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Ziyang Ceramics (ZYCI – OTCQB)

Ziyang Ceramics Manufactures High-Grade Floor and Wall Tiles for Commercial and Residential Use. Despite Its Excellent Financial Performance and its Own Clay Supply, ZYCI Shares Trade at Very Low Trailing and Forward P/E and P/S Multiples.

**Strong
Speculative
Buy**

Recent Price: US\$2.20

Summary and Investment Opportunity

Market Data (closing prices, October 17, 2012)

Market Capitalization (mln)	22
Enterprise Value (mln)	25.0
Basic Shares Outstanding (mln)	10.0
Fully Diluted Shares (mln)	10.0
Avg. Volume (90 day, approx.)	978
Insider Ownership	86%
Exchange	OTCQB

Balance Sheet Data (as of June 30, 2012)

Shareholders' Equity (mln)	29,019
Price/Book Value (as of 10/17/12)	0.75x
Cash (000s)	5,757
Net Working Capital (000s)	5,382
Long-Term Debt (000s)	0
Total Debt to Equity Capital	0.30

Company Overview

China-based Ziyang Ceramics Corp. is a leading manufacturer of high quality interior porcelain tiles for use in residential and commercial applications. The Company targets second-tier and third-tier urban markets in China, and markets its products under the brand names of FuYunDe, Gef, and Luckway through its network of 176 distributors in the People's Republic of China (PRC). The Company's products include porcelain floor and wall tiles for commercial and residential applications. The Company owns the clay mines that provide its raw materials as well.

The Company is based in Zhucheng City, Shandong Province, China, and trades on the OTCQB under the symbol ZYCI.

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• China's Luxury-Building Construction Industry is Strong and Likely to Remain So

China has an extremely large developing economy, characterized by high rates of infrastructure investment, high growth in personal and national income, and a high demand for ever-better living, shopping, and professional environments. We believe that these factors are likely to persist at least for the next ten to fifteen years, all but guaranteeing a strong market for the Company's products. This is especially true of the nation's tier-two and tier-three cities, which are the target markets of Ziyang Ceramics.

• Ziyang is Vertically Integrated and Moving Into Even Higher Margin Tile Markets

The Company currently produces high-grade ceramic tiles primarily for floor-tile applications. Because it owns five different white clay materials mines, it produces all of the inputs for its own production process, allowing it to generate additional revenues from clay sales and maintain very important supply and price protection for its white clay. Furthermore, the Company has begun to expand its business into the higher-margin wall tile market, which should become a much larger share of revenues this year and especially once it completes its new (planned) production facility. The Company sells its products directly to large construction contractors and through its network of 176 distributors located in ten Chinese provinces.

• The Company Trades at Low Multiples Despite Its Strong Financial Results

Ziyang Ceramics trades at exceptionally low multiples of trailing and forward sales and earnings; as of 10/17/12 ZYCI shares were trading at just 0.5 times 2011 sales per share (SPS) and 2.0 times 2011 EPS; based on our model it is trading at just 0.4 times estimated 2012 SPS and 1.4 times 2012 estimated EPS. We can only explain this as being due to one of these factors: 1) since the Company went public through a reverse merger, it lacks the large base of shareholders commonly generated by a traditional IPO, meaning quite literally that no one is paying attention, or 2) it has been unfairly maligned by the accounting fraud uncovered at several PRC-based companies last year.

• ZYCI Shares are Extremely Undervalued Based on Current Financial Results

Ziyang Ceramics operates in an industry with very strong underlying fundamentals (both past and likely future) and has demonstrated a long history of successful growth and financial performance. While we cannot completely discount the potential for accounting anomalies in and PRC-based enterprise, we believe that the Company's extremely low valuation certainly more than compensates investors for any financial reporting risks. **Therefore we rate the shares of Ziyang a Strong Speculative Buy, and set our 12-month price target at \$8.20 per share, just 5x our 2012 EPS estimate. We view this as an extremely low multiple.**

