

April 13, 2012

Stock Rating
Overweight

Industry View
In-Line

TCL Communication Technology

1Q Slump Not a Big Surprise; Look Beyond the Trough

What's Changed

Price Target **HK\$6.40 to HK\$5.70**
2012e/13e EPS **Down 13%/14%**

TCL's 1Q profit warning shouldn't come as a big surprise in view of the conservative consensus (including our estimate) for a 40-70% YoY earnings decline. Despite likely higher OPEX, this doesn't alter our view that 1Q should mark the trough ahead of an accelerating smartphone sales ramp from 2Q.

TCL indicated that 1Q12 earnings would fall significantly YoY... It cited a GM dip in feature phones; prolonged smartphone certification, delaying new model launches; and higher selling/R&D expenses, mainly for the smartphone ramp. Our previous top-line/GM estimates were conservative, discounting market and competitive risks. We think the key swing factor could be higher OPEX for smartphone development.

...but 1Q should mark the trough: The profit warning doesn't alter our view that the company is in the midst of a product transition, and that a more significant smartphone sales ramp will take place from 2Q.

The news may hit the share price in the near term, but we see downside protection: We cite reduced market expectations and cheap valuation (~4x P/E & ~1x P/B for 2012e). 1Q12 results are due on 4/26.

Signs of improvement beyond 1Q12 despite low visibility: 1) Enhanced smartphone lineup in 2Q – could tie in with carriers' procurement and boost revenue. 2) Order firm-up with emerging cost synergies through accelerating overseas smartphone sales – helping to ease greater margin pressure. 3) Benefits from more mature/cost-competitive smartphone solutions from MTK – we regard this as the key to matching peers (ZTE/Huawei) with strong Qualcomm endorsement.

Key Ratios and Statistics

Reuters: 2618.HK Bloomberg: 2618 HK

China Hardware Technology

Price target	HK\$5.70
Up/downside to price target (%)	70
Shr price, close (Apr 12, 2012)	HK\$3.36
52-Week Range	HK\$7.92-2.48
Sh out, dil, curr (mn)	1,114
Mkt cap, curr (mn)	HK\$3,744
EV, curr (mn)	HK\$9,669
Avg daily trading value (mn)	HK\$24

Fiscal Year ending	12/11	12/12e	12/13e	12/14e
ModelWare EPS (HK\$)	0.72	0.76	0.95	1.19
Prior ModelWare EPS (HK\$)	0.72	0.88	1.11	-
Consensus EPS (HK\$)	0.76	0.77	0.87	0.79
Revenue, net (HK\$ mn)	10,653	14,043	18,037	18,447
EBITDA (HK\$ mn)	1,094	1,303	1,551	1,855
ModelWare net inc (HK\$ mn)	800	852	1,060	1,322
P/E	4.9	4.4	3.5	2.8
P/BV	1.5	1.2	0.9	0.8
RNOA (%)	12.5	11.8	11.1	10.9
ROE (%)	36.0	31.9	32.7	33.4
EV/EBITDA	9.0	8.8	8.6	6.7
Div yld (%)	8.6	7.5	9.3	11.7
FCF yld ratio (%)	(15.6)	(43.5)	(39.8)	35.8
Leverage (EOP) (%)	220.2	238.9	241.2	177.3

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).

\$ = Consensus data is provided by Thomson Reuters Estimates.

e = Morgan Stanley Research estimates

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TCL Communication Technology: Financial Summary

HKD million; Years Ending December

Income Statement

	2010	2011	2012E	2013E
Net sales	8,701	10,653	14,043	18,037
COGS	-6,752	-8,325	-11,178	-14,318
Gross profit	1,948	2,328	2,865	3,719
Operating expenses	-1,140	-1,403	-1,779	-2,408
- Promotion	-620	-866	-1,212	-1,487
- ADM	-436	-558	-594	-861
- R&D	-357	-459	-564	-736
- Other Rev/Exp	-5	-28	-38	-46
- Other Opt. Income	278	508	629	721
Operating income	808	925	1,087	1,311
Financial Cost	-63	-140	-171	-171
Share of profits	0	-1	0	0
Pre-tax income	745	783	916	1,140
Income tax	-43	17	-64	-80
Net Income before Minority	702	801	852	1,060
Minority	0	-1	0	0
Net income	702	800	852	1,060
Modelware EPS (HKD)	0.65	0.72	0.76	0.95

