

CREDIT OPINION

18 October 2019

Update

✓ Rate this Research

RATINGS

Sparebanken Sogn og Fjordane

Domicile	Norway
Long Term CRR	A1
Type	LT Counterparty Risk Rating - Fgn Curr
Outlook	Not Assigned
Long Term Debt	Not Assigned
Long Term Deposit	A2
Type	LT Bank Deposits - Fgn Curr
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Sparebanken Sogn og Fjordane

Update to Credit Analysis

Summary

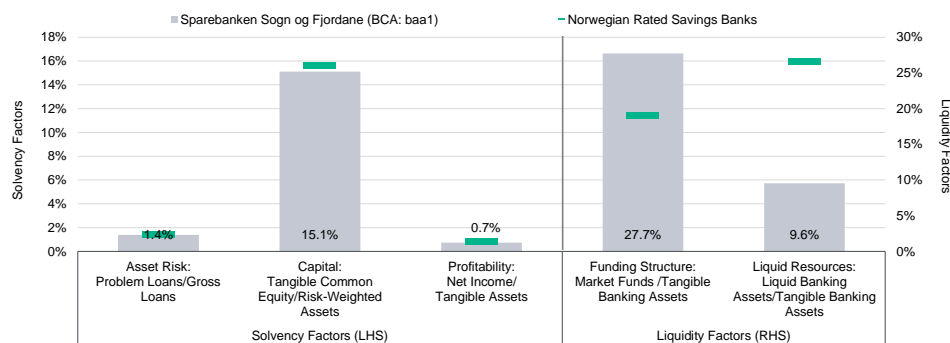
Sparebanken Sogn og Fjordane's (SSF) baseline credit assessment (BCA) of baa1 and long-term deposit and issuer ratings of A2, are driven by the bank's relatively strong financial fundamentals on the back of its expanding retail regional franchise (mainly in the county of Sogn og Fjordane), but also by the adequate protection provided to the bank's senior creditors.

SSF's standalone BCA of baa1 reflects the bank's Very Strong - operating environment, with problem loan levels at relatively low levels (problem loans equivalent to 1.4% of gross loans at end-June 2019), strong capital metrics with a Common Equity Tier 1 (CET1) ratio of 14.8%, but also its relatively high reliance on the domestic capital markets. Our assessment of the bank also incorporates some single name, geographic and real estate credit concentrations, which could result in higher provisioning requirements in a deteriorating operating environment, although we expect SSF's large residential mortgage portfolio (comprising around 75% of total loans) to remain resilient.

The bank's A2 long-term deposit and issuer ratings incorporate two notches of rating uplift from the bank's baa1 standalone BCA based on our Advanced Loss Given Failure (LGF) analysis. LGF takes into account the risks faced by the different debt and deposit classes across the liability structure should the bank enter into resolution. In SSF's case, depositors and senior creditors are protected from sufficiently subordinated funding resulting in the two notches rating uplift.

Exhibit 1

Rating Scorecard - Key Financial Ratios



Note: * average of other Moody's rated Norwegian savings banks
 Source: Moody's Financial Metrics

Credit strengths

- » Sparebanken Sogn og Fjordane's BCA is supported by its Very Strong- Macro Profile
- » Capital levels are strong, although higher requirements would challenge the bank
- » Problem loans are relatively low, although marginally increased
- » Sound recurring profitability supports the bank's BCA

Credit challenges

- » Asset quality could be vulnerable to some single name, geographic and real estate credit concentrations
- » Market funding reliance renders the bank vulnerable to fluctuations in investor sentiment, despite a large deposit base

Outlook

The stable outlook on the bank's ratings reflects our view that its underlying financial fundamentals will remain broadly resilient over the next 12-18 months, supporting its current ratings.