P&L (000s)	FY'11A	Q1'12A	Q2'12A	Q3'12E	Q4'12E	FY'12E	FY'13E	FY'14E
Revenues	43,147	11,411	14,361	14,500	15,000	55,273	68,750	84,219
y/y Growth	38.7%	52.5%	45.6%	20.6%	8.9%	28.1%	25.0%	22.5%
Gr. Margin	34.4%	37.8%	37.6%	37.5%	38.0%	37.7%	38.0%	38.0%
Op. Income	13,135	3,845	4,685	4,902	5,146	18,757	23,531	28,825
Op. Margin	30.4%	33.7%	33.9%	33.8%	34.3%	33.9%	34.2%	34.2%
Net Income	10,835	3,158	3,980	4,015	4,215	15,361	19,358	23,717
Dil. EPS	12.83	0.42	0.40	0.40	0.42	1.64	1.94	2.37
Dil. Shares	844	7,456	10,001	10,001	10,001	9,365	10,001	10,001

Industry Background and Analysis

Porcelain Tile

Porcelain tiles originally dates back to approximately 1800 B.C.E., where tiles have been excavated in Grecian ruins from the same period. First used by wealthy aristocrats for roofing material, during the industrial revolution tiles rapidly became popular for flooring and walling applications, and are now a common fixture in commercial buildings, retail malls and outlets, and many homes in the U.S. and around the world. In 2010, the total U.S. tile industry had sales of US\$2.015 Billion¹. The U.S. imports the vast majority of its tiles, mainly from Mexico, China, and Italy, and the largest tile producer in the world is the People's Republic of China, with global 2010 market share of 44.1²%.

Porcelain Manufacture

The quality of a tile is only as good as the quality of the porcelain of which it is made. Technically, porcelain is a “Triaxial composition of quartz, clay, and feldspar that when fired to between 1200 and 1400 degrees Celsius, produces a tough, white, usually translucent, and virtually non-permeable [less than 0.5%] body.” Porcelain comes in many forms, and each has its own quality characteristics, which include: hardness, durability, water impermeability, color, and luster. Although these qualities are partly due to the quality of the manufacturing process used to make the porcelain, they are also in large extent due to the mineral properties of the clay and other ingredients used in its manufacture. Thus the supply of raw materials is of paramount importance to the high-grade porcelain manufacturer, a category in which we would clearly place Ziyang Ceramics. Note that since the Company owns and operates its own clay mines, we believe supply disruption constitutes a negligible risk for the Ziyang.

Commercial and Residential Tile Flooring

The market for premium floor and wall tiles is highly sensitive to economic growth swings, since the construction of luxury buildings (both commercial and residential) tends drop rather precipitously during periods of economic recession. This was clearly seen in the United States' tile consumption during the 2006-2010 period, when housing prices fell as much as 50% and the demand for new construction slowed dramatically.

However, China's construction industry is somewhat different than U.S. construction industry, largely due to the underlying demand drivers in China's economy. Although not completely immune to the effects of changing economic conditions in China, the nation's construction of new residential and commercial buildings is likely to remain either strong or very strong for many years to come. This is largely due to the sheer size of China's population, and due the nation's rapidly rising GDP per capita and very strong urbanization trends. These factors, when considered in combination, suggest to us that Ziyang is likely to benefit from an extremely strong pricing and demand environment for its products for the foreseeable future.

The industry itself is comprised of raw materials producers, porcelain tile manufactures, finished goods (e.g. tile) distributors, building and construction contractors (the customer from Ziyang's perspective), and of course the final owners of the buildings in which the tile was used. The Company has relationships with over 176 distributors in ten provinces of the PRC.

¹ Catalina Research and the U.S. Department of Commerce sales of ceramic tile in 2010 the overall ceramic tile market increased from 2009 by 9.2% to \$2.015 billion in wholesale dollars.

² According to infotile.com

Company Analysis

Company Description

Ziyang Ceramics is a PRC-based manufacturer of high-grade porcelain tiles for use in indoor residential and commercial buildings. The company distributes its products through a network of some 176 distributors located in ten provinces of the People's Republic of China. The Company currently operates a 775,000 square foot production facility located in Zhucheng (Shandong province) that is capable of producing approximately 200 million square feet of tile annually. The Company produces three primary product lines of floor and wall tile, available in over 50 combinations of color and pattern, and markets these products both as white-label tiling for large distributors, and under its own three well-established brands. The Company owns and operates five six clay mines with total estimated white clay reserves of approximately 20 million tons, giving it important protection against adverse price swings and product shortages in the white clay materials market.

The Company trades on the OTCQB under the symbol ZYCI, and is based in Zhucheng, Shandong, People's Republic of China, with its U.S. offices operating in Deerfield Beach, FL.