Balance Sheet

	2010	2011	2012E	2013E
Cash	1,345	1,187	672	218
Pledged bank deposits	6,201	6,092	7,228	8,355
Financial Instruments	171	149	149	149
Accounts/Notes receivables	2,574	2,585	3,407	4,376
Inventory	780	981	1,318	1,688
Others	548	1,260	1,260	1,260
Current Assets	11,619	12,254	14,034	16,046
Long-term investments	28	29	-582	-1,192
Fixed assets	309	497	512	504
Intangible assets	106	702	702	702
Other assets	192	545	2,053	3,559
Total Assets	12,254	14,027	16,719	19,619
S/T borrowings	6,488	7,222	8,569	9,905
AP/NP	1,875	2,262	3,037	3,891
Other ST liabilities	1,651	1,831	1,831	1,831
Other current liabilities	18	39	39	39
L/T debt	0	0	0	0
Total Liabilities	10,031	11,354	13,475	15,665
Common shares	1,098	1,114	1,114	1,114
Other shareholders' equity	1,125	1,559	2,130	2,840
Shareholders' equity	2,222	2,673	3,244	3,954
Total Liab./Shrhldr's Equity	12,254	14,027	16,719	19,619

Cash Flow Statement

	2010	2011	2012E	2013E
Cashflow from operations	731	122	560	689
Net Profits	702	800	852	1,060
Depreciation & Amortization	171	169	217	240
Equity investment losses (income)	-194	-722	-384	-486
Other adjustments	52	-125	-125	-125
Cashflow from investing	-356	-966	-842	-842
(Purchases) sale of FA (capex)	-119	-232	-232	-232
(Purchases) sale of L/T investment	-165	-610	-610	-610
(Purchases) sale of S/T investment	0	0	0	0
Other adjustments	-72	-124	0	0
Cashflow from financing	-211	637	-281	-350
Increase in L/T debt	-1	0	0	0
Increase in S/T debt	5,027	734	1,346	1,336
Issuance of stock	-3	0	0	0
Cash dividends	-125	-336	-281	-350
Dir. & Emp. Bonus	0	0	0	0
Other adjustments	-5,109	239	-1,346	-1,336
Exchange rate adjustment	11	49	49	49
Net change in cash	176	-159	-515	-454

Financial Ratios

	2010	2011	2012E	2013E
Margins				
Gross margin	22.4%	21.9%	20.4%	20.6%
Operating margin	9.3%	8.7%	7.7%	7.3%
Pretax margin	8.6%	7.4%	6.5%	6.3%
Net margin	8.1%	7.5%	6.1%	5.9%
YoY growth				
Sales	100%	22%	32%	28%
Operating profits	479%	14%	17%	21%
Pretax profits	2086%	5%	17%	24%
Net profits	2951%	14%	6%	24%
EPS	1912%	11%	6%	24%
Cash dividend payout ratio	39%	33%	33%	33%
Adjusted cash dividend (HKD)	0.2	0.3	0.3	0.3
Yield	2%	9%	8%	9%
Net Debt/Equity	231%	226%	243%	245%
Liabilities/Equity	451%	425%	415%	396%
Liabilities/Assets	82%	81%	81%	80%
ROAE	42%	33%	29%	29%
ROAA	7%	6%	6%	6%
AR/NR Turnover (days)	86	88	78	79
AP/NP Turnover (days)	86	91	87	88
Inventory Turnover (days)	33	39	38	38
Cash conversion cycle (days)	34	36	29	29

Source: Company data, Morgan Stanley Research; E = Morgan Stanley Research estimates

April 13, 2012

TCL Communication Technology

Risk-Reward: TCL Communication Technology (2618.HK, \$3.36, OW, PT \$5.70)

Risk-Reward: Promising Low-end Player with Attractive Risk-Reward



Price Target HK\$5.70 Based on our US GAAP-adjusted residual income (RI) valuation

Bull Case	10x Bull Case 12e EPS	Better demand for 3G smartphones results in ASP/GM upside: Shipments jump 35% YoY on robust growth of 2G phones and stronger demand for low-priced 3G models. GM increase of 0.9ppt, to 22%, via favorable 3G mix. This lifts OpM to 10% with improving operating leverage.
Base Case	7x Base Case 12e EPS	Persistent 2G strength, as 3G momentum kicks in: Shipments grow 12% YoY, driven by accelerating demand for low-priced 3G models that offset the 2G weakness. GM contracts by 1.5ppt, to 20.4%; operating leverage would less significant given increasing R&D/selling expenses for smartphones.
Bear Case	2x Bear Case 12e EPS	Suppressed 2G sales amid intense competition, with stagnant 3G demand: Milder shipment growth of 5% YoY, capped by intense competition and weaker demand for low-priced 3G models. GM decline of 3ppt, to 19%, with accelerating OpM contraction of 3ppt, given operating deleverage.

