AMBIT INSIGHTS

23 July 2019

DAILY

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Ind-AS 116 - No impact on valuations

RESULTS UPDATE

Kotak Mahindra Bank (SELL)

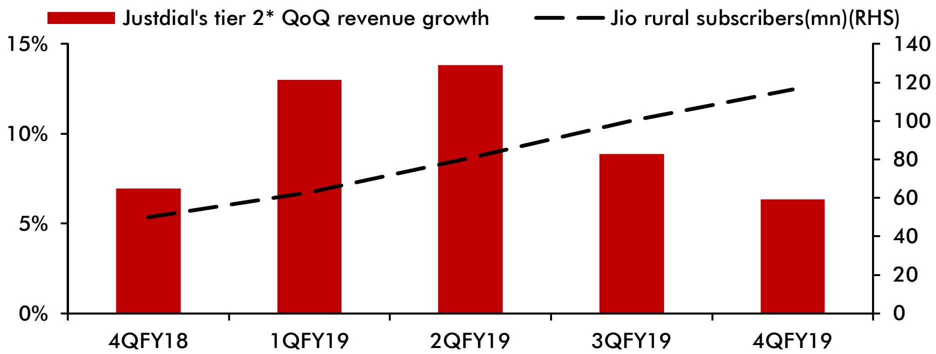
In-line core trends; stock remains expensive

ANALYST NOTES: Justdial: Sharp decline in unearned revenue growth
(Vivekanand Subbaraman, CFA, +91 22 3043 3261)

Unearned revenue, difference between collected amount from customers and accrued revenue, had recovered from <10% YoY growth and was growing 20-33% for the last 6 quarters. This had raised hopes of a sustainable business turnaround. But 1QFY20 results showed that this wasn't to be. Justdial's earned revenue growth stood at only 7.5% YoY. Reported revenue grew 14% YoY. Expectedly, EBITDA growth of 12% was lower than our estimates. The sudden drop in deferred revenue growth highlights the fact that Justdial's revenue growth is a challenge – the key reason for our SELL stance. Moreover, we also doubt the sustenance of the company's tier 2 growth engine in light of Jio's emergence in the rural markets. Similar to Google/Facebook, which earn digital advertising from merchants in tier 1 markets, we expect Jio to aggressively monetise merchants in tier 2 markets given its reach in those markets. This would adversely affect Justdial's ability to grow its business in these markets.

Source: Ambit Capital research

HAVE YOU SEEN THIS? Jio's emergence as a potent force in tier 2 markets is likely to hit Justdial's revenue growth



*Source: Company, TRAI, Ambit Capital research. * Tier-2 represents markets outside the top-11 cities for Justdial*

Please refer to our website for complete coverage universe

http://ambitresearch.co

Strategy

Ind-AS 116 - No impact on valuations

Quick Insight

Analysis	✓
Meeting Note	
News Impact	

Ind-AS 116 (leasing), applicable from 1 Apr'19, won't create structural changes to existing businesses but may only optically change key financial parameters like PBT margins, return ratios etc. While PBT margins could fluctuate due to Ind-AS 116 adoption, technically for every lease arrangement the difference in profits (between old method and Ind-AS 116) over the entire term of the lease will be 'nil'. Furthermore, Ind-AS 116 does not impact actual cash flows and, hence, won't affect DCF-based valuations. But, while making DCF predictions, investors should be sceptical of companies generating low or negative cash flows and actual non-cancellable lease commitments. Changes under Ind-AS 116 are aimed at knowing the true financial position of companies and facilitating better peer comparison. (Click here for our detailed note on Ind-AS 116).

Changes in PBT owing to Ind-AS 116 won't impact P/E multiple

Ind-AS 116 does not lead to any operational or structural changes to the businesses; the impact on PBT merely depends on the current term of the lease period (click here for our detailed note on new lease accounting). Assuming annual lease expenditure of Rs10mn, discount rate of 10% and lease term of 10 years, we arrive at the present value of lease liability and lease asset at commencement of lease at Rs61mn. Under Ind-AS, we charge depreciation on SLM basis on the lease asset of Rs6.1mn every year while financial liability is amortised over 10 years. We see three interesting trends:

- Total expenditure (interest and depreciation) under Ind-AS116 is higher than lease rentals charged under the erstwhile accounting norms during the first half term of the lease.
- Total expenditure (interest and depreciation) under Ind-AS 116 is almost equal to lease rentals charged under the erstwhile accounting norms during the time the lease phase is exactly at the middle of the total lease term.
- Total expenditure (interest and depreciation) under Ind-AS116 is lower than the lease rentals charged under the erstwhile accounting norms during the first half term of the lease.

