

Tencent (700 HK)

Solid earnings growth on GPM expansion

Tencent announced 2Q23 results on 16 Aug: total revenue grew by 11% YoY to RMB149.2bn, in line with CMBI/consensus estimate. Non-IFRS net income increased by 33% YoY to RMB37.5bn in 2Q23, beating CMBI/consensus estimate by 7/13%, mainly due to 1) better-than-expected ad revenue growth (+34% YoY); and 2) FBS/ad business GPM expansion (+5.1/8.3ppt YoY). Tencent's investments in Video Account, international games and business services continue to bear fruit, reaccelerating higher margin business segments growth and unleashing operating leverage. In view of the margin improvement, we raise FY23-FY25 net income forecast by 2-5%. Our SOTP-derived target price is fine-tuned to HK\$458.0 (previous: HK\$455.0). Maintain BUY.

- **Steady games business and strong ad revenue recovery.** Games revenue grew by 5% YoY to RMB44.5bn in 2Q23 (30% of total revenue), 4% below our expectation due to flattish domestic games revenue YoY. Tencent was more prudent on monetization of its top games in 2Q23, but management believes this was temporary and expects domestic games revenue will resume YoY growth in 3Q23E. International games grew by 19% YoY to RMB12.7bn in 2Q23 (or +12% YoY excluding currency impact). Online ad revenue increased by 34% YoY to RMB25bn in 2Q23 (17% of total revenue), mainly due to strong demand for Video Account ads, revenue of which surpassed RMB3bn in 2Q23. Despite macro uncertainty, management expects the ad revenue growth will continue to outpace industry rate in 2H23, driven by enhanced ad tech and Video Accounts contribution.
- **FBS: accelerating revenue growth and expanding margin.** Fintech and Business Services (FBS) revenue was up by 15% YoY to RMB48.6bn in 2Q23 (33% of total revenue). Fintech revenue grew in double digit YoY driven by growth in both offline and online commercial payment. Business Services revenue recorded low double-digit YoY growth in 2Q23, supported by incremental revenue from Video Account live streaming e-commerce and modest cloud revenue growth. Live streaming e-commerce business grew GMV by c.150% YoY in 2Q23, and generated high-margin commission revenue stream which supports GPM expansion of FBS business. For AI, management notes that the development of its proprietary large model is on track and the model is expected to be launched in the latter part of this year.
- **Ongoing margin expansion driven by multiple factors.** Overall GPM increased by 4.3ppt YoY to 47.5% in 2Q23, mainly due to: 1) improved monetization of Video Accounts which drove GPM expansion of both ad & FBS business; 2) solid growth of higher-margin mini game business; and 3) enhanced operation efficiency. Non-IFRS net income margin increased by 4.2ppt YoY to 25.2% in 2Q23. Looking ahead in 2H23E, management expects for continuous margin improvement.

Earnings Summary

(YE 31 Dec)	FY21A	FY22A	FY23E	FY24E	FY25E
Revenue (RMB mn)	560,118	554,552	613,800	665,858	717,812
YoY growth (%)	16.2	(1.0)	10.7	8.5	7.8
Gross margin (%)	43.9	43.1	46.4	46.8	47.4
Adjusted net profit (RMB mn)	123,788.0	115,649.0	150,540.6	179,940.5	198,077.0
YoY growth (%)	0.9	(6.6)	30.2	19.5	10.1
EPS (Adjusted) (RMB)	12.99	12.13	15.54	18.58	20.45
Consensus EPS (RMB)	12.99	12.13	15.12	17.96	20.37
P/S (x)	5.2	5.2	4.7	4.4	4.0
P/E (x)	18.1	14.1	24.8	20.1	17.2
ROE (%)	29.8	24.6	15.1	16.1	16.3

Source: Company data, Bloomberg, CMBIGM estimates

BUY (Maintain)

Target Price	HK\$458.00
(Previous TP)	HK\$455.00
Up/Downside	39.3%
Current Price	HK\$328.80

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Stock Data

Mkt Cap (HK\$ mn)	3,117,024.0
Avg 3 mths t/o (HK\$ mn)	6,402.6
52w High/Low (HK\$)	415.00/190.72
Total Issued Shares (mn)	9480.0