Investment Thesis

- We believe TCL Comm is in the midst of a product transition; 1Q12 should mark the trough followed by a more significant smartphone sales ramp from 2Q.
- Share price might suffer in the near term from 1Q12's profit warning...
- ...but we expect reduced market expectations and cheap valuation (~4x P/E & ~1x P/B for 2012e) to protect the downside.
- Warning shouldn't be a big surprise in view of conservative consensus (including our estimate) for a 40-70% YoY earnings decline.
- Our previous top-line/GM estimates were conservative, discounting market and competitive risks.
- We think the key swing factor could be higher OPEX for smartphone development.

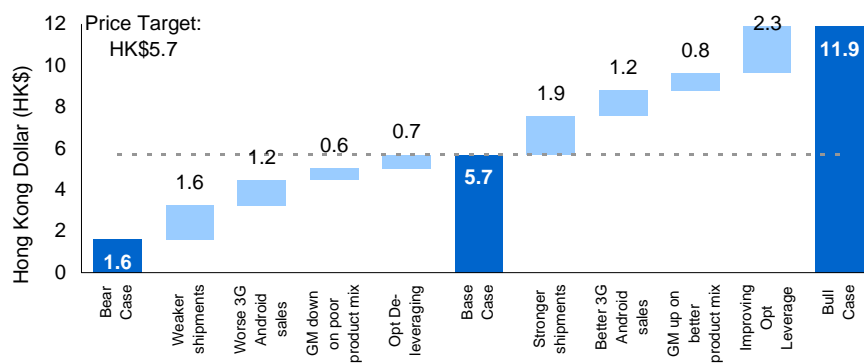
Key Value Drivers

- Handset shipment scale: critical to TCL Comm's cost structure and margin trend.
- Sales of low-priced 3G smartphones: key to ASP improvement.
- GM variance: directly affects valuation. GM reached 22.4% in 2010; we project a 19-23% range.
- Further confirmation of TCL Comm's new smartphone project wins from overseas operators.

Key Risks

- Prolonged macro weakness, leading to further deterioration of end demand.
- Faster ASP erosion in low-cost phones could nullify TCL Comm's cost-cutting efforts.
- Chinese/European telco operators postpone or reduce procurements of low-priced 3G Android phones.

Bull-Base-Bear Driven by Shipment, 3G Mix, and Resultant Margin



April 13, 2012

TCL Communication Technology

Earnings Estimate Revisions

We are lowering our 2012 and 2013 EPS estimates for TCL Communications by 13% and 14%, respectively.

We now factor in higher operating expense assumptions:

We cite the company's aggressiveness in the smartphone market and brand building. We now project HK\$1,779mn for 2012 and HK\$2,408mn for 2013, up from HK\$1,676mn and HK\$1,968mn.

- Within this, we raise our assumptions for promotional expenses to HK\$1,212mn for 2012 and HK\$1,487mn for 2013, up from HK\$1,054mn and HK\$1,212mn.
- Meanwhile, the company's accelerating diversification in chipset platforms and operating systems (Android/WinMo) would also drive higher R&D investments. We raise our assumptions to HK\$564mn for 2012 and HK\$736mn for 2013, up from HK\$547mn and HK\$636mn.
- As a result, our operating margin projections fall to 7.7% and 7.3%, from 8.7% and 9.0%.

We introduce our 2014 EPS estimate of HK\$1.19 (+25% YoY).

Price Target Discussion

We cut our PT to HK\$5.70 to discount the earnings estimate revisions. The new price target is based on our US-GAAP residual income model with a 9% medium-term growth rate (down from the previous 10%) and 4% terminal growth rate (unchanged). We continue to assume an average cost of equity of 10%, as we employ for other downstream companies.

Risks to Our Price Target

- 1) Prolonged macro weakness, leading to further deterioration of end demand;
- 2) Faster ASP erosion in low-cost phones, which could nullify the company's cost-cutting efforts;
- 3) Chinese/European telco operators postpone or reduce procurements of low-priced 3G Android phones.

