

Getting better with each passing quarter

We retain Buy on Karnataka Bank (KBL) with TP revised lower to Rs180. Q4'18 results were ahead of our estimates on both revenue / earnings front. This is even as the quarter saw bank recognise entire of its stressed asset portfolio (following RBI Feb, 2018 circular) including SMA2 portfolio and divergence related accounts as slippages in Q4'18. Management commentaries on growth, asset quality remain encouraging and we have factored the same into our estimates. Provisions are expected to remain higher thus impacting near term return ratios. We see RoA scale to 0.9% / RoE's at 12.6% levels by end-FY20E. Capital position remains strong; valuations at 0.7x FY20E ABV remain undemanding.

- **Q4FY18 result – Strong operational quarter:** Q4'18 NII at Rs5.4bn grew 54% YoY and was led by strong 27.7% YoY growth in loans and expansion in NIM (calc) to 3.2% (+74bps YoY). Int. income included interest on income tax refund to the tune of Rs800mn. Adjusted for the same, NII grew 31% YoY / NIM was up 44bps YoY. Fee income grew 93% YoY; with stable costs, operating profit at Rs4.7bn grew 44.6% YoY. Slippages came in higher at Rs10.4bn (8.8% of loans). Provisions, thus remained higher at Rs5.9bn. The quarter saw PCR inch towards 41.1% YoY (vs. 29.2% QoQ / 38.4% YoY). After accounting for provisions and tax reversals, the bank reported net profit of Rs117mn (vs our estimates of loss of Rs423mn). Deposits grew 10.8% YoY; CASA stood at 28% (vs. 29% YoY / 28.2% QoQ).
- **Large part of stressed pool recognised; building in elevated provisions:** Q4'18 slippages at Rs10.4bn included Rs8.5bn of slippages pertaining to RBI divergence (~Rs6bn), stressed asset portfolio (ie SDR + S4A) and NCLT cases. The bank has created ~50% provisions against these accounts. The quarter also saw a substantial part of SMA-2 portfolio (~Rs5bn) being recognised as NPA. Resultant, SMA-2 portfolio has now declined to Rs4.2bn (0.9% of loans vs. 2.7% QoQ). According to management, pool of stressed asset portfolio has reduced to 8.1% of loans (vs. 10.3% YoY). Pace of new NPA accretion is expected to moderate. Provisions, however is expected to remain elevated following NPA ageing and management guidance of increasing overall PCR to 55-60% levels. We have factored in 260bps of slippages (vs. 500bps for FY18) / 130bps of credit cost (vs. 240bps for FY18) over FY19-20E.
- **Earnings outlook:** Increasing loan-deposit ratio, (75%+ over FY18-20E vs. 67% in the past) and margins at ~2.9% levels on a steady-state basis, in our view is more realistic for the bank given the initiatives underway. This, in our view also augurs well for a superior revenue growth. On the costs side, the transformation journey across all the key business aspects ie people (HR), processes and IT platform have started to exhibit positive outcome. The ratio of cost / average assets is on a decline and augurs well for a healthy pre-provision profit. Even as we build in relatively higher loan loss provisions, we expect the bank to report in 13% / 11% CAGR in NII / PPOP and 54% CAGR in net profit over FY18-20E. Tier-I / CAR stood at 11.2% / 13% respectively.
- **Valuation, view and key risks:** KBL Q4'18 results further reiterates our belief on the bank and the strong earnings potential following various business initiatives underway. We have tweaked our FY19/FY20E estimates to factor for stable margins (vs. upwards trajectory earlier) and change to our credit cost estimates (more following the need to scale overall PCR higher). Valuations at 0.7x FY20E ABV remain attractive. Retain Buy with TP at Rs180 (valued at 1.1x FY20E ABV). The reduction to our target multiple follows likely compression in the near term earnings and thus the returns ratios. Key risks - Higher than expected loan-loss provisions or lower growth could impact earnings.

