

10 August 2010

# Rubber Gloves

## Stress test - tensile strength intact

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### Stress testing input costs; we remain bullish on the rubber glove industry

The recent rally of the ringgit (MYR), still high latex prices and concerns of higher natural gas prices have raised concerns on margin pressure and sustainability of earnings. The issues are not new to the rubber glove industry, given similar challenges seen in 2008. We stress-tested our assumptions and conclude that the industry's cost pass-through mechanism remains robust, and we expect a three-year EPS CAGR of c. 22% for 2009-12E for the rubber glove industry. We remain bullish on the industry as a global proxy to rising healthcare spending.

### Effective pricing power

The current challenges faced by glove manufacturers – 1) strengthening MYR, 2) still high latex prices and 3) expectations of rising natural gas prices – are not new. Our review of the quarterly historical performance of Top Glove and Supermax indicates that despite a significantly higher cost environment (latex prices +55.2%; MYR strengthened 10.6% YTD vs. the 2009 average), glove manufacturers have enjoyed higher net margins (+2-3ppt) and have grown their net profits by an average of 107% YoY during the period. This implies that glove demand is relatively price inelastic and that while there is a time lag, the cost pass-through mechanism remains robust.

### Earnings growth sustainable; sensitivity analysis

We have assumed MYR/US\$ of 3.10/3.00 for our FY10-12E earnings and net margins of c. 12-13% for Top Glove and 15-16% for Supermax. We stress-tested our assumptions and conclude that while there may be some seasonality weakness in earnings on a QoQ basis, we continue to expect earnings growth of 40% in FY10E and a three-year EPS CAGR of c. 22% from 2009-12E for the glove industry. Our sensitivity analysis shows that every 1% change in latex prices implies a 3% decline in Top Glove's FY10E net profit and a 0.5% decline in the DCF valuation. A similar change should lead to a 2.4% decline in Supermax's FY10E net profits and a 0.6% decline in its DCF valuation.

### Multi-year growth trend; global proxy to healthcare spending

The rubber glove industry remains a multi-year growth industry, driven by 1) population growth and aging population, 2) large and sustainable replacement demand in the developed countries, 3) increasing healthcare spending and reforms, 4) greater awareness of hygiene standards and 5) growth in emerging market demand.

### Reiterating our Buy on Top Glove and Supermax

Despite the positive fundamental backdrop, the Malaysian glove industry is trading at just 8.9x FY11E PE, a 35% and 29% discount to the Malaysian and ASEAN markets, respectively. We believe concerns of margin pressure are over done and we reiterate our Buy ratings on Top Glove (TOPG MK, RM6.13, RM8.25 target price) and Supermax (SUCB MK, RM6.00, RM7.23 target price). Top Glove is now our top pick in the industry given its market leader position (22% global market share), strong three-year EPS CAGR of 25% and higher potential upside of 34.6% (vs. Supermax's 20.5%). We use DCF valuations for Top Glove and Supermax, which continues to offer more than 20% in potential upside to our target prices. Key risks are: 1) volatile raw material costs and currency, 2) unfavourable regulations on the industry and 3) excess production capacity.

Deutsche Bank AG/Hong Kong

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## Industry Update

### Top picks

<b>Top Glove (TPGC.KL),MYR6.13</b>	<b>Buy</b>
<b>Supermax (SUPM.KL),MYR6.00</b>	<b>Buy</b>

### Companies featured

Top Glove (TPGC.KL),MYR6.13		Buy	
	2009A	2010E	2011E
P/E (x)	18.1	15.0	12.9
EV/EBITDA (x)	10.8	9.8	8.5
Price/book (x)	5.1	3.8	3.2

Supermax (SUPM.KL),MYR6.00		Buy	
	2009A	2010E	2011E
P/E (x)	5.6	10.9	9.1
EV/EBITDA (x)	4.2	9.0	7.2
Price/book (x)	2.8	2.9	2.3

### Trading at a discount



### Margins grew despite higher costs



### Share price sensitivity to input costs



# Strength in gloves

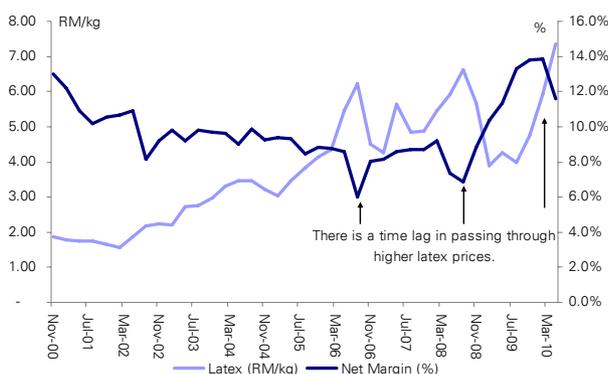
## Cost pass-through mechanism remains robust

Our review of the quarterly historical performances of Top Glove (TOPG MK, RM6.13, Buy, RM8.25 target price) and Supermax (SUCB MK, RM6.00, Buy, RM7.23 target price) indicated that despite a significantly higher cost environment (latex prices +55.2%; MYR strengthened 10.6% YTD versus the 2009 average), glove manufacturers have enjoyed higher net margins (and have grown their net profits by an average of 107% YoY). This implies that glove demand is relatively price inelastic and that while there is a time lag, the cost pass-through mechanism remains robust.