Each of these risks could lead to changes in earnings forecasts and thus our price target.

April 13, 2012

TCL Communication Technology

Exhibit 1

TCL Communication, 2010-2013E

HKD mn	1Q11	2Q11	3Q11	4Q11	1Q12E	2Q12E	3Q12E	4Q12E	2010	2011	2012E	2013E
Net Sales	2,124	2,476	2,862	3,191	1,961	3,112	4,173	4,797	8,701	10,653	14,043	18,037
COGS	-1,651	-1,935	-2,265	-2,474	-1,564	-2,488	-3,338	-3,787	-6,752	-8,325	-11,178	-14,318
Gross profit	473	541	597	717	396	624	835	1,010	1,948	2,328	2,865	3,719
Operating expenses	-259	-295	-334	-516	-276	-405	-515	-584	-1,140	-1,403	-1,779	-2,408
- Promotion	-166	-224	-218	-258	-183	-276	-369	-384	-620	-866	-1,212	-1,487
- ADM	-114	-134	-137	-173	-105	-158	-158	-173	-436	-558	-594	-861
- R&D	-90	-105	-86	-179	-99	-125	-125	-216	-357	-459	-564	-736
- Other Rev/Exp	-5	-1	-20	-2	-4	-2	-29	-4	-5	-28	-38	-46
- Other Opt. Income	115	169	128	97	115	156	167	192	278	508	629	721
Operating profit	214	247	263	201	121	220	320	426	808	925	1,087	1,311
Non-operating income	-31	-29	-39	-43	-43	-43	-43	-43	-63	-141	-171	-171
Pre-tax profit	183	218	224	158	78	177	278	383	745	783	916	1,140
Income tax	-3	-6	-9	36	-5	-12	-19	-27	-43	17	-64	-80
Minority	0	0	0	-1	0	0	0	0	0	-1	0	0
Net profit	180	211	215	194	73	164	258	357	702	800	852	1,060
Reported EPS (HKD)	0.16	0.19	0.19	0.17	0.07	0.15	0.23	0.32	0.65	0.72	0.76	0.95
Margins												
Gross margin	22.3	21.9	20.9	22.5	20.2	20.1	20.0	21.1	22.4	21.9	20.4	20.6
Operating margin	10.1	10.0	9.2	6.3	6.2	7.1	7.7	8.9	9.3	8.7	7.7	7.3
Pre-tax margin	8.6	8.8	7.8	5.0	4.0	5.7	6.7	8.0	8.6	7.4	6.5	6.3
Net margin	8.5	8.5	7.5	6.1	3.7	5.3	6.2	7.4	8.1	7.5	6.1	5.9
% QoQ												
Sales	-31	17	16	11	-39	59	34	15				
Gross profit	-33	14	10	20	-45	57	34	21				
Operating profit	-20	15	7	-24	-40	82	46	33				
Pre-tax profit	-27	19	3	-29	-51	126	57	38				
Net profit	-28	17	2	-10	-63	126	57	38				
% YoY												
Sales	44	25	33	3	-8	26	46	50	100	22	32	28
Gross profit	62	25	14	2	-16	15	40	41	105	19	23	30
Operating profit	165	11	10	-25	-44	-11	22	112	479	14	17	21
Pre-tax profit	151	6	4	-37	-57	-19	24	142	2,086	5	17	24
Net profit	159	17	7	-23	-60	-22	20	84	2,951	14	6	24

P = preliminary E= Morgan Stanley Research estimates Source: Company data, Morgan Stanley Research. nm=not meaningful.

April 13, 2012

TCL Communication Technology

Exhibit 2

TCT Communications: US GAAP-Adjusted Residual Income Valuation

HK\$ m; Y/E Dec 31	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E
Total Equity	3,244	3,954	4,957	6,045	7,226	8,507	9,896	11,335	12,824	14,364	15,959
Core Net Profit	852	924	1,003	1,088	1,181	1,281	1,390	1,438	1,489	1,541	1,595
Return on Equity	31.9%	28.5%	25.4%	21.9%	19.5%	17.7%	16.3%	14.5%	13.1%	12.0%	11.1%
Beta (Last 60 Mths)	1										
Equity Risk Premium (Rm-Rf)	7%										
Risk Free Rate (Rf)	4%										
Cost of Equity	10%										
Terminal Growth Rate	4%										
Continuing Value Spread	0%										
2012-2021 growth rate	9%										
Residual Income	576	589	594	576	556	534	511	416	318	216	111
Spread	22%	18%	15%	12%	9%	7%	6%	4%	3%	2%	1%
Beginning Equity Capital	2,673										
PV of Forecast Period	2,648										
PV of Continuing Value	1,007										
Equity Value	6,328										
No. of Shares	1,114										
Projected Price (EoY)	5.7										
PER 12e	7x										
PER 13e	6x										