Rs mn	Q4FY18	Q4FY17	% YoY	Q3FY18	% QoQ	Q4FY18E	% Var
Net interest income	5,422	3,522	54.0	4,515	20.1	4,481	21.0
Pre-provision profit	4,761	3,293	44.6	3,219	47.9	3,336	42.7
Net profit	117	1,384	(91.5)	874	(86.6)	(423)	(127.7)
GNPA	23,761	15,602	52.3	16,910	40.5	23,387	1.6
NNPA	14,005	10,657	31.4	12,300	13.9	12,863	8.9
PCR (%) calc	41.1	31.7	936bps	27.3	13.8bps	-	-

Source: Company, Centrum Research

Y/E Mar (Rs mn)	Net Income#	PPOP	Rep. PAT	YoY (%)	EPS (Rs)	P/E (x)	Adj BV (Rs)	P/Adj BV (x)	RoA (%)	RoE (%)
FY16	18,457	8,546	4,157	(8.0)	22.0	6.8	153.6	1.0	0.8	11.7
FY17	23,000	9,958	4,523	8.9	16.0	7.2	132.1	0.9	0.7	10.2
FY18P	28,120	14,732	3,256	(28.0)	11.5	13.3	127.6	1.2	0.5	6.2
FY19E	30,302	15,759	6,046	85.7	21.4	5.6	147.1	0.8	0.8	10.8
FY20E	35,015	18,085	7,687	27.1	27.2	4.3	167.5	0.7	0.9	12.6

Source: Company, Centrum Research Estimates #net income denotes NII + other income. Valuations are on average market cap basis for FY15-FY18EYTD.

In the interest of timeliness, this document is not edited

Centrum Equity Research is available on Bloomberg, Thomson Reuters and FactSet

Target Price	Rs180	Key Data	
CMP*	Rs117	Bloomberg Code	KBL IN
Upside	53.8%	Curr Shares O/S (mn)	282.6
Previous Target	Rs240	Diluted Shares O/S(mn)	282.6
Previous Rating	Buy	Mkt Cap (Rsbn/USDmn)	33/486.6
Price Performance (%)*		52 Wk H / L (Rs)	181.2/107
	1M 6M 1Yr	5 Year H / L (Rs)	181.2/56.3
KBL IN	(6.5) (25.5) (32.3)	Daily Vol. (3M NSE Avg.)	3093636
NIFTY	2.0 5.2 12.9		

*as on 16 May 2018; Source: Bloomberg, Centrum Research

Shareholding pattern (%)*

	Mar-18	Dec-17	Sep-17	Jun-17
Promoter	0.0	0.0	0.0	0.0
FIs	14.7	18.3	18.7	21.9
DIs	12.8	11.8	11.2	9.8
Others	72.5	69.9	70.1	68.3

Source: BSE, *as on 16 May 2018

Earnings revision

Particulars (Rs mn)	FY19E			FY20E		
	New	Old	Var (%)	New	Old	Var (%)
NII + Oth. Inc	30,302	29,965	1.1	35,015	34,633	1.1
PPoP	15,759	15,065	4.6	18,085	17,776	1.7
PAT	6,046	6,277	(3.7)	7,687	8,210	(6.4)

Source: Bloomberg, Centrum Research Estimates

Centrum vs. Bloomberg Consensus*

Particulars (Rs mn)	FY19E			FY20E		
	Centrum	BBG	Var (%)	Centrum	BBG	Var (%)
NII + Oth. Inc	30,302	39,137	(22.6)	35,015	45,049	(22.3)
PPoP	15,759	15,857	(0.6)	18,085	18,623	(2.9)
PAT	6,046	5,817	3.9	7,687	7,498	2.5

Bloomberg Consensus*				Centrum Target Price (Rs)	Variance (%)
BUY	SELL	HOLD	Target Price (Rs)		
6	1	1	175	180	2.9

*as on 16 May 2018; Source: Bloomberg, Centrum Research Estimates

Aalok Shah, aalok.shah@centrum.co.in; 91 22 4215 9075

Gaurav Jani, gaurav.jani@centrum.co.in; 91 22 4215 9110

Analyst meet takeaways

Balance Sheet and profitability

- FY18 loan portfolio grew 28% YoY and was led by strong traction in segments of SME (+36% YoY); LRD (+39% YoY), housing (+16% YoY) and corporate portfolio. IBPC portfolio stood at Rs20bn. Management has guided for 20%+ growth in loans over FY19-20E.
- Share of internally rated investment grade portfolio – KB1 to KB4 has increased to 63% (vs. 44%).
- Deposits grew 10.8% YoY and was led by 7% YoY growth in CASA deposits. Share of CASA deposits stood at 28% (vs. 28.2% QoQ / 29% in FY17).
- Capital position remains with tier-I at 11.3% / CAR at 12%. Management has guided for no fund raise in immediate future. o Management has guided for 1-1.25% RoA / 15% RoE / NIM at 3% / Cost-income ratio at 40-45% and PCR at 55-60% by FY20E