Exhibit 1: Impact on PBT over entire term of the lease is neutral, hence fluctuations in PBT on account of Ind-AS 116 need not be considered while arriving at P/E

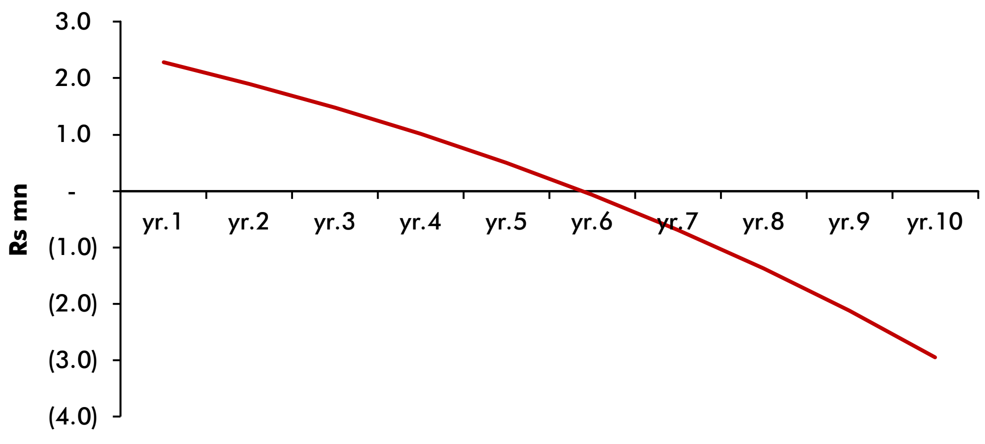
Lease term	Lease rental before Ind-AS 116 (Rs mn)	Interest under Ind-AS 116 (Rs mn)	Depreciation under Ind-AS 116 (Rs mn)	Ind-AS 116 total (Rs mn)	Difference (Rs mn)
Yr.1	10.0	6.1	6.1	12.3	2.3
Yr.2	10.0	5.8	6.1	11.9	1.9
Yr.3	10.0	5.3	6.1	11.5	1.5
Yr.4	10.0	4.9	6.1	11.0	1.0
Yr.5	10.0	4.4	6.1	10.5	0.5
Yr.6	10.0	3.8	6.1	9.9	(0.1)
Yr.7	10.0	3.2	6.1	9.3	(0.7)
Yr.8	10.0	2.5	6.1	8.6	(1.4)
Yr.9	10.0	1.7	6.1	7.9	(2.1)
Yr.10	10.0	0.9	6.1	7.1	(2.9)
Total	**100.0**	**39.0**	**61.0**	**100.0**	**0.0**

Source: Ambit Capital research

Research Analyst

Vinit Powle
vinit.powle@ambit.co
Tel: +91 22 6623 3149

Exhibit 2: Impact on PBT is nil at the middle of the lease term



Source: Ambit Capital research

Ind-AS 116 does not impact DCF-based valuations

While Ind-AS 116 does not impact DCF based valuations, Investors should be typically careful of 1) companies generating low cash flows 2) actual lease liabilities instead just carrying forward the rent expenditures from old DCF models.

Ind-AS 116 intends to curb the practice of carrying huge non-cancellable lease commitment outside financial statements. Now, majority of future non-cancellable lease commitments will be capitalised on the balance sheet as lease assets and lease liabilities. In simple terms, rent expenditure under old accounting norms will be replaced by interest (on lease liabilities) and depreciation expense (on lease assets) (click here for our detailed note on new lease accounting).