Source: Morgan Stanley Research; E= Morgan Stanley Research estimates

Exhibit 3

TCT Communications: Valuation Comparison

Ticker		Closing	Rating	Price	Market	EPS			Earnings		P/E (X)		P/S (X)		P/B (X)		ROA (%)		ROE (%)		
		Price		Target		Cap	(Local Dollar)			YoY Growth											
		4/12/2012		(Local Dollar)		(US\$ m)	10	11	12E	11	12E	11	12E	11	12E	11	12E	11	12E	11	12E
Handset Brands																					
2618.HK	TCL Comm	3.36	O	5.70	480	0.64	0.72	0.76	12%	6%	5x	4x	0.3	0.3	1.5	1.2	6.1	5.5	32.7	28.8	
0763.HK	ZTE	19.46	O	27.50	7,005	0.94	0.60	1.07	-37%	78%	26x	15x	0.6	0.5	2.6	1.8	2.1	3.1	8.0	13.1	
2498.TW	HTC	520.00	U	360.00	15,067	46.18	72.40	39.95	57%	-45%	7x	13x	1.0	1.2	4.2	4.7	27.9	15.4	69.8	34.7	
AAPL.O	Apple	626.20	O	720.00	590,355	15.15	27.68	46.52	85%	70%	23x	13x	5.5	3.6	4.6	4.8	26.7	29.7	41.7	44.2	
RIMM.O	RIM	13.05	E	NA	6,886	6.34	4.19	-0.22	37%	-36%	3x	-60x	0.4	0.6	0.7	0.7	55.5	-4.9	23.1	-1.1	
NOK1V.HE	Nokia	3.04	U	2.60	14,793	0.61	0.29	-0.20	-52%	-170%	10x	-15x	0.3	0.3	1.2	1.4	2.9	-2.2	8.2	-7.5	
Handset EMS/ODM/Component																					
2038.HK	FIH	5.03	E	5.20	4,621	-0.03	0.01	0.03	-133%	183%	NM	NM	0.7	0.6	1.2	1.1	1.3	3.3	2.0	5.3	
3008.TW	Largan	558.00	E	580.00	2,534	30.15	38.76	37.51	29%	-3%	14x	15x	4.7	4.1	3.8	3.3	23.7	19.2	28.7	23.8	
2018.HK	AAC Acoustic	23.95	O	25.00	3,078	0.80	0.84	1.28	5%	52%	23x	15x	5.9	4.3	3.6	4.0	16.9	21.2	23.1	29.3	
3311.TW	Sillitech	67.90	O	85.00	416	8.14	7.43	6.95	-9%	-7%	9x	10x	0.9	0.9	1.9	2.1	9.9	8.9	21.6	19.0	
China Telco																					
2454.TW	Mediatek	278.00	E	245.00	10,297	28.31	12.37	11.82	-56%	-4%	22x	24x	3.5	3.5	2.9	2.7	10.1	9.7	12.5	11.9	
SPRD.O	Spreadtrum	16.74	O	26.50	107	1.29	2.48	2.35	100%	-7%	7x	7x	0.2	0.1	3.0	1.7	20.4	15.2	50.6	31.7	
QCOM.O	Qualcomm	66.23	O	78.00	113,973	2.19	2.83	3.27	32%	18%	23x	20x	7.6	5.8	3.0	3.4	14.1	14.1	20.0	18.8	
GOOG.O	Google	635.96	E	590.00	209,404	26.31	29.76	32.18	14%	10%	21x	20x	7.2	6.0	3.6	2.9	14.7	13.2	18.7	16.5	
MSFT.O	Microsoft	30.35	O	37.00	256,870	2.11	2.70	2.65	23%	-3%	11x	11x	3.7	3.5	3.8	3.7	23.0	19.0	43.0	34.8	

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Source: Morgan Stanley Research; E= Morgan Stanley Research estimates



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Global Stock Ratings Distribution

(as of March 31, 2012)

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April 13, 2012

TCL Communication Technology

Stock Rating Category	Coverage Universe		Investment Banking Clients (IBC)		
	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	1105	38%	465	43%	42%
Equal-weight/Hold	1242	42%	471	43%	38%
Not-Rated/Hold	101	3%	26	2%	26%
Underweight/Sell	478	16%	126	12%	26%
Total	2,926		1088		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Not-Rated (NR) - Currently the analyst does not have adequate conviction about the stock's total return relative to the relevant country MSCI Index on a risk-adjusted basis, over the next 12-18 months.