Asset Quality

- Q4'18 slippages came in at Rs10.4bn and included Rs8.5bn of slippages following RBI circular and divergence related accounts. The bank has recognised the entire of its GNPA divergence of Rs10bn over Q1'-Q4'18 quarter. Rs4bn of accounts recognised in Q1'-Q3'18 quarter and balance of Rs6bn in Q4'18. The bank has also recognised 4 NCLT cases + 4 SDR and 2 S4A cases as slippages during the quarter. The RBI divergence account has an overlap with RBI circular
- The entire of above slippages is moved into SS / D1 and D2 category. Accordingly the bank has created necessary provisions against these accounts. Q4'18 saw bank provide ~Rs4bn towards the above slippages. In other words, the bank has created ~48% provisions against these accounts.
- SMA 2 portfolio for the bank has reduced to Rs4.2bn (vs. Rs12.1bn QoQ and Rs8.3bn YoY). The quarter saw bank recognise loans to the tune of ~Rs5bn as slippages; ~Rs5bn of accounts were upgraded to regular accounts / SMA 0 and SMA 1. GNPA came in at Rs23.7bn or 4.9% of loans. The stock of stressed assets – GNPA + restructuring + SMA2 according to management stood at 8.1% vs. 10.3% YoY.
- Overall PCR for the bank has increased to 41.1% vs. 38.7% YoY / 27% QoQ. The bank management has guided for scaling overall PCR to 55-60%. PCR (including tech-w/off) was at 54%
- FY18 recovery stood at Rs4.3bn vs. Rs2.9bn in FY17; up-gradation came in at Rs1.8bn (vs. Rs2bn in FY17). FY18 saw bank sell assets to the tune of Rs5.8bn to ARC – Rs3.9bn from w/off accounts and Rs1.9bn from standard accounts. SR portfolio stood at Rs4.4bn (vs. Rs4bn in FY17). The bank has created Rs250mn provisions towards these accounts.
- Power sector exposure stood at 5.3% of loans; GNPA stood at 0.6%. The quarter saw bank recognise 3 accounts amounting to Rs3.8bn into NPA.
- Q1'19 results could see ~Rs800-900mn of slippages from agriculture portfolio (bullet payment of dues) and ~Rs500-600mn of slippages from SME portfolio. The slippages from SME portfolio follows dispensation from RBI for SME units compliant with GST act.

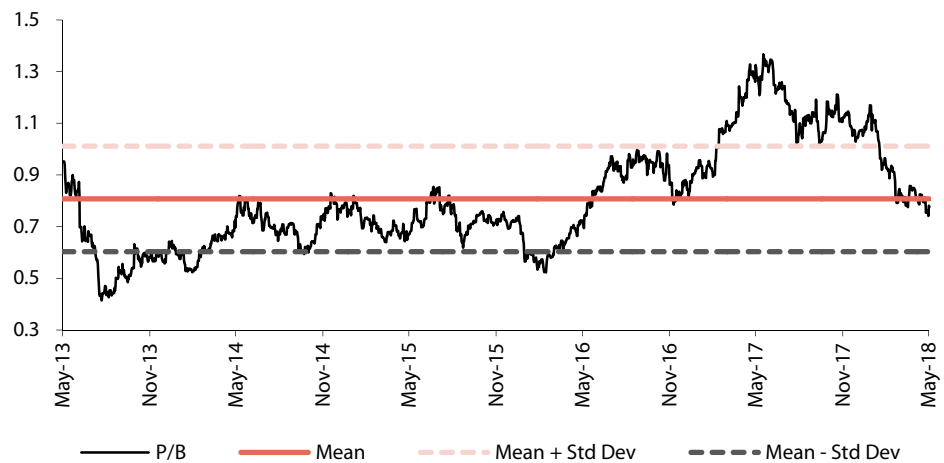
Sensitivity analysis & peer comparison

Exhibit 1: Sensitivity Analysis – impact of change in margins and credit cost on FY19PBT

%	Credit cost				
	+ 10bps	+ 20bps	' Current levels	+ 10bps	- 20bps
- 5bps	(10.9)	(17.3)	(4.5)	1.9	8.3
- 10bps	(15.3)	(21.7)	(8.9)	(2.5)	3.9
NIM Current levels	(6.4)	(12.8)	-	6.4	12.8
+ 5bps	(1.9)	(8.3)	4.5	10.9	17.3
+ 10bps	2.5	(3.9)	8.9	15.3	15.3