We believe the current concerns on margin pressure and earnings sustainability are not new. The dip in margins for the glove manufacturers in 3Q08 was led by three factors that occurred simultaneously: 1) high latex prices; 2) volatile and fast appreciation of the MYR; and 3) the Malaysian government raising the price of natural gas paid by glove manufacturers by 72.5%, from RM12.80/mmbtu to RM22.08/mmbtu in July 2008. Given that the glove manufacturers had previously locked in prices and sold forward their products by 3-4 months, there was a longer time lag for the glove manufacturers to pass through the cost increases to their customers. As the effect of higher prices was immediate and sharp, the effect on margins and earnings were greater.

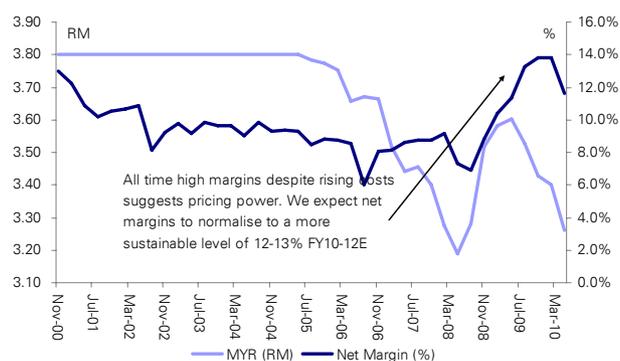
Having learned from its experience in 2008, glove manufacturers are now more sophisticated in their cost pass-through structure, in our view. We understand from the major players that while they continue to keep 2-3 months of forward sales volume, prices are locked in for a shorter period, i.e. one month, and the remaining order prices would be based on a range to capture cost volatility.

**Figure 1: Top Glove’s quarterly net margins vs. latex prices since IPO – cost pass-through intact**



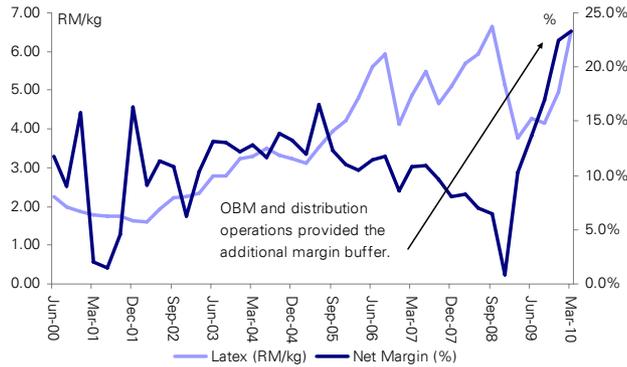
Source: Deutsche Bank, company data, Bloomberg Finance LP

**Figure 2: Top Glove quarterly net margins vs. MYR since IPO – sustainable margins despite higher costs**



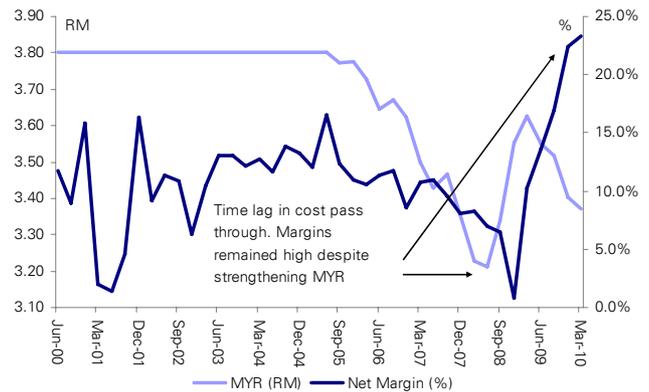
Source: Deutsche Bank, company data, Bloomberg Finance LP