Factors that could lead to an upgrade

- » Upward rating pressure could develop if SSF demonstrates (1) sustained strong asset quality in its retail and corporate loan books, including in the more volatile segments, and further reduction in credit concentrations; (2) stronger earnings generation without an increase in its risk profile; and (3) broader shareholder base and capital structure that will improve its capacity to raise new capital if needed.

Factors that could lead to a downgrade

- » Future downward rating pressure would emerge if (1) SSF's risk profile increases as a result of increased concentration, for example if construction and real-estate concentration or top-20 client concentration as a percent of Core Tier 1 Capital exceeds 150% or if the problem loan ratio increases above 2%; (2) financing conditions become more difficult locally, from where the bank raises most of its funding;

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Key indicators

Exhibit 2

Sparebanken Sogn og Fjordane (Consolidated Financials) [1]

	06-19 ²	12-18 ²	12-17 ²	12-16 ²	12-15 ²	CAGR/Avg. ³
Total Assets (NOK Billion)	56.4	54.2	51.8	49.3	45.9	6.0 ⁴
Total Assets (USD Million)	6,611.2	6,256.6	6,338.9	5,727.8	5,189.7	7.2 ⁴
Tangible Common Equity (NOK Billion)	4.5	4.4	4.1	3.7	3.4	8.1 ⁴
Tangible Common Equity (USD Million)	527.3	509.1	496.6	435.3	386.5	9.3 ⁴
Problem Loans / Gross Loans (%)	1.4	1.3	1.1	0.7	1.1	1.1 ⁵
Tangible Common Equity / Risk Weighted Assets (%)	15.1	15.3	15.2	14.4	13.5	14.7 ⁶
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	14.2	13.0	11.6	7.4	11.9	11.6 ⁵
Net Interest Margin (%)	1.6	1.6	1.7	1.6	1.7	1.6 ⁵
PPI / Average RWA (%)	2.2	2.1	2.2	2.0	1.8	2.1 ⁶
Net Income / Tangible Assets (%)	0.8	0.8	0.7	0.6	0.5	0.7 ⁵
Cost / Income Ratio (%)	42.8	43.8	44.5	44.8	46.7	44.5 ⁵
Market Funds / Tangible Banking Assets (%)	27.4	27.7	27.8	28.4	29.4	28.2 ⁵
Liquid Banking Assets / Tangible Banking Assets (%)	11.6	9.6	11.4	11.9	12.2	11.3 ⁵
Gross Loans / Due to Customers (%)	184.5	188.6	177.6	172.3	174.7	179.5 ⁵

[1]All figures and ratios are adjusted using Moody's standard adjustments. [2]Basel II; IFRS. [3]May include rounding differences due to scale of reported amounts. [4]Compound Annual Growth Rate (%) based on time period presented for the latest accounting regime. [5]Simple average of periods presented for the latest accounting regime. [6]Simple average of Basel II periods presented.

Source: Moody's Investors Service; Company Filings

Profile

Sparebanken Sogn og Fjordane (SSF) is the largest bank in the county of Sogn og Fjordane and offers retail and corporate customers products in banking, financing, insurance, savings, pensions and payment services. SSF's main geographical market is Sogn og Fjordane in western Norway, but the bank has expanded the scope of its retail operations to include several larger cities around Norway, with around 43% of its retail lending spread outside the county of Sogn og Fjordane. The bank has been growing its market share in its home region having a strong positioning among SMEs, and was ranked second among all banks nationally in a customer satisfaction index (EPSI) in 2019. As of 30 June 2019, the bank reported total consolidated assets of around NOK56 billion (\$6.6 billion).

Detailed credit considerations

SSF's BCA is supported by its Very Strong- Macro Profile

As a domestically focused bank, SSF's Macro Profile is aligned with that of Norway at Very Strong-. Banks in [Norway](#) (Aaa stable) reflect the oil rich nation's economic resilience, which is bolstered by countercyclical mechanisms that provide support when global oil prices go down. Norwegian banks benefit from operating in a wealthy and developed country with very high economic, institutional and government financial strength, as well as very low susceptibility to adverse events. The main risks to the banking sector stem from Norway's high household indebtedness, elevated real-estate prices, and extensive use of market funding by the domestic banks. At the moment these risks are mitigated by the household sector's strong ability to service debt and by the Norwegian government's well coordinated monetary and regulatory policies. Additional supporting factors are the country's sizeable sovereign wealth fund that is able to support the economy in the event of financial crisis.