Source: FactSet

Shareholding Structure

MIH TC	26.9%
Advance Data Services Limited	8.4%

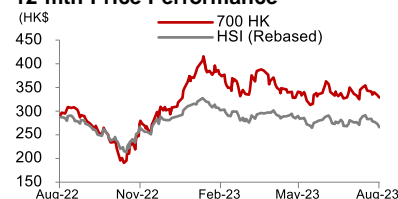
Source: HKEx

Share Performance

	Absolute	Relative
1-mth	-6.7%	-1.2%
3-mth	-4.6%	3.9%
6-mth	-14.1%	-1.6%

Source: FactSet

12-mth Price Performance



Source: FactSet

Business forecasts update and valuation

Figure 1: Tencent: forecast revision

RMB bn	Current			Previous			Change (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	613.8	665.9	717.8	616.0	671.3	723.3	-0.4%	-0.8%	-0.8%
Gross Profit	284.6	311.6	339.9	275.5	304.7	334.6	3.3%	2.3%	1.6%
Adjusted net profit	150.5	179.9	198.1	142.9	173.5	193.5	5.3%	3.7%	2.4%
Adjusted EPS (RMB)	15.5	18.6	20.5	14.8	17.9	20.0	5.0%	3.8%	2.3%
Gross Margin	46.4%	46.8%	47.4%	44.7%	45.4%	46.3%	1.7 ppt	1.4 ppt	1.1 ppt
Adjusted net margin	24.5%	27.0%	27.6%	23.2%	25.8%	26.8%	1.3 ppt	1.2 ppt	0.8 ppt

Source: CMBIGM estimates

Figure 2: CMBIGM estimates vs consensus

RMB bn	CMBIGM			Consensus			Diff (%)		
	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Revenue	613.8	665.9	717.8	625.1	699.2	774.4	-1.8%	-4.8%	-7.3%
Gross Profit	284.6	311.6	339.9	281.5	318.8	355.6	1.1%	-2.3%	-4.4%
Adjusted net profit	150.5	179.9	198.1	144.5	174.4	195.1	4.2%	3.2%	1.5%
Adjusted EPS (RMB)	15.5	18.6	20.5	15.1	18.0	20.4	2.8%	3.5%	0.4%
Gross Margin	46.4%	46.8%	47.4%	45.0%	45.6%	45.9%	1.3 ppt	1.2 ppt	1.4 ppt
Adjusted net margin	24.5%	27.0%	27.6%	23.1%	24.9%	25.2%	1.4 ppt	2.1 ppt	2.4 ppt

Source: Bloomberg, CMBIGM estimates

Figure 3: Tencent: quarterly financial

(RMB bn)	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	Cons.	Diff%	CMBI	Diff%
SNS revenue	29.1	29.1	29.2	29.9	28.6	31.0	29.7	29.1	2.0%	30.3	-2.1%
YoY %	4.4%	1.0%	0.6%	-1.4%	-1.7%	6.4%	1.8%				
Games revenue	42.8	43.6	42.5	42.9	41.8	48.3	44.5	46.3	-4.0%	46.3	-3.8%
YoY %	9.5%	0.0%	-1.2%	-4.6%	-2.3%	10.8%	4.7%				
Online ad revenue	21.5	18.0	18.6	21.4	24.7	21.0	25.0	23.0	8.9%	22.7	10.3%
YoY %	-12.7%	-17.6%	-18.4%	-4.7%	14.6%	16.5%	34.2%				
FBS revenue	48.0	42.8	42.2	44.8	47.2	48.7	48.6	50.6	-4.0%	49.3	-1.4%
YoY %	24.6%	9.6%	0.8%	3.5%	-1.5%	13.9%	15.2%				
Total revenue	144.2	135.5	134.0	140.1	145.0	150.0	149.2	152.0	-1.8%	149.9	-0.4%
YoY %	7.9%	0.1%	-3.1%	-1.6%	0.5%	10.7%	11.3%				
Gross profit margin	40.1%	42.1%	43.2%	44.2%	42.6%	45.5%	47.5%	43.7%	3.8 ppt	44.4%	3.0 ppt
G&A%	16.9%	19.7%	19.6%	18.9%	18.8%	16.4%	17.0%				
S&M%	8.1%	5.9%	5.9%	5.1%	4.2%	4.7%	5.6%				
Non-IFRS net margin	17.3%	18.9%	21.0%	23.0%	20.5%	21.7%	25.2%				
Non-IFRS net profit	24.9	25.5	28.1	32.3	29.7	32.5	37.5	33.2	13.0%	35.2	6.6%
YoY %	-25.1%	-22.9%	-17.3%	1.6%	19.4%	27.4%	33.4%				