**Figure 3: Supermax – profitability intact despite the all-time high latex prices**



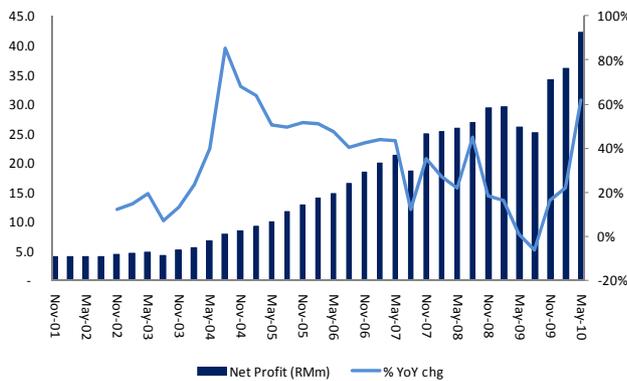
Source: Deutsche Bank, company data, Bloomberg Finance LP

**Figure 4: Supermax net margins at all-time high and thus able to better sustain the higher MYR**



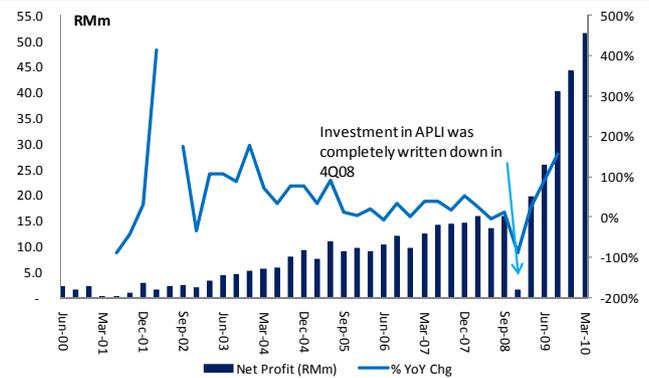
Source: Deutsche Bank, company data, Bloomberg Finance LP

**Figure 5: Top Glove – earnings growth remains robust despite cost pressures**



Source: Deutsche Bank, company data

**Figure 6: Supermax – OBM and distribution operations providing the additional boost**



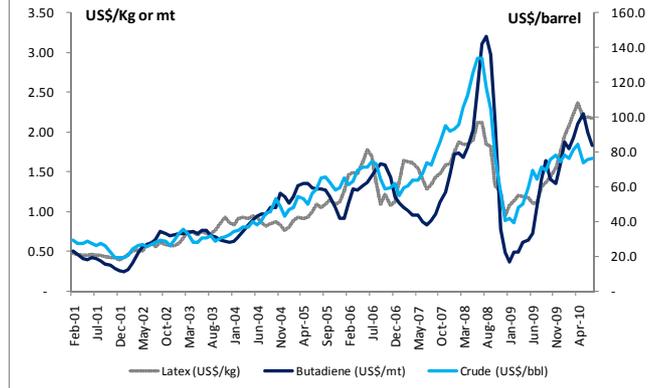
Source: Deutsche Bank, company data

**Figure 7: Share prices are correlated to higher latex prices and stronger MYR**



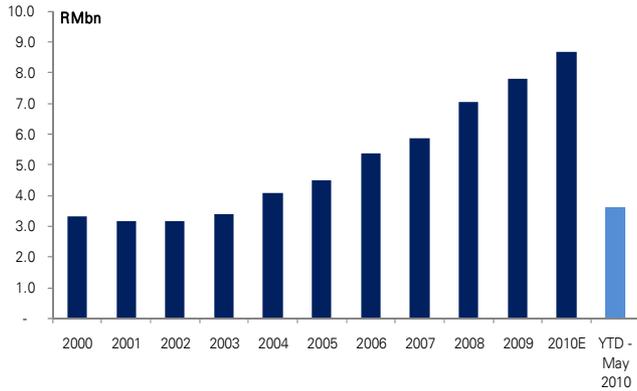
Source: Deutsche Bank, Bloomberg Finance LP

**Figure 8: 3Q08 saw all-time high crude oil prices, which led to a price rally in other commodities**



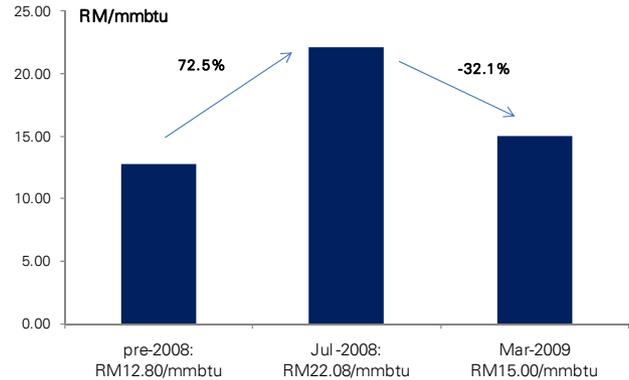
Source: Bloomberg Finance LP

**Figure 9: Malaysia's rubber gloves exports +26.5% YoY, YTD-May 2010**



Source: Deutsche Bank, MREPC, Malaysia Department of Statistics.