Problem loans are relatively low, although marginally increased with to some single name, geographic and real estate credit concentrations

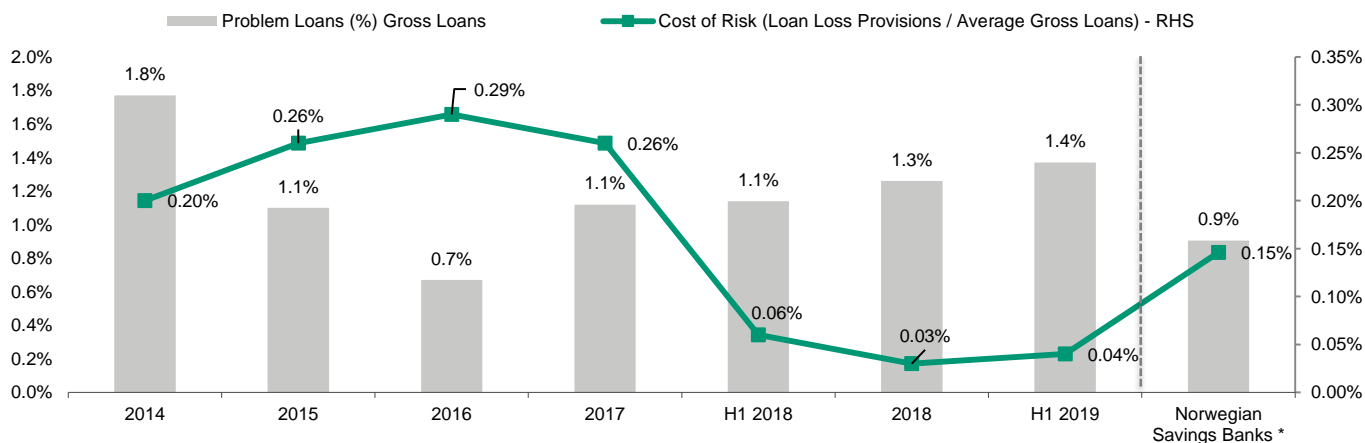
We expect SSF's asset quality to remain broadly resilient in the next twelve months, supported by the increased granularity and lower top client concentration in the bank's loan book stemming from its high allocation to mortgages (approximately 75% of gross lending was to the retail market as of end-June 2019), a market segment with low delinquencies and losses historically. SSF has been growing its retail book more actively outside its home county (in Hordaland and Oslo/Akershus) driven by lower population growth in Sogn og Fjordane compared to other regions. Despite the risks of managing this more diverse portfolio, the bank's expanding loan book outside its home region confers some benefits to its credit risk profile in terms of geographical diversification.

The bank's problem loans as a percentage of gross loans were at 1.4% at end-June 2019 up from 1.1% in June 2018, which is relatively low in the global context although marginally higher than domestic similarly-rated peers (see Exhibit 3) reflecting increases in defaults in both its retail and corporate book. The bank's problem loans coverage ratio was 44% at end-June 2019, while credit costs (loan loss provisions as a percentage of average gross loans) declined slightly to 0.04% in the first half of 2019 compared to 0.06% basis points in the same period last year.

