3.25**
Operating Margin	*13.8%*	*-2.8%*	*-3.1%*	*2.8%*	*5.7%*	*8.7%*	*27%*	*30%*	*28%*	*14%*	*4%*	*9%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0.06	0.15	0.12	0.10	-0.05	0.15	0.06	-0.06	-0.05	0.33	0.32	0.40
% of Revenue	*1.07%*	*2.25%*	*1.55%*	*1.20%*	*-0.65%*	*1.74%*	*0.40%*	*-0.30%*	*-0.22%*	*1.37%*	*0.97%*	*1.05%*
Tax Provision	0.091	-0.077	-0.115	0.017	0.046	0.020	0.010	0.000	0.028	0.027	-0.032	0.500
Effective Tax Rate												
Net Income -	**0.74**	**0.27**	**0.00**	**0.30**	**0.36**	**0.88**	**4.10**	**5.41**	**6.25**	**3.94**	**1.54**	**3.15**
Net Income Margin	*13.2%*	*3.9%*	*-0.1%*	*3.7%*	*4.5%*	*10.2%*	*27.0%*	*29.8%*	*27%*	*16%*	*5%*	*8%*
				0								
EARNINGS PER SHARE												
EPS - Basic	$0.03	$0.01	$0.00	$0.00	$0.01	$0.03	$0.17	$0.24	$0.26	$0.16	$0.05	$0.12
EPS - Diluted	$0.03	$0.01	$0.00	$0.00	$0.01	$0.03	$0.17	$0.21	$0.26	$0.16	$0.05	$0.12

Ken Nagy, CFA Zacks Investment Research 11/14/2013

HISTORICAL ZACKS RECOMMENDATIONS



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