**Figure 10: Natural gas prices have been relatively stable**



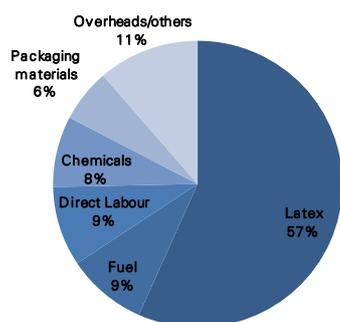
Source: Deutsche Bank, company data

### Sensitivity to earnings

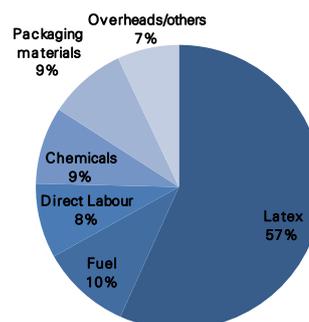
Latex accounts for c. 57% of a gloves manufacturer's total operating costs. Given that most suppliers source c. 50% of their latex requirement from Thailand, where payments are made in US dollars, there is a 50% natural hedge of the companies' US dollar exposure. The current latex price of RM6.97/kg is 55.2% higher than the 2009 average of RM4.49/kg, while the MYR has strengthened 8.1% YTD. Adding to investor concerns is anticipation of increasing natural gas prices as the Malaysian government increases its efforts to cut subsidies.

In light of a higher cost effect, we stress-tested our assumptions. We conclude that while there may be some seasonality weakness in earnings on a QoQ basis arising from the normalization of margins due to the time lag in cost pass-through and purchasing patterns of the distributors, we continue to expect earnings growth of 40% in FY10E and a three-year EPS CAGR of c. 22% from 2009-12E for the glove industry.

Assuming no adjustments to the natural currency hedges, our sensitivity analysis shows that every 1% change in latex prices implies a 3% decline in Top Glove's FY10E net profit and a 0.5% decline in its DCF valuation. A similar change will likely lead to a 2.4% decline in Supermax's FY10E net profits and a 0.6% decline in DCF valuations. The risk to earnings arises in cases of sharp price volatility. Margins during the period are likely to be negatively affected until the selling prices are pushed through, which in many cases has a one-month time lag.

**Figure 11: Top Glove – cost of production breakdown (2010E)**

Source: Deutsche Bank

**Figure 12: Supermax – cost of production breakdown (2010E)**

Source: Deutsche Bank

**Figure 13: Sensitivity to a 1% change in costs**

	Change in FY10E NP		Change in DCF valuations	
	Top Glove	Supermax	Top Glove	Supermax
Latex costs (RM/kg)	3.0%	2.4%	0.5%	0.6%
MYR/US\$	6.1%	5.2%	1.0%	1.3%
Total costs (RM m)	5.4%	4.4%	0.9%	1.1%

Source: Deutsche Bank

## Our positive view remains

The aggregate top three Malaysian glove manufacturers currently trade at 13.7x FY10E PE, below the five-year historical average PE of 15.3x. Peak and trough PE valuations for the sector have ranged from 26.9x to 7.6x since 2002. Despite the better-than-market earnings profile (22% 3-year EPS CAGR), ROE and gearing levels, the Malaysian glove industry as a whole trades at just 8.9x FY11E PE, a 35% and 29% discount to the Malaysian and ASEAN markets, respectively.

Our DCF-based valuations of the two companies offer over 20% in potential upside. We like Top Glove's market leading position in the industry, un-levered balance sheet with a net cash position and its strategy of focusing on capturing the emerging markets' glove demand through its production of low-cost medical natural rubber powdered gloves. We like Supermax for its strong number two position in the global glove industry, low net gearing of 0.3x and its strategy of developing its own brand of gloves on top of being an OEM manufacturer, which would generate both manufacturing and distribution income. We base our target prices on DCF valuations to take into account the strong cash flow generation and sustainable earnings growth for these companies.