Exhibit 3

SSF's Asset Quality Evolution

The bank's problem loans are somewhat elevated, cost of risk is however low and compares well with peers



Note: * average of other Moody's rated Norwegian savings banks
Source: Moody's Banking Financial Metrics

The bank's retail portfolio, mainly comprising of mortgages with an average loan-to-value (LTV) of around 57% in June 2019, has performed well in the past and we expect it to remain resilient, although we note an increase in defaults to 0.32% of gross loans in June 2019 from 0.17% in June 2018. Despite the risks stemming from an elevated level of household indebtedness in Norway, we expect households to continue to service their debts as unemployment remains very low (Sogn og Fjordane has one of the lowest registered unemployment rates at 1.5% compared to 2.3% for Norway in August 2019) and interest rates (although increasing) are still at low levels and manageable.

SSF's corporate credit risk profile is higher, with loans in default at 0.9% in June 2019 from 0.77% in June 2018, while exposure to the more volatile real-estate and construction sectors stood at around 10.4% of total loans as of end-June 2019. We note that around half of nonperforming loans to corporates are related to the construction and real estate sectors. Similar to most of its Nordic peers, the bank exhibits certain single-name concentrations, which could heighten the pace and the extent of any deterioration in asset quality in a potential worsening operating environment. However, we recognise the bank's efforts to reduce its single name concentrations over the past years (top 20 exposures decreased to 100% of CET1 capital in June 2019 from 111% in 2015), which we view positively because it makes its credit risk profile less vulnerable to potential problems arising in one exposure.

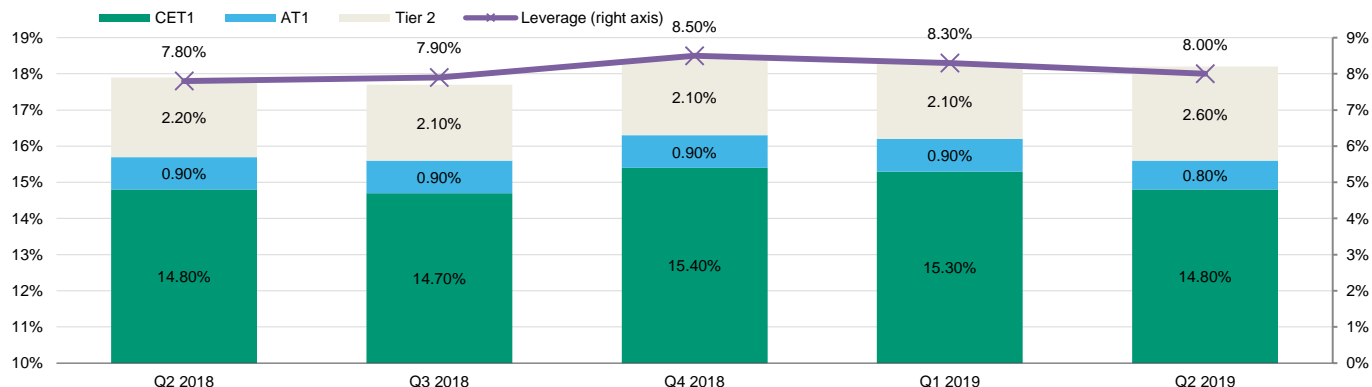
Our baa2 score for the bank's asset risk takes into account the relatively low level of problem loans, but also the slightly higher level of problem loans than its domestic peers and some single name, geographic and real estate credit concentrations.

Capital levels are strong, although higher requirements would challenge the bank

We consider SSF's capital levels as strong for the bank's risk profile and broadly in line with its Norwegian peers. The bank's tangible common equity to risk-weighted assets (as calculated by Moody's) was at 15.1% as of end-June 2019, from 15.3% at the end of 2018. SSF reported a CET1 ratio of 14.8% at end-June 2019 (see Exhibit 4), which increases to 15.3% including half-year less a proportionate share of expected dividends. Accordingly, the bank meets its regulatory minimum CET1 capital requirement of 13.9%, which comprises of 12% in Pillar 1 and 1.9% in Pillar 2.