Source: Company, Centrum Research Estimates

Exhibit 2: Rolling forward P/ABV chart



Source: Company, Centrum Research Estimates

Exhibit 3: Comparative Valuations

Company Name	Mkt Cap (Rs mn)	CAGR (FY18-FY20E) %			PE (x)			RoA (%)			RoE (%)			P/BVPS (x)			Div Yield (%)		
		NII + Oth inc	PPOP	PAT	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E
KBL*	33,064	11.6	10.8	53.6	13.3	5.6	4.3	0.5	0.8	0.9	6.2	10.8	12.6	0.9	0.6	0.6	2.0	4.2	5.6
CUBK *	1,23,773	10.1	7.6	15.9	18.5	17.7	15.6	1.6	1.6	1.6	15.4	15.6	15.7	2.7	2.6	2.3	0.6	0.5	0.5
DCB *	58,281	16.4	22.8	34.1	23.3	17.0	13.2	0.9	1.0	1.1	10.9	12.5	14.3	2.2	2.0	1.8	0.4	0.4	0.4
KVB	72,701	12.5	14.8	53.9	21.5	10.7	7.4	0.6	0.9	1.1	8.0	11.2	14.1	1.5	1.2	1.0	2.0	2.0	2.5
Federal Bk	1,65,032	17.9	20.6	25.6	19.8	14.8	10.1	0.8	0.9	0.9	9.8	10.0	11.7	1.7	1.4	1.1	1.5	1.5	1.3
SIB	47,318	15.8	15.5	54.8	15.1	7.3	5.7	0.4	0.7	0.8	7.2	12.1	14.0	1.1	0.9	0.8	2.3	2.3	2.0
RBL	2,15,625	31.4	32.7	38.0	33.5	23.9	18.2	1.2	1.3	1.3	11.6	12.7	14.7	3.3	2.9	2.4	0.6	0.6	0.4

Source: Bloomberg consensus, *Centrum Research Estimates. FY18 – FY19E have been valued on average market cap basis.

Quarterly financials

Exhibit 4: Quarterly Financials

(Rs mn)	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18	Q4FY18
Income statement								
Interest earned	12,606	13,064	13,239	12,945	13,305	13,179	13,322	14,438
Interest expended	8,959	9,091	9,474	9,423	9,061	8,777	8,808	9,015
Net interest income	3,647	3,973	3,765	3,522	4,244	4,402	4,515	5,422
Non-interest income	1,744	1,897	1,336	3,117	2,174	2,478	1,946	2,945
Total income	5,391	5,870	5,101	6,639	6,418	6,881	6,461	8,367
Operating expenses	2,771	3,542	3,382	3,346	3,321	3,218	3,242	3,607
PPOP	2,619	2,328	1,719	3,293	3,097	3,662	3,219	4,761
Provisions	1,363	1,306	1,006	1,604	1,989	2,260	1,964	5,418
PBT	1,256	1,022	713	1,689	1,108	1,403	1,255	-657
Tax	41	(216)	27	305	(230)	469	381	-774
Reported PAT	1,215	1,238	685	1,384	1,339	934	874	117
Ratios								
Growth YoY (%)								
<i>NII</i>	10.1	29.4	23.5	(2.1)	16.4	10.8	19.9	54.0
<i>Non-interest income</i>	46.4	56.8	0.7	83.3	24.7	30.6	45.7	-5.5
<i>Opex</i>	31.1	37.0	37.5	21.5	19.8	(9.1)	-4.2	7.8
<i>PPOP</i>	9.6	37.3	(10.3)	29.5	18.2	57.4	87.3	44.6
<i>Reported PAT</i>	11.2	21.2	(29.3)	29.6	10.1	(24.6)	27.5	-91.5
<i>Loans</i>	11.5	12.8	8.7	9.1	10.1	12.3	24.1	27.7
<i>Deposits</i>	10.1	8.6	15.6	12.4	9.2	6.5	0.6	10.8
Margins (%)								
<i>Yield on total assets</i>	9.9	9.9	10.0	9.8	9.6	9.2	8.9	9.3
<i>Cost of funds</i>	6.3	6.2	6.3	6.0	5.7	5.5	5.4	5.3
<i>Spread</i>	3.0	3.1	3.2	3.2	3.3	3.0	2.9	3.4
<i>NIM</i>	2.6	2.7	2.5	2.2	2.7	2.8	2.7	3.1
Key drivers (%)								
<i>Cost-income</i>	51.4	60.3	66.3	50.4	51.7	46.8	50.2	43.1
<i>GNPA</i>	3.9	3.6	4.3	4.2	4.3	4.1	4.0	5.0
<i>NNPA</i>	2.6	2.6	3.0	2.6	3.2	3.0	2.9	3.0
<i>Provision coverage</i>	34.4	28.5	31.7	38.4	27.3	27.3	29.2	41.1
<i>Tier I CAR</i>	10.3	9.8	11.9	12.2	11.9	11.4	11.1	11.3
<i>Tier II CAR</i>	1.4	1.4	1.3	1.1	1.1	1.0	1.1	0.8
<i>RoA</i>	0.9	0.8	0.5	0.9	0.8	0.6	0.5	0.1
<i>RoE</i>	13.0	12.8	6.8	12.0	10.4	7.1	6.6	0.9