Source: Company data, CMBIGM estimates

Our SOTP-derived target price of HK\$458.0 comprises, per share:

- 1) HK\$191.0 for the online games business, based on a 20x 2023E PE, which is at discount to average PE for its global gaming peers (22x). The discount reflects Tencent's gaming business has entered mature stage with more stable growth outlook versus peers.
- 2) HK\$27.4 for the SNS business, including the market cap of Tencent's stake in its subsidiaries, the valuation of Tencent Video (based on a 3.0x 2023E PS, at a premium to the 2.4x average PS of its peers given its content and user traffic leadership), and the valuation of other membership services (based on a 2.0x 2023E PS).
- 3) HK\$54.8 for the advertising business, based on a 18x 2023E PE, at a discount to the industry average (20x) as its advertising business entered mature phase.
- 4) HK\$98.5 for the fintech business, based on a 5.0x 2023E PS, at a premium to the peer average (1.9x). This mainly reflected our positive view on the recovery of China's digital payment volume in FY23/24E, and Tencent, as one of the largest digital payment platforms in China, is well-positioned to benefit from the recovery
- 5) HK\$22.7 for the cloud business, based on a 5.0x 2023E PS, at a discount to the industry average (5.2x) as Tencent's current offerings come mainly from the lower-margin IaaS Business
- 6) HK\$56.6 for strategic investments, based on the current market value of Tencent's listed investment and the book value of its unlisted investment. We applied a 30% holding company discount to the fair value of Tencent's equity investment.
- 7) HK\$7.3 for net cash.

Figure 4: Tencent: SOTP valuation

	2023E net profit (RMBmn)	2023E revenue (RMBmn)	2023E PE (x)	2023E PS (x)	Market cap (RMBmn)	Valuation to Tencent (RMBmn)	As % of total valuation	Per share valuation (HK\$)
Online games	81,036		20x			1,620,718	41.7	191.0
Social network services (SNS)		119,162				232,505	6.0	27.4
Tencent Music (TME)					76,236	42,006	1.1	5.0
China Literature					29,948	17,723	0.5	2.1
Huya					4,543	2,153	0.1	0.3
Online video – subscription		27,300		3.0x		81,900	2.1	9.7
Others		44,361		2.0x		88,722	2.3	10.5
Online advertising	25,857		18x			465,429	12.0	54.8
Fintech		167,189		5.0x		835,946	21.5	98.5
Cloud (business services)		37,926		5.0x		189,628	4.9	22.3
Net cash						61,645	1.6	7.3
Valuation of core business						3,405,871		
RMB/HK\$						0.90		
Valuation of core business (HK\$mn)						3,805,017		
Valuation per share – core business (HK\$)						401.4		
Valuation per share – investment (HK\$)						56.6	12.4	
Valuation per share – Tencent (HK\$)						458.0		

Source: Company data, CMBIGM estimates

Figure 5: Peer comparison: online games and advertising sector

		Price	EPS growth (YoY %)			PE (x)		
Companies	Ticker	(Local)	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Online games								
NetEase	NTES US	102.7	6	9	3	19	17	17
Activision Blizzard	ATVI US	90.9	37	4	6	22	21	20
Electronic Arts	EA US	121.4	(14)	13	13	20	18	16
Take Two Interactive	TTWO US	139.5	(27)	(10)	145	39	43	18
IGG	799 HK	3.5	(22)	(385)	30	na	6	5
Nexon	3659 JP	2,760.0	5	7	11	21	19	18
Nintendo	7974 JP	6,301.0	(9)	4	(13)	19	18	21
Bandai Namco	7832 JP	3,371.0	18	4	10	24	23	21
Perfect World	002624 CH	14.3	(5)	23	16	18	15	13
37 Interactive	002555 CH	26.5	12	15	14	18	15	13
Average PE						22	20	16
Online advertising								
Focus Media	002027 CH	7.3	61	22	13	21	18	16
Baidu	BIDU US	135.3	24	3	9	14	14	13
Meta	Meta US	302.0	23	28	15	22	18	15
Google	GOOG US	130.3	14	16	20	22	19	16
Average PE						20	17	15