Exhibit 4

SSF's regulatory capital ratios evolution



Source: SSF's Q3 2019 investor presentation

Nonetheless, we note that the bank would be challenged to meet the increasing capital requirements that are likely to be implemented in the next two years, and maintain its current dividend payment policy (of around 40%) and capital management buffer of 1%. At the end of 2019, the countercyclical buffer will increase to 2.5% from 2% and the systemic risk buffer will likely increase to 3.5% in 2020 to be phased-in to 4.5% by 2022 from 3% (pending approval from the Ministry of Finance).

In effect, there will be an overall increase in the bank's capital requirements of about 200 basis points to 15.9%, while the benefit that the bank will get from the CRD IV/CRR implementation through the SME discount is significantly lower. It should be noted that SSF is on the standardised model in calculating its risk-weighted assets (RWAs) and thus will not benefit from the upcoming removal of the 80% Basel I floor, which will give an RWA relief to IRB-model banks only.

Our assigned Capital score of a1 reflects the bank's capital metrics (Tier 1 of 15.6% and capital adequacy ratio of 18.2% in June 2019) and leverage (8% in June 2019), but also its limited shareholder investor base and capital structure that contains its ability and capacity to raise new capital if needed.

Sound recurring profitability supports the bank's BCA

SSF's recurring profitability is sound and has marginally improved year-on-year as of June 2019, driven mainly by higher net interest income coupled with lower credit costs. The bank's annualised reported Return on Equity (ROE) increased to 10.4% in the first half of 2019 from 10.2% in the same period last year, while its return on average assets was 0.88% in June 2019 compared to 0.84% in June 2018, a trend we expect to continue in the second half of the year.

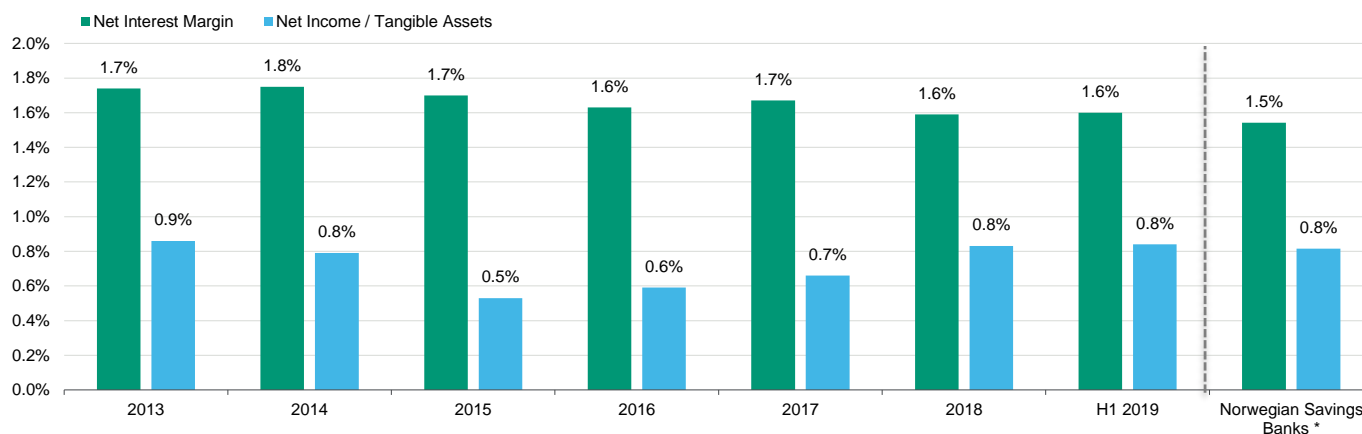
In the first half of 2019, the bank's reported net interest margin improved slightly to 1.64% (see Exhibit 5) from 1.62% in the first six months of 2018, as a result of higher customer deposit margins and corporate lending margins combined with some pressure in retail lending margins. The bank's revenues were supported by robust loan growth, with lending to retail clients growing year-on-year by 5.4% and to the corporate market by 6.5% at end-June 2019.