Exhibit 3: Rent expense will no longer exist; EBITDA and EBIT will rise while impact on PBT will depend on a case-by-case basis

	Before Ind-AS 116		Ind-AS 116
	Finance leases	Operating leases	All leases
Revenue	X	X	X
Operating costs (ex-depreciation and amortisation)	-	Rent expense	-
EBITDA			⇧
Depreciation and amortisation	Depreciation	-	Depreciation
Operating profit	-	-	⇧
finance cost	Interest	-	Interest
Profit before tax	-	-	Depends

Source: Ambit Capital research

Adoption of Ind-AS 116 does not have any impact on actual cash outflows. Optically, in a revised DCF model (after incorporating Ind-AS 116 changes), firm value (FCFF) will go up by the amount of present value of rent expenditure (since rent expense no longer exist under Ind-AS 116) ; but on the other hand there is increase in debt (lease liabilities) by the same amount, hence the total equity value remains the same.

Exhibit 4: Increase in EBITDA will be compensated by increase in borrowings (lease liabilities) while arriving at the firm value

	Before Ind-AS 116	After Ind-AS 116	Comments
	Rs mn	Rs mn	
PV of lease rentals	61	-	PV of lease rentals for a certain period will be exactly equal to the lease liabilities and hence the total equity value of the firm will remain the same.
PV of lease liabilities	-	61	
Equity value of the firm	⟺		

Source: Ambit Capital research. Assumptions are the same as those of Exhibit 1

Ind-AS 116 makes comparison between peers more meaningful

Capitalisation of huge assets and liabilities in the balance sheet will certainly lead to changes in ratios like ROCE, ROIC etc. We believe one of the main reasons for making Ind-AS 116 applicable was to enable investors to understand the true financial position in terms of financial leverage and capital employed. For instance, it will facilitate true comparison between companies which adopt lease models vs companies which are dependent on borrowings for purchasing assets. We believe changes in return ratios should not be adjusted for the new lease liabilities and lease assets arising out of Ind-AS 116 adoption.

Kotak Mahindra Bank

In-line core trends; stock remains expensive

Operating profit and standalone PAT grew 18% and 33% YoY respectively, broadly in line with our estimates. In 1QFY20, most operating trends were broadly stable for the bank with 18% YoY loan growth and stable NIMs QoQ. CASA growth was strong at 21% YoY and better than competitors. Asset quality was broadly stable with annualised credit cost of ~60bps. Subsidiaries' performance was muted with just 4% YoY PAT growth in subsidiaries. Trends for Kotak Prime remained weak and PAT declined YoY for Kotak Securities. However, AUM grew 7% for asset management business and premiums grew 38% YoY for insurance business. We expect consoliodated RoE to remain at 13-14% by FY21E and hence we find current valuations of 4.1x FY20E consolidated BVPS and 34x FY20E consolidated EPS expensive. We remain SELLers with unchanged TP of Rs927 (implied FY20 P/B of 2.3x).

Results overview

KMB's standalone PAT grew ~33% YoY which was broadly in line with our estimates. PAT growth of 33% was higher than operating profit growth of 18% YoY as the bank had Rs2.1bn MTM provisions on investments in 1QFY19 vs just Rs442mn of investment provisions this quarter. Loan growth slowed down to 18% YoY (vs 21% in FY19). NIMs were steady QoQ. Fee income (up 16% YoY) was slightly lower vs trends witnessed in FY19 and opex growth at 21% YoY was slightly higher than FY19 trends. Asset quality was stable QoQ and credit cost during the quarter was at 60bps. The management guided for steady ~20% growth and stable asset quality.

Average CASA deposits grew 21% YoY which indicates growing market share for the bank in CASA deposits. This helped the bank maintain NIMs on a QoQ basis.

Mixed show from subsidiaries

PAT of all subsidiaries combined increased 4% YoY. Trends for Kotak Prime remain muted as AUM remained flat both YoY and QoQ, with PAT increasing 10% YoY. PAT declined 15% for Kotak Securities. However, asset management business continued to do well with AUM growing 7%/25% QoQ/YoY and PAT growing 43% YoY. The life insurance subsidiary continues to go from strength to strength with 38% YoY increase in gross premium.

Where do we go from here?