Ziyang Ceramics Headquarters and Manufacturing Facility

Valuation and Financial Analysis

In our experience we rarely find companies trading at the exceptional low trailing and forward multiples reflected in ZYCI's share price. We believe that based on its financial results alone Ziyang Ceramics' shares deserve a much higher market valuation than they currently exhibit. We can only speculate that this is due to the Company's current lack of investor visibility, and/or the currently negative sentiment being expressed by the U.S. equity markets towards PRC-based companies, especially those that became public through a reverse-merger such as Ziyang. As a U.S. based firm, we cannot definitively allay all such concerns, but we do personally know individuals who have been to the PRC and visited the Company, and we believe that overall the low valuation inherent in ZYCI shares more than compensates risk-tolerant investors for the accounting risk that affects all U.S.-traded shares of PRC-based companies. We therefore rate the shares of ZYCI as a Strong Speculative Buy, and set our 12-month price target at \$8.20 per share.

Products

Ziyang Ceramics offers three primary types of tile products to its customers and distributors. Each type of tile is available in 23.6" x 23.6" (60cm x 60cm) and 31.5" x 31.5" (80cm x 80cm) sizes. The Company's product series are as follows:



Ziyang Patterned Polished Tiles (Porcelain)



Ziyang Ultra-Bright Polished Tiles (Porcelain)



Ziyang Polycrystalline Tiles (Porcelain)

The Company's own literature explains these three product categories as follows:

Patterned polished porcelain tiles: Porcelain tiles are fired at extreme temperatures to achieve its high density, high strength, and low water absorption characteristics. They are extremely durable and have antibacterial, high stain resistant, wear-resistant, and anti-slip qualities making them especially suitable for public and residential use.

Ultra bright polished porcelain tiles: The surface of ultra-bright porcelain tiles are treated with nanotechnology creating a glossy mirrored surface. These tiles are antibacterial and have super wear-resistant, stain resistant, acid-resistant, low water absorption and non-slip qualities. Fired under high temperature and with the use of special penetrating technology, these tiles result in soft colors and elegant surface patterns, suitable for high-end decorative residential use.

Polycrystalline porcelain tiles: Polycrystalline tiles have elegant, natural-looking patterns that are marble like. The surface is delicate, transparent, glossy, and feels like jade. This product is antibacterial; it has no radiation and is environmentally friendly. These tiles are frost resistant, thermal shock resistant, wear-resistant, and acid-resistant. This product is superior to natural granite and can be used as high-end decorative paving products for residential and commercial use.

Traditionally, the Company has used these three varieties of tiles for residential and commercial applications; the Polycrystalline Tiles launched by the Company in 2010 are especially geared to high end use. However, the Company newest product line uses these same three product categories, but in the wall tile market. According to our sources, this new line of tiles has "been a big hit." Note that the Company has stated it will probably be seeking some additional capital in the coming quarters to build a new facility dedicated just to the production of wall tiles.

Production Process

Ziyang's process of transforming its materials inputs of white clay, quarts, and feldspar into a finished high-end porcelain product consists of the following eight steps.

1. **Raw materials inspection.** This insures both physical and chemical specs are met.
2. **Mixing.** Materials that have passed inspect are combined in vats with 30 tons of capacity per batch.
3. **Grinding.** The materials are ground for approximately 14 hours, at which time coloring agents are added and larger particulates are extracted via vibrating screening. The slurry is then purified to spec.
4. **Spray Granulation.** Mixed material is brought to the desired level of water content and physical uniformity.
5. **Molding.** Materials is poured into molds and formed into the final shape of the tile product (called a bisque at this stage).
6. **Drying and Firing.** The bisques dried in previously-heated kilns at 180 degrees Celsius (356 degrees Fahrenheit) before being fired at 1210 degrees Celsius (2210 degrees Fahrenheit) for several hours. During firing the chemical composition of the raw materials is altered into that of porcelain.

7. **Polishing.** The porcelain is polished with buffers for shine and smoothness, and then was treated for stain resistance.
8. **Inspection and Packaging.** The tiles are sorted by grade, color, and cut, and then packaged for sale.

We believe the quality control and automation aspects of Ziyang's manufacturing processes and its ready supply of high-grade materials are responsible for both strong market demand for the Company's products, and for the expanding gross margins the Company has been and expects to continue experiencing.