As a result, the bank's return on tangible assets was 0.8% for the first half of 2019 (excluding one-offs, 0.7% is the three-year average we use in our scorecard), at similar level compared to 2018 and to other Norwegian Savings banks' performance. That said, we note the relatively low contribution of fees and commissions to the bank's profitability, comprising only around 11% of its total revenues in June 2019. The recent launch of the bank's credit card is likely to provide some traction in this regard.

Exhibit 5

SSF's Profitability Metrics Evolution

Margins are stabilising



Note: * average of other Moody's rated Norwegian savings banks
 Source: Moody's Banking Financial Metrics

Operating expenses increased year-on-year by 9.5% as of end-June 2019, mainly due to the ongoing IT development projects, payment services and cards. IT-related expenses are increasing due to the bank's ambitious investments in new digital solutions in order to offer competitive products to its customers. The NOK241 million operating expenses incurred in the first half of 2019 translated into a reported cost to income ratio (including income from financial instruments) of 42.4%, in line with the 42.3% in the first half of 2018, and below the bank's 2019 target of 45%. Looking ahead, the bank aims to contain its cost-to-income ratio at 41% in 2020.

Credit costs for the bank remained low, with impairments as a percentage of gross loans at only 0.02% in the first half of 2019, compared to 0.03% in June 2018, and significantly below the historical yearly average of the bank of 0.2% over the last five years.

Market funding reliance renders the bank vulnerable to fluctuations in investor sentiment, despite a large deposit base

SSF's funding profile benefits from a sizeable deposit base constituting 52% of non-equity funding at end-June 2019 while more than 60% of the bank's deposits come from retail customers and have been stable over the years. However it is also significantly reliant on market funding, rendering it vulnerable to swings in investor sentiment. The bank draws most of this funding in the form of domestically-issued senior debt and covered bonds. Covered bonds are issued through the bank's wholly-owned covered bond company Bustadkreditt Sogn og Fjordane AS that was established in 2009.

Based on our methodology we reflect the stability of covered bonds relative to unsecured market funding through an adjustment to our market funds to tangible banking assets ratio and our adjusted ratio for the bank is 27.7% at end-2018 (27.4% at end-June 2019). Although SSF's size limits somewhat its ability to undertake large benchmark issuances, we view the bank's larger issuances positively, due to their eligibility as liquid assets under the liquidity coverage ratio rules which extends the bank's investor base. We do not expect the bank to issue any senior non-preferred (Tier 3) notes in the next 12 months, given that it is not expected to receive its MREL requirement before sometime in 2020.

We consider the bank's stock of liquid banking assets as broadly adequate. Liquid assets mainly comprised government securities and covered bonds. We note that the bank's holdings are mostly Norwegian covered bonds, which leads to some concentration risk. At the year-end 2018 SSF reported less liquid banking assets totaling 9.6% of tangible banking assets (incorporated in our scorecard) compared to 11.4% as of year-end 2017, due to a decrease in deposits placed at other financial institutions, although the ratio recovered back to 11.6% as of end-June 2019. Concurrently, the bank reported a Liquidity Coverage Ratio (LCR) of 144% at end-June 2019 (128% at year-end 2018), while its net stable funding ratio (NSFR) was also a comfortable 108%.

Environmental, Social, and Governance (ESG) Considerations

In line with our general view for the banking sector, SSF has a low exposure to Environmental risks and low exposure to Social risks. See our Environmental and Social risks [Environmental heatmap](#) for further information.

SSF recently obtained an environmental certification under the Eco-Lighthouse scheme, which is Norway's most widely used certification scheme for enterprises that wish to document their environmental credentials and show corporate social responsibility. The bank believes that the newly developed digital systems will allow it to work systematically and will improve their environmental performance with respect to the working environment, waste management, energy consumption, purchasing and transport. SSF was one of the first few banks to issue an unsecured green bond (NOK300 million in August 2019) in Norway and has hired an individual to lead its ESG-related initiatives, indicating its commitment to sustainable banking.