### Top Glove (TOPG MK) is our top pick

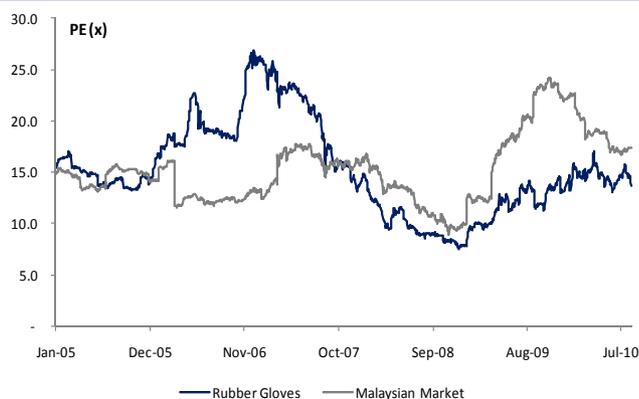
We reiterate our Buy recommendations on Top Glove (TOPG MK, RM6.13, RM8.25 target price) and Supermax (SUCB MK, RM6.00, RM7.23 target price). Top Glove is now our top pick in the industry given its market leader position (22% global market share), strong three-year EPS CAGR of 25% and higher potential upside of 34.6% (vs. Supermax's 20.5%).

For Top Glove, we use DCF and P/E to value Top Glove. DCF as our primary tool to take into account top Glove's strong cash flow generation and current net cash balance sheet. Our target price of RM16.50 is based on a WACC of 9.98% (4.1% risk-free rate, 6.1% average Malaysia market equity risk premium and average 2-year beta of 0.8x) and terminal growth rate of 5%. The terminal growth rate is based on our longer-term view that glove demand will be driven by both overall population growth and growth of the aging population. Our target

price values Top Glove at 18.6x annualized FY10 P/E or a 22% premium to the market P/E of 15.2x. The stock has been trading at a five-year historical average premium of 21.1% to the Malaysian market. We believe that the premium valuation for Top Glove is justified given the company's higher-than-market earning growth (EPS growth of 47% in FY10E vs. the market's 29%) and strong balance sheet, (net cash vs. market's net gearing of 36%). The market has always implied a premium for quality companies such as Public Bank and KL Kepong in Malaysia and we believe that Top Glove, given its global leader position in a defensive industry should trade at such a premium. Key risks include: 1) excess production capacity going into 2H10 as gloves manufacturers had embarked on aggressive capacity expansion plans that started in mid-2009 following the run-up in demand during the peak of the pandemic influenza threat; 2) volatile raw material costs and currency fluctuations, which will affect margins; and 3) slowing global demand for gloves, as concerns over the threat of the H1N1 influenza subside.

For Supermax, we likewise use DCF as our primary valuation methodology because it also takes into account its strong cash flow generation and low gearing balance sheet of 0.3x (as at FY09). Our target price of RM7.23/share is based on a WACC of 11.6% (4.1% risk-free rate, 6.1% average equity risk premium and two-year average beta of 1.1x). Our price target values the company at 12.3x forward-rolling PE (May10-Apr-11E) or at a 34% discount to Top Glove's implied PE target of 18.6x on forward-rolling EPS (May 2010-Apr 2011E). Historically, Supermax's five-year PE valuations have traded at a 37% discount to Top Glove's. We believe that the discount is justified as the market needs to take into account risks on small cap stocks and that Supermax is c.50% the size of Top Glove in terms of production capacity, market share of the global glove industry and market capitalization. Key risks include (1) excess production capacity going into 2H10 as glove manufacturers have embarked on an aggressive capacity expansion, (2) volatile raw material costs and currency fluctuations which would impact margins, (3) a slowdown in global demand for gloves as concerns over the threat of the H1N1 influenza subsides.

**Figure 14: Malaysia's top three glove manufacturers' PE is trading at a discount to the Malaysian market**



Source: Deutsche Bank, Bloomberg Finance LP. (Top three glove manufacturers include Top Glove, Supermax and Kossan)

**Figure 15: Aggregated PE valuation of the top three glove manufacturers by global market share**



Source: Deutsche Bank, Bloomberg Finance LP. (Top three glove manufacturers include Top Glove, Supermax and Kossan)