Source: Bloomberg, CMBIGM estimates

Note: data as of the market close on 15 Aug

Figure 6: Peer comparison: online video, fintech, and cloud sectors

Companies	Ticker	Price	Revenue growth (YoY %)			PS (x)		
		(Local)	FY23E	FY24E	FY25E	FY23E	FY24E	FY25E
Online video								
iQiyi	IQ US	5.6	5.2	7.5	6.7	1.2	1.1	1.0
Mango Excellent Media	300413 CH	31.2	7.5	12.9	10.3	3.6	3.2	2.9
Average PS						2.4	2.2	2.0
Cloud								
Microsoft	MSFT US	321.9	11.5	12.8	14.1	10.2	9.0	7.9
Google	GOOG US	130.3	7.7	12.7	13.3	6.5	5.8	5.1
Salesforce	CRM US	208.8	11.8	10.9	11.0	5.9	5.3	4.8
Kingsoft Cloud	KC US	5.4	(2.0)	11.3	14.7	1.2	1.1	0.9
Amazon	AMZN US	137.7	11.3	12.0	12.6	2.5	2.2	2.0
Average PS						5.2	4.7	4.1
Fintech								
PayPal	PYPL US	59.5	7.8	9.2	9.3	2.2	2.0	1.8
Square	SQ US	58.4	22.9	13.6	13.9	1.7	1.5	1.3
Average PS						1.9	1.7	1.6

Source: Bloomberg, CMBIGM estimates

Note: data as of the market close on 15 Aug

Our calculation for the valuation of Tencent's strategic investments is based on the current market value of Tencent's listed investment and the book value of its unlisted investment. We applied a 30% holding company discount to the fair value of Tencent's equity investment.

Figure 7: Tencent: valuation of strategic investment

Name	Ticker	Tencent's stake %	Mkt cap (US\$mn)	Value to Tencent (HK\$bn)
PDD Holdings Inc	PDD US	15.5	99,684	120,440
Kuaishou Technology	1024 HK	19.0	35,279	52,311
Sea Ltd	SE US	20.2	22,999	36,237
Snap Inc	SNAP US	14.7	15,514	17,837
NU Holdings Ltd/Cayman Islands	NU US	6.0	37,289	17,451
Spotify Technology SA	SPOT US	8.6	25,827	17,305
KE Holdings Inc	BEKE US	11.3	19,521	17,206
Meituan	3690 HK	1.7	105,288	14,125
JD.com Inc	9618 HK	2.7	57,574	11,945
Futu Holdings Ltd	FUTU US	21.6	6,732	11,347
Tongcheng Travel Holdings Ltd	780 HK	21.4	5,120	8,538
Vipshop Holdings Ltd	VIPS US	11.5	9,037	8,120
China International Capital Co	3908 HK	4.5	20,042	7,004
Bilibili Inc	9626 HK	13.4	6,543	6,844
Warner Music Group Corp	WMG US	4.9	16,987	6,519
Krafton Inc	259960 KS	13.5	5,761	6,062
Kanzhun Ltd	BZ US	9.9	6,621	5,097
Netmarble Corp	251270 KS	17.5	3,048	4,165
Yixin Group Ltd	2858 HK	53.9	659	2,768
ZhongAn Online P&C Insurance C	6060 HK	8.1	4,310	2,720
Paradox Interactive AB	PDX SS	9.1	2,870	2,040
Kadokawa Corp	9468 JP	6.9	3,331	1,782
Ubisoft Entertainment SA	UBI FP	5.5	3,847	1,638
Oxford Nanopore Technologies P	ONT LN	7.7	2,596	1,549
Maoyan Entertainment	1896 HK	13.7	1,416	1,517
Waterdrop Inc	WDH US	26.5	626	1,294
DHC Software Co Ltd	002065 CH	4.9	2,984	1,140
Other listed entities as a whole			52,842	12,088
Listed investment (Current value)				397,090
Unlisted investment (Book Value)				369,659
Total investment value				766,749
Holdco discount				30%
Valuation of strategic investment				536,724
Valuation of strategic investment per share				56.6