Strategic Growth Plan

The Company has a relatively simple, straightforward strategic growth plan: it intends to continue to scale its capacity, especially in the higher-margin wall-tile market, as well as continue developing its base of distributors and large contractor relationships. Based on the Company's historical record, we believe that this plan is likely to lead to continued strong financial results and Company growth.

Leadership Team

Linbo Chi, *Chief Executive Officer*

Mr. Chi founded Ziyang Ceramic Corporation in 2006 and has served as the CEO since then. Prior to establishing Ziyang Ceramic Corporation, Mr. Chi started as a technology specialist of Zhucheng Electronics Co., Ltd in 1986 and was later promoted to its general manager. Mr. Chi graduated from Shandong Industrial University in 1986 with a Bachelor's degree in Semiconductor Studies.

Nianzhang Zhao, *General Manager*

Mr. Zhao has more than 10 years of experience in the ceramics industry prior to 2006 working as the technology director and vice president of Zhucheng Luzhong Ceramics Co., Ltd. Mr. Zhao graduated from Shandong Light Industry Institute in 1987 with a Bachelor's degree in Ceramics Studies.

Ping Wang, *Chief Financial Officer*

Ms. Wang has more than 15 years of experience in the field of financial accounting and had received numerous awards from the local government for outstanding accountant achievements. Ms. Wang graduated from Shandong Radio and Television College with an accounting degree.

Competition

The global market for floor and wall tiling is highly competitive across both product categories and geographical boundaries. The Company faces rather intense competitive pressure in the PRC, although this pressure is somewhat mitigated by both the fact that the Company owns and operates its own white clay mines, and because the Company is focusing on tier-two and tier-three metropolitan areas, where competition is somewhat less intense. We believe the Company has faced and will continue to face significant competition in its key markets, but we do not think that this competition is likely to increase that significantly from current levels under any foreseeable scenario. Therefore we are not overly concerned with competitive risk in this particular case.

Risks

As we have stated in the Valuation section of this report, the largest risk we see in ZYCI's shares involves the same risk that affects all U.S. traded shares of PRC-based companies: accounting risk. While we cannot completely allay concerns stemming from this risk, since we have not made an independent verification of the Company's PRC-based operations, we do feel that the Company's low valuation more than adequately compensates investors for this risk, which affects all PRC-based U.S. traded companies.

Other risks include those stemming from future downturns in the PRC construction industry, the possibility that the Company is unable to secure additional funding for its new facilities, and the (albeit remote) possibility that some new material could become available that would reduce or eliminate the demand for porcelain tiles.

Valuation and Investment Thesis

Given the range of equity valuations typical of companies such as Ziyang, it is obvious to us that (accounting risk aside) this Company is **extremely** undervalued. Using even conservative valuation benchmarks, such as a P/E

ratio of just over 7.6x times reported 2011 net EPS, we still arrive at a fair current price per share of \$8.20, which would imply a return to investors of over 360% were the stock to reach our target price from these levels. On a risk-adjusted basis, we believe that this more than adequately compensates prospective investors for the risks we do see in ZYCI shares, and therefore rate the shares a Strong Speculative Buy, setting our 12-month price target at \$8.20 per share.

Conclusion

Overall, we believe that the shares of ZYCI offer investors an excellent risk-reward trade-off at current levels. Ziyang Ceramics offers a high-quality family of ceramic tile products to high growth PRC tier-two and tier-three urban markets. Based on underlying economic fundamental factors operating within China, and based on the Company's relatively long history of generating solid and growing sales and earnings, we believe that ZYCI shares are significantly undervalued at current levels. Therefore we rate the shares of ZYCI as a Strong Speculative Buy, and set our 12-month price target at \$8.20 per share.

Our Rating System

We rate enrolled companies based on the appreciation potential we believe their shares represent. The performance of those companies rated “Speculative Buy” or “Strong Speculative Buy” are often highly dependent on some future event, such as FDA drug approval or the development of a new key technology.

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STRONG BUY	We believe the enrolled company will appreciate more than 20% relative to the general market for U.S. equities during the next 12 to 24 months.
BUY	We believe the enrolled company will appreciate more than 10% relative to the general market for U.S. equities during the next 12 to 24 months.
STRONG SPECULATIVE BUY	We believe the enrolled company could appreciate more than 20% relative to the general market for U.S. equities during the next 12 to 24 months, if certain assumptions about the future prove to be correct.
SPECULATIVE BUY	We believe the enrolled company could appreciate more than 10% relative to the general market for U.S. equities during the next 12 to 24 months, if certain assumptions about the future prove to be correct.
NEUTRAL	We expect the enrolled company to trade between -10% and +10% relative to the general market for U.S. equities during the following 12 to 24 months.
SELL	We expect the enrolled company to underperform the general market for U.S. equities by more than 10% during the following 12 to 24 months.