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.

Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

Analyst Industry Views

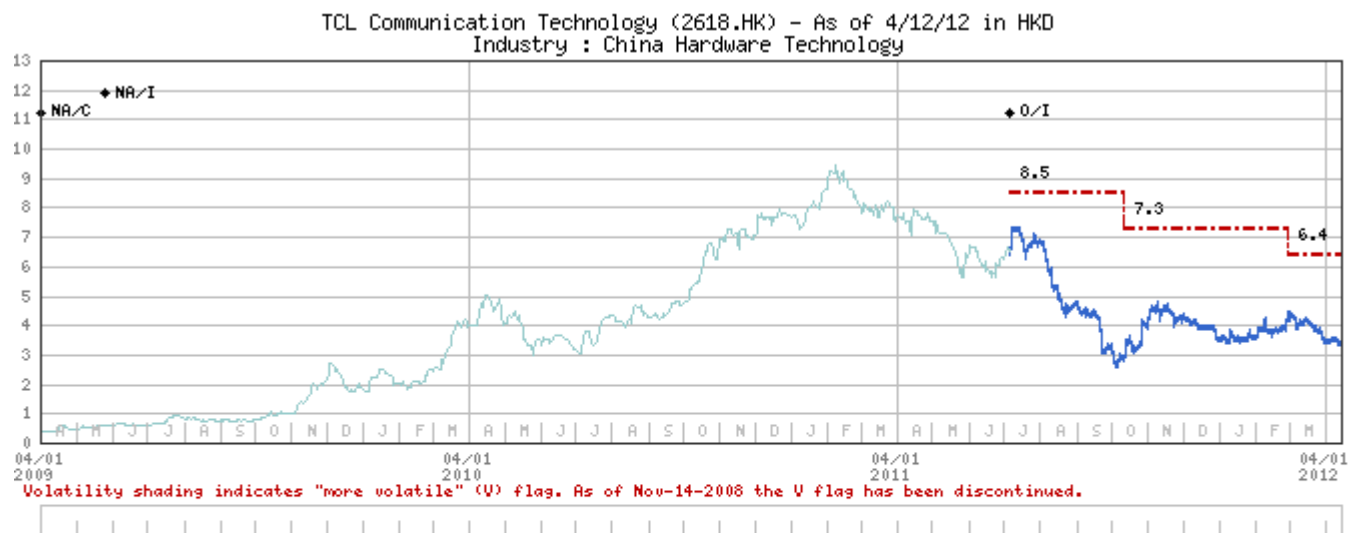
Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 4/1/09 : NA/C; 5/25/09 : NA/I; 7/6/11 : O/I

Price Target History: 7/6/11 : 8.5; 10/11/11 : 7.3; 2/28/12 : 6.4

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target -- No Price Target Assigned (NA)
 Stock Price (Not Covered by Current Analyst) — Stock Price (Covered by Current Analyst) —
 Stock and Industry Ratings (abbreviations below) appear as ♦ Stock Rating/Industry View
 Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) More Volatile (V) No Rating Available (NA)
 Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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April 13, 2012

TCL Communication Technology

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Industry Coverage: China Hardware Technology

Company (Ticker)	Rating (as of)	Price* (04/12/2012)
Grace Chen		
Digital China Holdings Limited (0861.HK)	O (01/26/2010)	HK\$16.1
Lenovo (0992.HK)	O (09/10/2010)	HK\$7.31
Tim Hsiao		
BYD Company Limited (1211.HK)	E (03/02/2012)	HK\$21.45
China Wireless Technologies (2369.HK)	E (07/06/2011)	HK\$1.24
Comba Telecom System Holdings Ltd. (2342.HK)	E (03/14/2012)	HK\$4.35
TCL Communication Technology (2618.HK)	O (07/06/2011)	HK\$3.36
ZTE Corporation (0763.HK)	O (07/06/2011)	HK\$19.46

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