Source: Company, Centrum Research

Financials

Exhibit 5: Income Statement

Y/E March (Rs mn)	FY16	FY17	FY18P	FY19E	FY20E
Interest Income	49,922	51,854	54,238	61,697	72,779
Interest Expense	36,894	36,948	35,661	41,367	48,925
Net Interest Income	13,029	14,906	18,576	20,330	23,854
Non-Interest Income	5,429	8,093	9,543	9,972	11,161
Fee & Other Income	2,380	2,711	4,799	5,075	5,873
Gains / (Losses) on Securities	624	3,044	1,970	1,773	1,596
Total Net Income	18,457	23,000	28,120	30,302	35,015
Total Operating Expenses	9,912	13,042	13,388	14,543	16,931
Employee Expenses	4,430	6,010	5,248	6,115	7,198
Other Operating Expenses	5,482	7,031	8,140	8,428	9,733
Pre-provision Profit	8,546	9,958	14,732	15,759	18,085
Provisions & Contingencies	3,265	5,279	11,630	7,697	7,836
NPA Provisions	2,672	5,514	10,112	7,228	7,361
Other Provisions	594	(236)	1,518	469	475
Profit Before Tax	5,280	4,679	3,101	8,062	10,249
Taxes	1,127	157	(155)	2,015	2,562
Profit after tax	4,153	4,523	3,256	6,046	7,687

Source: Company, Centrum Research Estimates

Exhibit 6: Balance Sheet

Y/E March (Rs mn)	FY16	FY17	FY18P	FY19E	FY20E
Cash and balance with RBI	26,456	29,293	35,458	37,611	44,644
Inter-bank borrowings	3,993	3,448	552	5,895	6,997
Loans & Advances	3,39,024	3,70,037	4,72,518	5,60,049	6,66,781
Investments	1,62,567	2,02,197	1,54,444	1,72,381	1,99,251
Total Int Earning Assets	5,05,584	5,75,681	6,27,514	7,38,324	8,73,028
Fixed Assets	3,066	7,206	7,616	8,158	8,601
Other Assets	29,897	29,086	33,149	34,672	36,272
Total Assets	5,65,003	6,41,266	7,03,736	8,18,765	9,62,546
Deposits	5,04,882	5,67,331	6,28,713	7,36,816	8,74,611
Current	32,435	36,233	38,729	45,756	54,751
Savings	1,00,172	1,28,498	1,37,248	1,64,531	1,99,674
Term	3,72,275	4,02,600	4,52,736	5,26,529	6,20,187
Other Int Bearing Liabilities	10,515	8,326	8,160	10,160	10,160
Interest Bearing Liabilities	5,15,397	5,75,657	6,36,873	7,46,976	8,84,771
Other non int bearing Liabilities	12,701	14,182	12,763	13,443	13,953
Total Liabilities	5,28,098	5,89,840	6,49,635	7,60,419	8,98,724
Equity	36,906	51,426	54,101	58,346	63,822
Total Liabilities	5,65,003	6,41,266	7,03,736	8,18,765	9,62,546

Source: Company, Centrum Research Estimates

Exhibit 7: DuPont analysis

(% of avg assets)	FY16	FY17	FY18P	FY19E	FY20E
Interest income	9.2	8.6	8.1	8.1	8.2
Interest expenses	6.8	6.1	5.3	5.4	5.5
NII	2.4	2.5	2.8	2.7	2.7
Other income	1.0	1.3	1.4	1.3	1.3
Total income	3.4	3.8	4.2	4.0	3.9
Operating expenses	1.8	2.2	2.0	1.9	1.9
PPOP	1.6	1.7	2.2	2.1	2.0
Provisions	0.6	0.9	1.7	1.0	0.9
PBT	1.0	0.8	0.5	1.1	1.2
Tax	0.2	0.0	0.0	0.3	0.3
RoA	0.8	0.7	0.5	0.8	0.9
Leverage	15.3	12.5	13.0	14.0	15.1
RoE	11.7	10.2	6.2	10.8	12.6