As highlighted in our note 'Higher growth ≠ higher RoE', we believe that as KMB accelerates its loan growth to utilise its excess equity (tier-1 of ~17%), incremental growth would come at lower profitability, given: (i) KMB would have to compromise yields to quickly expand its balance sheet; (ii) CASA growth slowdown at the system level and maturing CASA per branch of KMB (>Rs790mn) would put CASA growth under pressure; and (iii) NIMs would compress with increased leverage as debt replaces equity. This, coupled with the overhang of the promoter stake dilution below the threshold limit of 20%, will remain an overhang on the bank.

We expect RoE to remain at 13-14% by FY21E and hence we find current valuations of 4.1x FY20E consolidated BVPS and 34x FY20E consolidated EPS expensive. We remain SELLers with unchanged TP of Rs927 (implied FY20 P/B of 2.3x).

SELL

Result Update

Stock Information

Bloomberg Code:	KMB IN
CMP (Rs):	1,454
TP (Rs):	927
Mcap (Rs bn/US$ bn):	2,777/40.3
3M ADV (Rs mn/US$ mn):	3,941/57.2

Stock Performance (%)

	1M	3M	12M	YTD
Absolute	(2)	7	9	16
Rel. to Sensex	1	9	5	10

Source: Bloomberg, Ambit Capital research

Ambit Estimates (Rs bn)

	FY19	FY20E	FY21E
NII	112.6	132.5	153.3
PAT – stand.	48.7	56.5	66.6
PAT – consol.	72.0	81.5	95.0
EPS (Rs)-consol.	37.7	42.7	49.8

Source: Bloomberg, Ambit Capital research

Research Analysts

Pankaj Agarwal, CFA
Tel: +91 22 3043 3206
pankaj.agarwal@ambit.co

Gaurav Kochar
Tel: +91 22 3043 3246
gaurav.kochar@ambit.co

Exhibit 1: Kotak's SOTP valuation

KMB SOTP	Holding %	Valuation methodology	Value per share	Contribution to TP (%)
Kotak - Parent Bank	100%	2.5x FY20E P/B	594	64%
Kotak Prime	100%	2.1x FY20E P/B	75	8%
Kotak Life	100%	4x FY19 EV	134	14%
Capital Markets	100%	20x FY19E P/E	70	8%
Kotak MF	100%	7% of AUM	58	6%
Kotak Invst Advisors	100%	10% of AUM	9	1%
Less: Cost of investments			(13)	-1%
Total		**2.3x FY20E consolidated P/B**	**927**	**100%**

Source: Ambit Capital research.

Exhibit 2: Quarterly snapshot (standalone, unless mentioned)

(Rs mn)	1QFY19	4QFY19	1QFY20	YoY (%)	QoQ (%)	1QFY20E	A/E (%)
NII	**25,829**	**30,479**	**31,730**	**23%**	**4%**	**31,687**	**0%**
Non-Interest income	**11,646**	**12,703**	**13,047**	**12%**	**3%**	**13,524**	**-4%**
Total Income	**37,475**	**43,182**	**44,778**	**19%**	**4%**	**45,211**	**-1%**
Employee Cost	7,204	8,567	9,015	25%	5%		
Other Operating Expenses	9,945	11,792	11,773	18%	0%		
Total Operating Expenses	17,150	20,359	20,789	21%	2%	21,046	-1%
Operating Profit	**20,325**	**22,823**	**23,989**	**18%**	**5%**	**24,165**	**-1%**
Total Provisions	**4,696**	**1,713**	**3,168**	**-33%**	**85%**	**3,941**	**-20%**
PBT	15,629	21,110	20,822	33%	-1%	20,224	3%
Tax	5,380	7,032	7,220	34%	3%	6,876	5%
Reported Profit	**10,249**	**14,078**	**13,602**	**33%**	**-3%**	**13,348**	**2%**
Consolidated PAT	**15,745**	**20,393**	**19,322**	**23%**	**-5%**	**19,044**	**1%**
Balance sheet (Rs bn)							
Deposits	1,897.4	2,258.8	2,329.3	23%	3%	2,292.7	2%
Net Advances	1,769.3	2,056.9	2,080.3	18%	1%	2,139.2	-3%
Total Assets	**2,714.9**	**3,121.7**	**3,151.1**	**16%**	**1%**	**3,184.2**	**-1%**
Loan-Deposit ratio (%)	93.2%	91.1%	89.3%				
Key Ratios							
Credit Quality							
Gross NPAs (Rs mn)	38,995	44,679	46,140	18%	3%		
Net NPAs (Rs mn)	15,271	15,444	15,240	0%	-1%		
Gross NPA (%)	2.17%	2.14%	2.19%				
Net NPA (%)	0.86%	0.75%	0.73%				
Loan Loss Provisions (%)	1.08%	0.34%	0.61%				
Coverage Ratio (%)	60.8%	65.4%	67.0%				
Capital Adequacy							
Tier I (%)	17.6%	16.9%	17.3%				
CAR (%)	18.3%	17.5%	17.8%				
Du-pont Analysis							
NII / Assets (%)	3.85%	4.02%	4.05%			4.02%	
Non-Interest Inc. / Assets (%)	1.74%	1.68%	1.66%			1.72%	
Operating Cost / Assets (%)	2.56%	2.69%	2.65%			2.67%	
Operating Profits / Assets (%)	3.03%	3.01%	3.06%			3.07%	
Provisions / Assets (%)	0.70%	0.23%	0.40%			0.50%	
ROA (%)	**1.53%**	**1.86%**	**1.73%**			**1.69%**	