Analyst Certification

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Our Team

Brian R. Connell, CFA

Senior Managing Director

Mr. Connell has over 20 years' experience in the securities industry, as an equity analyst and portfolio manager, and as the founder and CEO of StreetFusion (acquired by CCBN/StreetEvents), a software company serving the institutional investment community. On the sell-side, Mr. Connell served as the technology analyst for Neovest, an Atlanta-based boutique, and as a Senior Analyst - Internet for Preferred Capital Markets, an investment bank based in San Francisco. Mr. Connell has also held the position of Executive Director of Marquis Capital Management, a technology-focused hedge fund.

Mr. Connell founded Harbinger Research in 2004 with the purpose of providing high quality research coverage to deserving smaller companies. Mr. Connell holds degrees in Economics and Psychology from Duke University, and is a CFA Charterholder.

Ziyang Ceramics Corp and Subsidiaries Profit and Loss Model, October 2012, Calendar Fiscal Year

(USD, in 000s, except per-share amounts)	2010A	2011A	Q1 '12A	Q2 '12A	Q3 '12E	Q4 '12E	2012E	2013E	2014E	2015E
Revenues										
Net sales	31,101	43,147	11,411	14,361	14,500	15,000	55,273	69,091	84,636	101,563
<i>Sequential period-over-period growth</i>		38.7%	52.5%	45.6%	20.6%	8.9%	28.1%	25.0%	22.5%	20.0%
Cost of goods sold	20,234	28,313	7,101	8,966	9,063	9,300	34,430	42,836	52,474	62,969
<i>Gross margin</i>	34.9%	34.4%	37.8%	37.6%	37.5%	38.0%	37.7%	38.0%	38.0%	38.0%
Gross profit	10,867	14,834	4,310	5,395	5,438	5,700	20,843	26,255	32,162	38,594
Operating expenses										
Sales and marketing expenses	172	213	52	68	68	71	259	324	396	476
General and administrative expenses	1,646	1,486	413	463	467	483	1,827	2,283	2,797	3,357
Total operating expenses	1,818	1,699	465	531	536	554	2,086	2,607	3,193	3,832
Operating income (loss)	9,049	13,135	3,845	4,865	4,902	5,146	18,757	23,648	28,968	34,762
<i>Operating margin</i>	29.1%	30.4%	33.7%	33.9%	33.8%	34.3%	33.9%	34.2%	34.2%	34.2%
Other income (expense)										
Interest income	80	403	105	102	105	105	417	459	504	555
Interest expense	(407)	(580)	(123)	(111)	(110)	(110)	(454)	(499)	(549)	(604)
Interest income (expense), net	(327)	(177)	(18)	(9)	(5)	(5)	(37)	(41)	(45)	(49)
Interest expense, related party		(20)								
Gain (loss) from change in DL fair value		121	(0)	25						
Other income (expense)	(1)	(49)	(3)	(14)						
Total other expenses	(328)	(125)	(21)	2	(5)	(5)	(37)	(41)	(45)	(49)
Income (loss) before income taxes	8,721	13,010	3,824	4,866	4,897	5,141	18,720	23,607	28,924	34,713
Provision for income taxes	1,453	2,175	666	887	881	925	3,360	4,249	5,206	6,248
<i>Implied tax rate</i>	16.7%	16.7%	17.4%	18.2%	18.0%	18.0%	17.9%	18.0%	18.0%	18.0%
Net income (for EPS calculation)	7,268	10,835	3,158	3,980	4,015	4,215	15,361	19,358	23,717	28,464
Gain (loss) from foreign currency translation	440	622	(12)	155						
Comprehensive income	7,707	11,456	3,146	4,135	4,015	4,215	15,361	19,358	23,717	28,464
Basic and diluted net income per share	12.32	12.83	0.42	0.40	0.40	0.42	1.64	1.94	2.37	2.85
Weighted average common shares outstd.	590	844	7,456	10,001	10,001	10,001	9,365	10,001	10,001	10,001