Source: Bloomberg, Company data, CMBIGM estimates

Note: data as of the market close on 15 Aug

Financial Summary

INCOME STATEMENT	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Revenue	482,064	560,118	554,552	613,800	665,858	717,812
Cost of goods sold	(260,532)	(314,174)	(315,806)	(329,219)	(354,278)	(377,867)
Gross profit	221,532	245,944	238,746	284,581	311,580	339,945
Operating expenses	(37,295)	25,676	(3,040)	(120,773)	(131,722)	(141,116)
Selling expense	(33,758)	(40,594)	(29,229)	(32,531)	(35,290)	(37,326)
Admin expense	(67,625)	(89,847)	(106,696)	(103,118)	(113,196)	(120,592)
Others	64,088	156,117	132,885	14,877	16,764	16,802
Operating profit	184,237	271,620	235,706	163,808	179,858	198,829
Share of (losses)/profits of associates/JV	3,672	(16,444)	(16,129)	2,500	2,500	2,500
Interest income	6,957	6,650	8,592	11,101	12,875	12,796
Interest expense	(7,887)	(7,114)	(9,352)	(10,932)	(11,028)	(2,693)
Pre-tax profit	180,022	248,062	210,225	155,376	171,329	198,636
Income tax	(19,897)	(20,252)	(21,516)	(34,960)	(23,129)	(25,680)
After tax profit	160,125	227,810	188,709	120,416	148,200	172,956
Minority interest	(278)	(2,988)	(466)	(3,131)	(3,853)	(4,278)
Net profit	159,847	224,822	188,243	117,286	144,347	168,678
Adjusted net profit	122,742	123,788	115,649	150,541	179,941	198,077
Gross dividends	12,653	12,704	20,256	14,514	17,862	19,832
BALANCE SHEET	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Current assets	317,647	484,812	565,989	543,454	644,218	786,903
Cash & equivalents	152,798	167,966	156,739	253,155	319,260	421,943
Account receivables	44,981	49,331	45,467	48,621	51,163	53,500
Inventories	814	1,063	2,333	1,874	1,932	2,041
Prepayment	40,321	65,390	76,685	78,657	82,768	86,549
ST bank deposits	68,487	83,813	104,776	127,294	154,105	185,913
Financial assets at FVTPL	6,593	10,573	27,963	29,361	30,829	32,371
Other current assets	3,653	106,676	152,026	4,491	4,161	4,585
Non-current assets	1,015,778	1,127,552	1,012,142	1,058,131	1,130,903	1,176,735
PP&E	59,843	61,914	53,978	71,849	85,785	97,051
Deferred income tax	21,348	26,068	29,882	20,485	34,154	24,748
Investment in JVs & assos	305,258	323,188	252,715	264,094	275,842	287,948
Intangibles	159,437	171,376	161,802	190,515	216,877	241,217
Financial assets at FVTPL	165,944	192,184	206,085	206,085	206,085	206,085
Other non-current assets	303,948	352,822	307,680	305,103	312,160	319,686
Total assets	1,333,425	1,612,364	1,578,131	1,601,585	1,775,121	1,963,638
Current liabilities	269,079	403,098	434,204	325,378	351,749	378,155
Short-term borrowings	14,242	19,003	22,026	17,637	18,979	20,243
Account payables	94,030	109,470	92,381	101,747	108,397	114,458
Tax payable	12,134	12,506	13,488	14,431	15,219	15,908
Other current liabilities	144,851	256,673	299,955	185,209	202,800	221,192
Lease liabilities	3,822	5,446	6,354	6,354	6,354	6,354
Non-current liabilities	286,303	332,573	361,067	382,900	394,135	405,329
Long-term borrowings	112,145	136,936	163,668	164,560	164,829	164,909
Bond payables	122,057	145,590	148,669	154,244	157,136	158,609
Deferred income	6,678	4,526	3,503	13,169	14,171	15,115
Other non-current liabilities	45,423	45,521	45,227	50,927	57,999	66,695
Total liabilities	555,382	735,671	795,271	708,278	745,884	783,483
Retained earnings	538,464	669,911	705,981	813,297	945,374	1,092,014
Other reserves	165,520	136,388	15,410	15,410	15,410	15,410
Total shareholders equity	703,984	806,299	721,391	828,707	960,784	1,107,424
Minority interest	74,059	70,394	61,469	64,600	68,453	72,731
Total equity and liabilities	1,333,425	1,612,364	1,578,131	1,601,585	1,775,121	1,963,638