We also note that SSF has a close relationship to local communities in the county. The Bank returns significant amounts of money to the local community through gifts and sponsorship agreements, which over the years has strengthened its competitive position locally and its client loyalty.

Corporate governance is highly relevant to all banks creditworthiness. Corporate governance weaknesses can lead to a deterioration in a company's credit quality, while governance strengths can benefit its credit profile. Governance risks are largely internal rather than externally driven. We do not have any concerns around SSF's governance and there is no corporate behaviour adjustment in the ratings.

Source of facts and figures cited in this report

Unless noted otherwise, bank specific figures originate from bank's reports and Moody's Banking Financial Metrics. Moody's Banking Financial Metrics figures are based on our own chart of account and may be adjusted for analytical purposes. Please refer to the document: "[Financial Statement Adjustments in the Analysis of Financial Institutions](#)" published on 09 August 2018.

Support and structural considerations

Loss Given Failure

Norway is in the process of transposing the EU Bank Resolution and Recovery Directive (BRRD) into local legislation and as such we consider the country an Operational Resolution Regime. In accordance with our methodology we therefore apply our Advanced LGF analysis, considering the risks faced by different debt and deposit classes across the liability structure should the bank enter resolution.

In our LGF analysis for the bank we use our standard assumptions and assume residual tangible common equity of 3%, losses post-failure of 8% of tangible banking assets, a 25% runoff in "junior" wholesale deposits, and a 5% run-off in preferred deposits. We assign a 25% probability to deposits being preferred to senior unsecured debt.

Under these assumptions, SSF's deposits and senior unsecured debt are likely to face very low loss-given-failure, due to the volume of the deposits and senior debt themselves and the amount of debt subordinated to them. This results in a Preliminary Rating Assessment (PRA) of two notches above the BCA for both the deposit and issuer ratings of the bank.

Government support

We do not incorporate government support uplift to SSF's deposit and issuer ratings as a result of the expected implementation of resolution legislation in Norway. SSF is a regional savings bank with a strong market position in the county of Sogn og Fjordane (Western Norway), where we estimate that it commands a 54% market share in gross lending at end-December 2018. Despite its dominant local position, the bank lacks geographical diversification and its national franchise is limited by a national market share of around 3% as of end-June 2019 (based on total lending nationwide, using Statistics Norway data). We therefore consider the probability of government support for Sparebanken Sogn og Fjordane's debt and deposits to be low (in line with similarly-sized domestic peers), resulting in no ratings uplift.

Counterparty Risk (CR) Assessment

We assign long- and short-term CR assessments of A1(cr) and Prime-1 (cr) respectively to SSF. CR Assessments are opinions of how counterparty obligations are likely to be treated if a bank fails and are distinct from debt and deposit ratings in that they (1) consider only the risk of default rather than the likelihood of default and the expected financial loss suffered in the event of default and (2) apply to counterparty obligations and contractual commitments rather than debt or deposit instruments. The CR Assessment is an opinion of the counterparty risk related to a bank's covered bonds, contractual performance obligations (servicing), derivatives (e.g., swaps), letters of credit, guarantees and liquidity facilities.

SSF's CR Assessment is positioned at A1(cr)/P-1(cr)

SSF's CR Assessment is positioned at A1(cr)/P-1(cr), three notches above the bank's Adjusted BCA of baa1, based on the cushion against default provided by junior deposits, senior unsecured, subordinated debts and preference shares. The bank's CR Assessment does not benefit from any government support, in line with deposits and senior unsecured debt ratings.

Counterparty Risk Ratings (CRRs)

CRRs are opinions of the ability of entities to honour the uncollateralised portion of non-debt counterparty financial liabilities (CRR liabilities) and also reflect the expected financial losses in the event such liabilities are not honoured. CRRs are distinct from ratings assigned to senior unsecured debt instruments and from issuer ratings because they reflect that, in a resolution, CRR liabilities might benefit from preferential treatment compared with senior unsecured debt. Examples of CRR liabilities include the uncollateralised portion of payables arising from derivatives transactions and the uncollateralised portion of liabilities under sale and repurchase agreement.