Source: Company, Ambit Capital research

Balance sheet – Standalone

Year to March (Rs mn)	FY17	FY18	FY19	FY20E	FY21E
Networth	276,161	374,817	423,984	478,528	543,230
Deposits	1,574,259	1,926,433	2,258,804	2,665,388	3,145,158
Borrowings	210,955	251,542	327,483	407,547	507,517
Other Liabilities	84,525	96,543	111,451	128,165	147,387
Total Liabilities	**2,145,900**	**2,649,334**	**3,121,721**	**3,679,629**	**4,343,292**
Cash & Balances with RBI & Banks	225,720	196,201	246,755	276,792	328,583
Investments	450,742	645,623	711,891	828,716	983,779
Advances	1,360,821	1,697,179	2,056,948	2,468,338	2,912,639
Other Assets	108,616	110,330	106,127	105,783	118,291
Total Assets	**2,145,900**	**2,649,334**	**3,121,721**	**3,679,629**	**4,343,292**

Source: Company, Ambit Capital research

Income statement – Standalone

Year to March (Rs mn)	FY17	FY18	FY19	FY20E	FY21E
Interest Income	176,989	197,485	239,432	286,145	339,284
Interest Expense	95,728	102,168	126,843	153,662	185,947
Net Interest Income	**81,261**	**95,317**	**112,590**	**132,483**	**153,337**
Total Non-Interest Income	34,772	40,522	46,040	56,184	68,127
Total Income	**116,033**	**135,839**	**158,630**	**188,667**	**221,464**
Total Operating Expenses	56,185	64,257	75,148	88,792	102,111
Employees expenses	27,685	29,502	31,594	38,705	44,511
Other Operating Expenses	28,500	34,755	43,554	50,087	57,600
Pre Provisioning Profits	**59,848**	**71,582**	**83,482**	**99,875**	**119,352**
Provisions	8,367	9,400	9,624	14,177	18,234
PBT	51,481	62,182	73,858	85,698	101,118
Tax	17,366	21,339	25,205	29,245	34,507
PAT	**34,115**	**40,843**	**48,653**	**56,453**	**66,611**
Consolidated PAT	49,403	62,009	72,023	81,481	95,025

Source: Company, Ambit Capital research

Ratio analysis – Standalone bank

Year to March (Rs mn)	FY17	FY18	FY19	FY20E	FY21E
Credit-Deposit (%)	86.4%	88.1%	91.1%	92.6%	92.6%
CASA ratio (%)	44.0%	50.8%	52.5%	51.2%	50.0%
Cost/Income ratio (%)	48.4%	47.3%	47.4%	47.1%	46.1%
Gross NPA (Rs mn)	35,786	38,254	44,679	50,092	55,713
Gross NPA (%)	2.59%	2.23%	2.14%	2.00%	1.89%
Net NPA (Rs mn)	17,181	16,651	15,444	15,028	16,714
Net NPA (%)	1.26%	0.98%	0.75%	0.61%	0.57%
Provision coverage (%)	52.0%	56.5%	65.4%	70.0%	70.0%
NIMs (%)	4.23%	4.17%	4.05%	4.02%	3.93%
Tier-1 capital ratio (%)	15.9%	17.6%	18.0%	16.9%	16.0%