Figure 16: Peer comparison

Deutsche Bank - Global Rubber Comps																											As at			09-Aug-10		
Company	BBerg	Year End	Rec	Curcy	Price	TP	Market Cap	Market Cap		EV/EBITDA (x)			P/E (x)			EPSg			P/BV (x)			Div Yield (%)			ROE (%)			Net Gearing (%)				
								(US\$ m)	(US\$ m)	2009E	2010E	2011E	2009E	2010E	2011E	2009E	2010E	2011E	2009E	2010E	2011E	2009E	2010E	2011E	2009E	2010E	2011E	2009E	2010E	2011E	2009E	2010E
<b>MNC resellers</b>																																
Kimberly-Clark	KMB US	31-Dec	Hold	USD	65.29	65.00	27,137	27,137	197.8	7.1	8.4	7.8	12.2	13.5	12.5	12.0	6.9	7.8	4.7	5.1	5.2	4.4	4.0	4.4	39.4	34.3	40.7	80.9	100.5	105.4		
Beiersdorf	BEI GR	31-Dec	Hold	EUR	43.13	46.00	9,783	13,002	37.5	10.6	10.5	9.0	22.4	21.2	17.9	(22.9)	23.1	18.4	4.0	3.4	3.1	1.9	2.0	2.4	14.7	16.7	17.9	(26.1)	(29.2)	(33.5)		
Cardinal Health	CAH US	30-Jun	Hold	USD	33.10	35.00	11,962	11,962	143.7	6.6	6.5	6.0	12.5	14.9	13.5	(40.5)	(1.7)	10.0	0.9	2.3	2.3	2.0	2.1	2.1	9.9	11.5	16.7	20.6	(11.9)	(10.4)		
							<b>17,367.2</b>	<b>126.3</b>		<b>8.1</b>	<b>8.5</b>	<b>7.6</b>	<b>15.7</b>	<b>16.5</b>	<b>14.7</b>	<b>(17.2)</b>	<b>9.5</b>	<b>12.0</b>	<b>3.2</b>	<b>3.6</b>	<b>3.5</b>	<b>2.7</b>	<b>2.7</b>	<b>3.0</b>	<b>21.3</b>	<b>20.8</b>	<b>25.1</b>	<b>25.1</b>	<b>19.8</b>	<b>20.5</b>		
<b>Rubber glove</b>																																
Top Glove	TOPG MK	31-Aug	Buy	MYR	6.13	8.25	3,785	1,203	4.4	10.8	9.8	8.5	18.1	15.0	12.9	52.7	46.5	16.1	5.1	3.8	3.2	1.6	5.3	6.2	22.7	27.4	26.8	(19.5)	(27.0)	(32.3)		
Ansell	ANN AU	30-Jun	Buy	USD	13.35	14.50	1,759	1,632	8.8	9.0	11.5	10.3	12.7	17.9	16.3	(5.9)	13.3	9.4	1.8	2.7	2.4	2.7	2.2	2.2	16.0	17.3	17.0	19.2	16.9	4.8		
Semperit	SEM AV	31-Dec	Buy	EUR	28.50	37.00	586	779	1.0	3.2	4.9	4.3	10.7	14.0	12.4	3.2	8.0	12.7	1.8	1.8	1.7	5.7	4.6	5.1	12.9	13.1	13.9	(49.0)	(41.3)	(44.2)		
Supermax	SUCB MK	31-Dec	Buy	MYR	6.00	7.23	2,036	647	3.9	4.2	9.0	7.2	5.6	10.9	9.1	173.0	41.7	19.7	2.8	2.9	2.3	4.1	2.1	2.5	26.6	29.5	28.2	31.5	23.7	16.5		
Hartalega	HART MK	31-Mar	NR	MYR	7.98	NA	1,892	616	0.6	10.4	8.0	6.8	14.3	11.9	9.9	87.9	80.6	19.1	5.3	4.1	3.2	2.1	2.8	3.3	33.3	40.8	36.9	-	(18.3)	(21.1)		
Kossan	KRI MK	31-Dec	NR	MYR	3.67	NA	1,185	374	0.8	9.7	7.0	6.0	7.9	9.8	8.2	NA	94.7	27.0	1.7	2.6	2.0	2.2	2.0	2.4	21.4	27.2	26.3	23.2	36.3	21.5		
Latexx Partners	LTX MK	31-Dec	NR	MYR	3.52	NA	729	237	1.0	11.7	6.3	5.2	18.5	8.5	6.2	NA	59.0	40.0	-	-	-	1.1	1.6	2.4	35.9	46.5	40.4	-	-	-		
Adventa	ADV MK	31-Oct	NR	MYR	2.81	NA	475	135	0.4	14.0	9.2	6.6	16.2	10.7	7.5	NA	38.3	30.8	2.1	1.9	1.6	1.6	2.7	3.5	8.6	18.3	18.5	51.8	-	-		
Riverstone	RSTON SP	31-Dec	NR	SGD	1.40	NA	187	103	0.0	9.6	6.6	5.3	14.9	11.0	8.5	(73.7)	287.7	15.8	2.5	2.2	1.9	3.1	3.8	4.5	17.5	20.4	20.6	-	(20.2)	27.6		
							<b>636</b>	<b>2.3</b>		<b>9.2</b>	<b>8.0</b>	<b>6.7</b>	<b>13.2</b>	<b>12.2</b>	<b>10.1</b>	<b>39.5</b>	<b>74.4</b>	<b>21.2</b>	<b>2.9</b>	<b>2.7</b>	<b>2.3</b>	<b>2.7</b>	<b>3.0</b>	<b>3.6</b>	<b>21.7</b>	<b>26.7</b>	<b>25.4</b>	<b>9.5</b>	<b>(3.7)</b>	<b>(3.4)</b>		
<b>Rubber products</b>																																
Lanxess	LXS GR	31-Dec	Buy	EUR	40.14	47.00	3,340	4,439	35.3	6.7	5.9	5.4	16.3	9.7	8.8	(69.4)	263.0	9.9	1.5	2.0	1.7	2.7	2.5	3.1	2.8	20.9	20.9	58.2	60.5	51.1		
Goodyear Tire & Rubber	GT US	31-Dec	Buy	USD	11.15	19.00	2,698	2,698	58.5	7.0	4.6	3.4	NM	24.6	5.6	(265.5)	(147.5)	341.4	3.5	2.9	1.9	-	-	-	(23.3)	10.9	40.8	164.5	200.5	162.0		
Sumitomo Rubber	5110 JP	31-Dec	NR	JPY	863.00	NA	230,689	2,697	21.8	8.0	6.9	6.0	37.8	15.9	12.3	121.2	138.4	29.3	1.3	1.2	1.1	2.1	1.9	2.1	3.5	6.9	8.8	119.5	123.8	113.2		
Yokohama Rubber	5101 JP	31-Mar	NR	JPY	451.00	NA	151,428	1,770	10.5	6.2	6.1	5.5	16.5	13.9	10.4	(261.6)	19.1	32.8	1.0	0.9	0.9	2.2	2.3	2.6	(4.7)	6.1	7.4	112.3	97.8	85.4		
Tokai Rubber Industries	5191 JP	31-Mar	NR	JPY	1,037.00	NA	121,522	1,421	3.0	-	2.8	2.7	-	13.4	10.9	NA	NA	23.4	0.8	0.7	0.7	1.2	1.4	1.8	1.0	-	5.6	(4.6)	-	-		
Sri Trang Agro	STA TB	31-Dec	NR	THB	65.50	NA	13,100	410	12.3	18.0	13.0	15.1	3.8	11.4	12.5	108.1	3.6	(7.1)	0.7	2.4	2.1	7.8	2.3	2.1	19.2	19.4	15.8	-	-	-		
							<b>2,239</b>	<b>23.6</b>		<b>9.2</b>	<b>6.6</b>	<b>6.4</b>	<b>18.6</b>	<b>14.8</b>	<b>10.1</b>	<b>(73.5)</b>	<b>55.3</b>	<b>71.6</b>	<b>1.5</b>	<b>1.7</b>	<b>1.4</b>	<b>2.7</b>	<b>1.7</b>	<b>1.9</b>	<b>(0.2)</b>	<b>12.9</b>	<b>16.6</b>	<b>90.0</b>	<b>96.5</b>	<b>82.3</b>		
<b>DB global rubber universe average</b>									<b>242.0</b>	<b>8.9</b>	<b>8.5</b>	<b>8.2</b>	<b>23.1</b>	<b>15.6</b>	<b>14.1</b>	<b>(7.9)</b>	<b>27.9</b>	<b>38.8</b>	<b>2.3</b>	<b>2.7</b>	<b>2.5</b>	<b>2.1</b>	<b>2.2</b>	<b>2.4</b>	<b>13.0</b>	<b>18.9</b>	<b>20.4</b>	<b>33.2</b>	<b>27.5</b>	<b>24.6</b>		
Source: Deutsche Bank estimates, Bloomberg																																
* Refers to Bloomberg consensus estimates																																
Source: Deutsche Bank, Bloomberg Finance LP																																