SSF's CRRs are positioned at A1/P-1

The CRR is positioned three notches above the Adjusted BCA of baa1 and at the same level as the counterparty risk assessment, reflecting the buffer against default provided by more junior instruments to the CRR liabilities.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating methodology and scorecard factors

Exhibit 6

Sparebanken Sogn og Fjordane

Macro Factors

Weighted Macro Profile **Very Strong -** **100%**

Factor	Historic Ratio	Initial Score	Expected Trend	Assigned Score	Key driver #1	Key driver #2
Solvency						
Asset Risk						
Problem Loans / Gross Loans	1.4%	aa2	↔	baa1	Single name concentration	Sector concentration
Capital						
Tangible Common Equity / Risk Weighted Assets (Basel II)	15.1%	aa3	↔	a1	Access to capital	
Profitability						
Net Income / Tangible Assets	0.7%	baa2	↔	baa2	Return on assets	
Combined Solvency Score		a1		a3		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	27.7%	baa2	↔	baa3	Market funding quality	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	9.6%	ba2	↔	ba2	Stock of liquid assets	
Combined Liquidity Score		baa3		ba1		
Financial Profile						
				baa1		
Qualitative Adjustments				Adjustment		
Business Diversification				0		
Opacity and Complexity				0		
Corporate Behavior				0		
Total Qualitative Adjustments				0		
Sovereign or Affiliate constraint				Aaa		
Scorecard Calculated BCA range				a3 - baa2		
Assigned BCA				baa1		
Affiliate Support notching				0		
Adjusted BCA				baa1		

Balance Sheet	in-scope (NOK Million)	% in-scope	at-failure (NOK Million)	% at-failure
Other liabilities	19,205	34.1%	22,125	39.3%
Deposits	28,636	50.9%	25,715	45.7%
Preferred deposits	21,191	37.6%	20,131	35.7%
Junior deposits	7,445	13.2%	5,584	9.9%
Senior unsecured bank debt	5,749	10.2%	5,749	10.2%
Dated subordinated bank debt	785	1.4%	785	1.4%
Preference shares (bank)	250	0.4%	250	0.4%
Equity	1,689	3.0%	1,689	3.0%
Total Tangible Banking Assets	56,314	100.0%	56,314	100.0%

Debt Class	De Jure waterfall		De Facto waterfall		Notching		LGF Notching Guidance vs. Adjusted BCA	Assigned LGF notching	Additional Notching	Preliminary Rating Assessment
	Instrument volume + subordination	Sub-ordination	Instrument volume + subordination	Sub-ordination	De Jure	De Facto				
Counterparty Risk Rating	25.0%	25.0%	25.0%	25.0%	3	3	3	3	0	a1
Counterparty Risk Assessment	25.0%	25.0%	25.0%	25.0%	3	3	3	3	0	a1 (cr)
Deposits	25.0%	4.8%	25.0%	15.0%	2	3	2	2	0	a2

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency Rating	Foreign Currency Rating
Counterparty Risk Assessment	3	0	a1 (cr)	0	A1(cr)	
Deposits	2	0	a2	0	A2	A2

[1]Where dashes are shown for a particular factor (or sub-factor), the score is based on non-public information.

Source: Moody's Investors Service

Ratings

Exhibit 7

Category	Moody's Rating
SPAREBANKEN SOGN OG FJORDANE	
Outlook	Stable
Counterparty Risk Rating	A1/P-1
Bank Deposits	A2/P-1
Baseline Credit Assessment	baa1
Adjusted Baseline Credit Assessment	baa1
Counterparty Risk Assessment	A1(cr)/P-1(cr)
Issuer Rating	A2

Source: Moody's Investors Service

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