CASH FLOW	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec (RMB mn)						
Operating						
Profit before taxation	180,022	248,062	210,225	155,376	171,329	198,636
Depreciation & amortization	50,774	56,818	60,230	55,298	68,013	78,822
Tax paid	(19,897)	(20,252)	(21,516)	(34,960)	(23,129)	(25,680)
Change in working capital	27,423	(2,844)	(28,405)	37,917	17,531	18,225
Others	(44,203)	(106,598)	(74,443)	0	0	(8,416)
Net cash from operations	194,119	175,186	146,091	213,631	233,744	261,587
Investing						
Capital expenditure	(33,906)	(34,931)	(33,892)	(36,763)	(39,084)	(41,290)
Acquisition of subsidiaries/ investments	(108,665)	(117,642)	59,711	(23,752)	(60,422)	(44,001)
Net proceeds from disposal of short-term investments	15,376	0	0	0	0	0
Others	(54,760)	(25,976)	(130,690)	(65,118)	(69,228)	(73,137)
Net cash from investing	(181,955)	(178,549)	(104,871)	(125,633)	(168,734)	(158,429)
Financing						
Net borrowings	44,490	45,239	31,982	8,721	12,363	12,203
Proceeds from share issues	1,716	0	0	0	0	0
Others	(32,559)	(23,619)	(91,935)	(304)	(11,267)	(12,679)
Net cash from financing	13,647	21,620	(59,953)	8,418	1,096	(476)
Net change in cash						
Cash at the beginning of the year	132,991	152,798	167,966	156,739	253,155	319,260
Exchange difference	(6,004)	(3,089)	7,506	0	0	0
Cash at the end of the year	152,798	167,966	156,739	253,155	319,260	421,943
GROWTH	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Revenue	27.8%	16.2%	(1.0%)	10.7%	8.5%	7.8%
Gross profit	32.2%	11.0%	(2.9%)	19.2%	9.5%	9.1%
Operating profit	55.2%	47.4%	(13.2%)	(30.5%)	9.8%	10.5%
Net profit	71.3%	40.6%	(16.3%)	(37.7%)	23.1%	16.9%
Adj. net profit	30.1%	0.9%	(6.6%)	30.2%	19.5%	10.1%
PROFITABILITY	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Gross profit margin	46.0%	43.9%	43.1%	46.4%	46.8%	47.4%
Operating margin	38.2%	48.5%	42.5%	26.7%	27.0%	27.7%
Adj. net profit margin	25.5%	22.1%	20.9%	24.5%	27.0%	27.6%
Return on equity (ROE)	28.1%	29.8%	24.6%	15.1%	16.1%	16.3%
GEARING/LIQUIDITY/ACTIVITIES	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
Net debt to equity (x)	0.1	0.2	0.2	0.1	0.0	(0.1)
Current ratio (x)	1.2	1.2	1.3	1.7	1.8	2.1
Receivable turnover days	34.1	32.1	29.9	28.9	28.0	27.2
VALUATION	2020A	2021A	2022A	2023E	2024E	2025E
YE 31 Dec						
P/E	23.2	18.1	14.1	24.8	20.1	17.2
P/E (diluted)	23.6	18.4	14.3	25.2	20.4	17.5
P/B	5.3	5.0	3.7	3.5	3.0	2.6

Source: Company data, CMBIGM estimates. Note: The calculation of net cash includes financial assets.

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