# Appendix 1

## Important Disclosures

Additional information available upon request

### Disclosure checklist

Company	Ticker	Recent price*	Disclosure
Top Glove	TPGC.KL	6.13 (MYR) 9 Aug 10	NA
Supermax	SUPM.KL	6.00 (MYR) 9 Aug 10	NA

\*Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies.

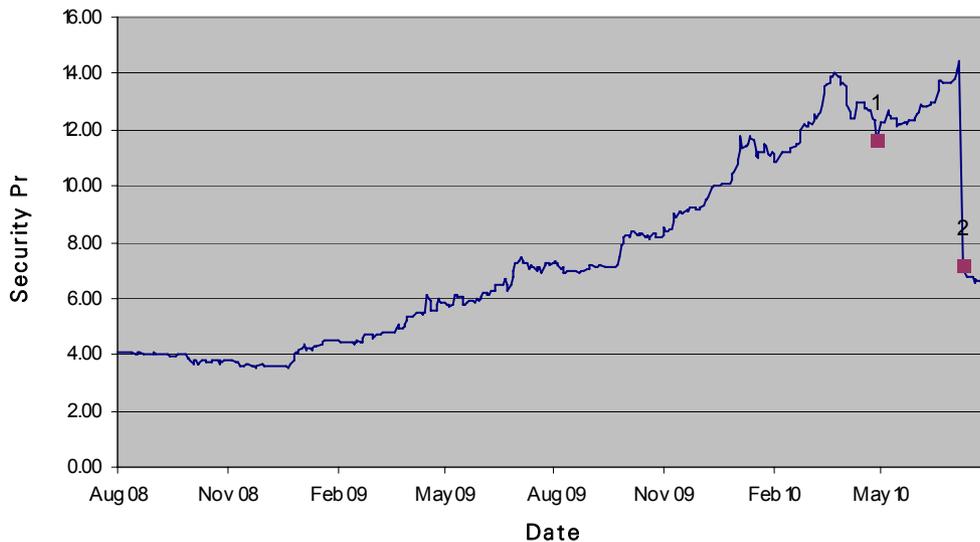
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### Historical recommendations and target price: Top Glove (TPGC.KL)