Source: Company, Ambit Capital research

Du-pont analysis – Standalone

Year to March	FY17	FY18	FY19	FY20E	FY21E
NII / Assets (%)	4.0%	4.0%	3.9%	3.9%	3.8%
Other income / Assets (%)	1.7%	1.7%	1.6%	1.7%	1.7%
Total Income / Assets (%)	5.7%	5.7%	5.5%	5.5%	5.5%
Cost to Assets (%)	2.8%	2.7%	2.6%	2.6%	2.5%
PPP / Assets (%)	2.9%	3.0%	2.9%	2.9%	3.0%
Provisions / Assets (%)	0.4%	0.4%	0.3%	0.4%	0.5%
PBT / Assets (%)	2.5%	2.6%	2.6%	2.5%	2.5%
Tax Rate (%)	33.7%	34.3%	34.1%	34.1%	34.1%
ROA (%)	1.7%	1.7%	1.7%	1.7%	1.7%
Leverage	7.9	7.4	7.2	7.5	7.9
ROE (%)	13.2%	12.5%	12.2%	12.5%	13.0%

Source: Company, Ambit Capital research

Valuation parameters – Consolidated

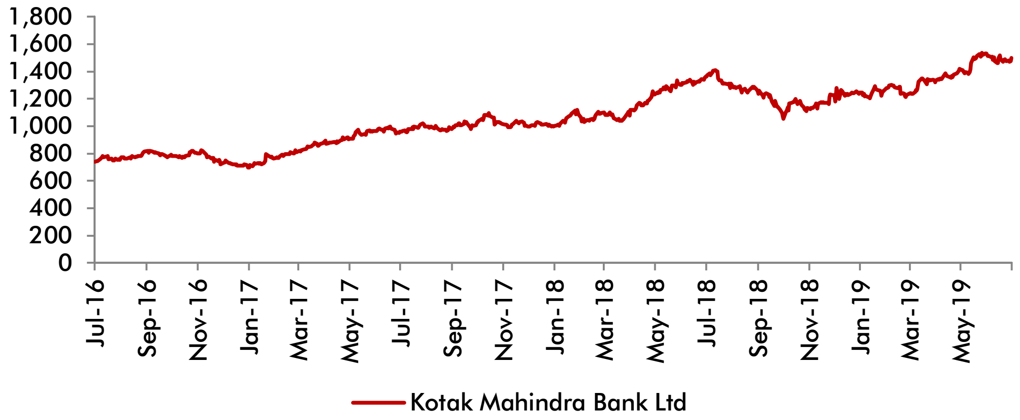
Year to March	FY17	FY18	FY19	FY20E	FY21E
Consolidated EPS (Rs)	26.9	32.5	37.7	42.7	49.8
Consolidated EPS growth (%)	42%	21%	16%	13%	17%
Consolidated ROE (%)	13.8%	13.9%	13.2%	13.1%	13.4%
Consolidated BVPS (Rs)	209.1	264.9	305.3	347.0	395.8
P/E (x)	54.1	44.7	38.5	34.1	29.2
P/BV (x)	7.0	5.5	4.8	4.2	3.7