Source: Company, Centrum Research Estimates

Exhibit 8: Key Ratios

Y/E March	FY16	FY17	FY18P	FY19E	FY20E
B/S Structure Ratios (%)					
CD Ratio	67.1	65.2	75.2	76.0	76.2
Incremental CD Ratio	49.6	49.7	167.0	81.0	77.5
CASA Ratio	26.3	29.0	28.0	28.5	29.1
Growth Ratios (%)					
Loans	7.0	9.1	27.7	18.5	19.1
Deposits	9.7	12.4	10.8	17.2	18.7
NII	11.5	14.4	24.6	9.4	17.3
Opex	9.8	31.6	2.7	8.6	16.4
PPOP	10.5	16.5	47.9	7.0	14.8
Provisions	52.6	61.6	120.3	(33.8)	1.8
PAT	(8.0)	8.9	(28.0)	85.7	27.1
Operating Ratios (%)					
Yield on funds	9.8	9.1	8.6	8.6	8.6
Cost of funds	7.3	6.5	5.6	5.7	5.8
NIM	2.6	2.6	2.9	2.8	2.8
Non-int inc / Total income	1.0	1.3	1.4	1.3	1.3
Fee to avg assets	0.4	0.4	0.7	0.7	0.7
Cost/Income	53.7	56.7	47.6	48.0	48.4
Opex/ Avg assets	1.8	2.2	2.0	1.9	1.9
Provisioning cost	0.8	1.6	2.4	1.4	1.2
Effective tax rate	21.3	3.4	(5.0)	25.0	25.0
RoA	0.8	0.7	0.5	0.8	0.9
RoE	11.7	10.2	6.2	10.8	12.6
Credit Quality Ratios (%)					
Gross NPA	3.6	4.5	5.6	4.9	4.2
Net NPA	2.4	2.8	3.3	2.5	2.0
Slippage rate to op advances	3.4	3.8	5.0	2.8	2.4
NPA coverage ratio	32.6	37.7	41.1	48.9	51.1
Capital Adequacy Ratios (%)					
Total CAR	12.0	13.3	12.0	12.2	11.1
Tier I	10.6	12.2	11.3	11.5	10.5
Tier II	1.5	1.1	0.7	0.7	0.6
Dividend details					
DPS (Rs)	5.0	4.0	3.0	5.0	6.5
Dividend Pay-out (%)	22.7	25.0	26.0	23.4	23.9

Per Share (Rs)

BVPS	195.8	167.0	177.2	192.6	211.9
Adjusted BVPS	153.6	132.1	127.6	147.1	167.5
EPS - basic	22.0	16.0	11.5	21.4	27.2

Valuations Ratios*

Price/BV (x)	0.8	0.7	0.9	0.6	0.6
Price/Adj. BV (x)	1.0	0.9	1.2	0.8	0.7
P/E (x)	6.8	7.2	13.3	5.6	4.3
Dividend Yield (%)	3.3	3.5	2.0	4.2	5.6

Source: Company, Centrum Research Estimates. * has been valued on average market cap basis FY16-19EYTD.

Appendix A

Disclaimer

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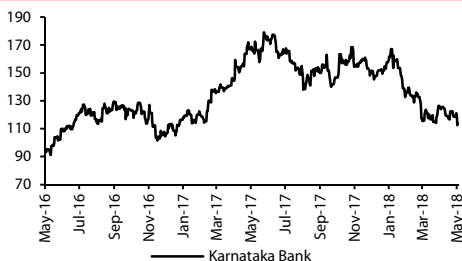
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Karnataka Bank price chart



Source: Bloomberg

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SEBI REGN NO.: INP000004383

Website: www.centrum.co.in

Investor Grievance Email ID: investor.grievances@centrum.co.in

Compliance Officer Details:

Kavita Ravichandran
 (022) 4215 9842; Email ID: Compliance@centrum.co.in

Centrum Broking Ltd. (CIN :U67120MH1994PLC078125)

Registered Office Address Bombay Mutual Building , 2nd Floor, Dr. D. N. Road, Fort, Mumbai - 400 001	Corporate Office & Correspondence Address Centrum House 6th Floor, CST Road, Near Vidya Nagari Marg, Kalina, Santacruz (E), Mumbai 400 098. Tel: (022) 4215 9000
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