(as of 8/9/2010)



#### Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

#### Current Recommendations

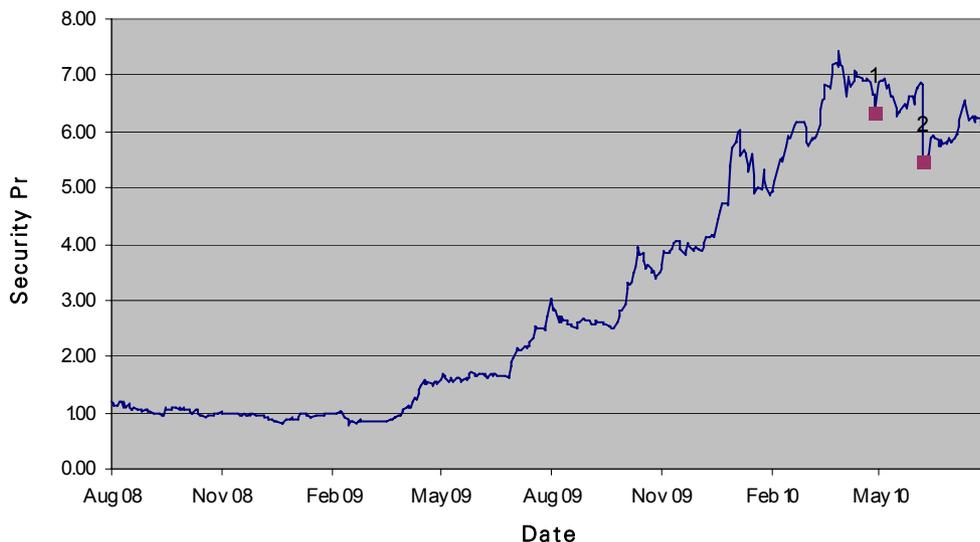
- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

\*New Recommendation Structure as of September 9, 2002

1. 7/5/2010:	Buy, Target Price Change MYR16.50	2. 19/7/2010:	Buy, Target Price Change MYR8.25
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**Historical recommendations and target price: Supermax (SUPM.KL)**

(as of 8/9/2010)



Previous Recommendations

- Strong Buy
- Buy
- Market Perform
- Underperform
- Not Rated
- Suspended Rating

Current Recommendations

- Buy
- Hold
- Sell
- Not Rated
- Suspended Rating

\*New Recommendation Structure as of September 9, 2002

1. 7/5/2010: Buy, Target Price Change MYR9.00

2. 16/6/2010: Buy, Target Price Change MYR7.23

**Equity rating key**

**Equity rating dispersion and banking relationships**

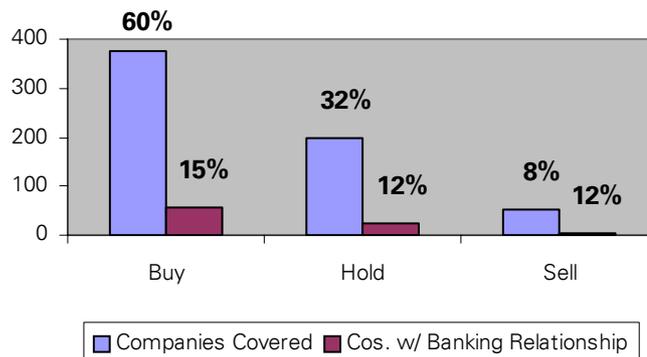
**Buy:** Based on a current 12- month view of total shareholder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield ) , we recommend that investors buy the stock.

**Sell:** Based on a current 12-month view of total shareholder return, we recommend that investors sell the stock

**Hold:** We take a neutral view on the stock 12-months out and, based on this time horizon, do not recommend either a Buy or Sell.

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  - Sell: Expected total return (including dividends) of -10% or worse over a 12-month period



Asia-Pacific Universe

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