Source: Company, Ambit Capital research

Institutional Equities Team

Research Analysts			
Name	**Industry Sectors**	**Desk-Phone**	**E-mail**
Nitin Bhasin - Head of Research	E&C / Infra / Cement / Home Building / Aviation	(022) 66233241	nitin.bhasin@ambit.co
Aadesh Mehta, CFA	Mid-Caps	(022) 66233239	aadesh.mehta@ambit.co
Amandeep Singh Grover	Small-Caps	(022) 66233082	amandeep.grover@ambit.co
Ashish Kanodia, CFA	Consumer Discretionary	(022) 66233264	ashish.kanodia@ambit.co
Basudeb Banerjee	Automobiles / Auto Ancillaries	(022) 66233141	basudeb.banerjee@ambit.co
Deep Shah	Media / Telecom / Oil & Gas	(022) 66233064	deep.shah@ambit.co
Dhruv Jain	Mid-Caps	(022) 66233177	dhruv.jain@ambit.co
Gaurav Kochar	Banking / Financial Services	(022) 66233246	gaurav.kochar@ambit.co
Kanwalpreet Singh	Small-Caps / Strategy	(022) 66233223	kanwalpreet.singh@ambit.co
Karan Khanna, CFA	Small-Caps / Strategy	(022) 66233251	karan.khanna@ambit.co
Karan Kokane	Automobiles / Auto Ancillaries	(022) 66233028	karan.kokane@ambit.co
Kushagra Bhattar	Healthcare	(022) 66233062	kushagra.bhattar@ambit.co
Nikhil Mathur, CFA	Healthcare	(022) 66233220	nikhil.mathur@ambit.co
Pankaj Agarwal, CFA	Banking / Financial Services	(022) 66233206	pankaj.agarwal@ambit.co
Prateek Maheshwari	Cement	(022) 66233234	prateek.maheshwari@ambit.co
Ritesh Gupta, CFA	Consumer Discretionary / Agri & Chemicals	(022) 66233242	ritesh.gupta@ambit.co
Ritika Mankar Mukherjee, CFA	Economy / Strategy	(022) 66233175	ritika.mankar@ambit.co
Ronil Dalal, CFA	Aviation / Home Building	(022) 66233278	ronil.dalal@ambit.co
Sudheer Guntupalli	IT / Engineering / Business Services	(022) 66233203	sudheer.guntupalli@ambit.co
Sumit Shekhar	Economy / Strategy	(022) 66233229	sumit.shekhar@ambit.co
Udit Kariwala	Banking / Financial Services	(022) 66233197	udit.kariwala@ambit.co
Varun Ginodia, CFA	E&C / Infrastructure / Aviation	(022) 66233174	varun.ginodia@ambit.co
Vihang Subramanian	Agri Inputs / Chemicals	(022) 66233297	vihang.subramanian@ambit.co
Vinit Powle	Strategy / Forensic Accounting	(022) 66233149	vinit.powle@ambit.co
Vivekanand Subbaraman, CFA	Media / Telecom / Oil & Gas	(022) 66233261	vivekanand.s@ambit.co
Sales			
Name	**Regions**	**Desk-Phone**	**E-mail**
Dhiraj Agarwal - MD & Head of Sales	India	(022) 66233253	dhiraj.agarwal@ambit.co
Bhavin Shah	India	(022) 66233186	bhavin.shah@ambit.co
Dharmen Shah	India / Asia	(022) 66233289	dharmen.shah@ambit.co
Nityam Shah, CFA	Europe	(022) 66233259	nityam.shah@ambit.co
Pranav Verma	Asia	(022) 66233214	pranav.verma@ambit.co
Shaleen Silori	India	(022) 66233256	shaleen.silori@ambit.co
USA / Canada			
Hitakshi Mehra	Americas	+1(646) 793 6751	hitakshi.mehra@ambitamerica.co
Achint Bhagat, CFA	Americas	+1(646) 793 6752	achint.bhagat@ambitamerica.co
Singapore			
Sundeep Parate	Singapore	+65 6536 1918	sundeep.parate@ambit.co
Production			
Sajid Merchant	Production	(022) 66233247	sajid.merchant@ambit.co
Sharoz G Hussain	Production	(022) 66233183	sharoz.hussain@ambit.co
Jestin George	Editor	(022) 66233272	jestin.george@ambit.co
Richard Mugutmal	Editor	(022) 66233273	richard.mugutmal@ambit.co
Nikhil Pillai	Database	(022) 66233265	nikhil.pillai@ambit.co
Babyson John	Database	(022) 66233209	babyson.john@ambit.co

Kotak Mahindra Bank Ltd (KMB IN, SELL)



Source: Bloomberg, Ambit Capital research

Explanation of Investment Rating

Investment Rating	**Expected return (over 12-month)**
BUY	>10%
SELL	≤10%
NO STANCE	We have forward looking estimates for the stock but we refrain from assigning valuation and recommendation
UNDER REVIEW	We will revisit our recommendation, valuation and estimates on the stock following recent events
NOT RATED	We do not have any forward looking estimates, valuation or recommendation for the stock
POSITIVE	We have a positive view on the sector and most of stocks under our coverage in the sector are BUYs
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