

Scottish Oriental Smaller Companies

Investment management changes announced

Scottish Oriental Smaller Companies Trust (SST) was launched in 1995, aiming to generate long-term capital growth from a portfolio of small-cap Asian equities (excluding Japan and Australasia). When Wee-Li Hee returns from maternity leave in July 2017, she will assume the role of co-manager; interim lead manager Vinay Agarwal has become lead manager on a permanent basis. SST's board has been strengthened with the March 2017 appointment of Jeremy Whitley as a non-executive director. While the trust's focus on preserving capital led to underperformance versus the benchmark and peers in 2016 (which was a year characterised by strong equity returns), SST's longer-term performance record remains intact. It has outperformed its benchmark and the peer group average over five and 10 years.

12 months ending	Share price (%)	NAV (%)	MSCI AC Asia ex-Japan (%)	MSCI AC Asia ex-Japan Small Cap (%)	FTSE All-Share (%)
31/05/13	56.3	43.1	21.1	31.0	30.1
31/05/14	(11.4)	(4.2)	(2.8)	(6.2)	8.9
31/05/15	12.1	14.7	21.6	24.2	7.5
31/05/16	(11.9)	(6.3)	(13.2)	(16.3)	(6.3)
31/05/17	38.3	34.1	44.8	31.6	24.5

Source: Thomson Datastream. Note: All % on a total return basis in pounds sterling.

Investment strategy: In-depth fundamental research

Lead manager Vinay Agarwal and his team undertake rigorous fundamental analysis, seeking to identify high-quality, small-cap Asian equities that are trading on reasonable valuations. Portfolio turnover is currently higher than historical averages as the new lead manager has reduced the number of holdings from c 100 to c 60; he states that the portfolio reorganisation is nearly complete. The bottom-up investment process means that SST's sector and geographic exposure can deviate significantly versus the benchmark MSCI AC Asia ex-Japan Index. At end-April 2017, SST had a net cash balance of 9.4%; this is higher than average as the manager is waiting for more attractive company valuations before investing.

Market outlook: Attractive relative valuations

Compared with six months ago, Asian equities are trading on a wider forward P/E discount to world equities. This is despite higher forecast medium-term GDP growth in the region (source: IMF). For investors seeking exposure to Asia, a fund focusing on higher-growth, quality small-cap companies may appeal.

Valuation: Scope for discount to narrow

SST's current 11.3% share price discount to cum-income NAV is narrower than the 13.7% average of the last 12 months (range of 10.4% to 16.7%). However, it is wider than the averages of the last three, five and 10 years (range of 7.3% to 10.6%). There is scope for the discount to narrow if SST's near-term relative performance improves or there is higher investor demand for Asian small-cap equities. While focusing on capital growth rather than income, the board aims to at least maintain the level of the annual dividend; SST's current dividend yield is 1.1%.

Investment trusts

2 June 2017

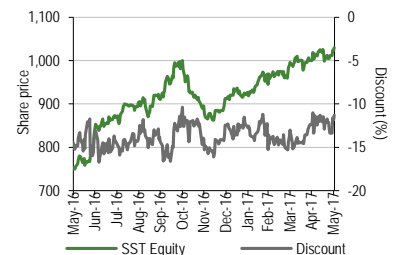
Price 1,030.0p
Market cap £319m
AUM £381m

NAV* 1,161.3p
Discount to NAV 11.3%
NAV** 1,161.4p
Discount to NAV 11.3%

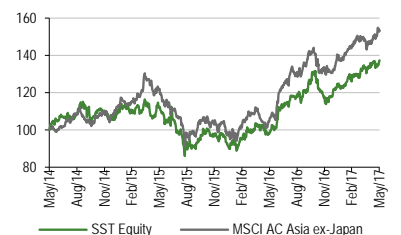
*Excluding income. **Including income. As at 31 May 2017.

Yield 1.1%
Ordinary shares in issue 31.0m
Code SST
Primary exchange LSE
AIC sector Asia Pacific ex-Japan
Benchmark MSCI AC Asia ex-Japan

Share price/discount performance



Three-year performance graph



52-week high/low 1,030.0p 750.0p
NAV* high/low 1,178.0p 869.0p

*Including income.

Gearing

Gross* 5.7%
Net cash* 9.4%

*As at 30 April 2017.

Analysts

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Scottish Oriental Smaller Companies Trust is a research client of Edison Investment Research Limited

Exhibit 1: Trust at a glance

Investment objective and fund background

Scottish Oriental Smaller Companies Trust's objective is to provide shareholders with long-term capital growth through investment in smaller Asian (excluding Japanese and Australasian) quoted companies. Its assets are invested in a diversified portfolio of equities. While the manager takes account of cultural, political and economic factors, stock-specific features are the main driver of portfolio selection, with the aim of identifying good-quality companies with solid long-term growth prospects.

Recent developments

- 1 June 2017: Repayment of £20m five-year fixed-rate loan.
- 27 April 2017: Vinay Agarwal assumes permanent role as lead manager. Former lead manager Wee-Li Hee will return from maternity leave in July as co-portfolio manager.
- 12 April 2017: Interim report for six months ending 28 February. NAV TR +7.7% versus benchmark +10.1%, share price TR +5.8%.
- 6 March 2017: Appointment of Jeremy Whitley as non-executive director.

Forthcoming

AGM	December 2017
Final results	October 2017
Year end	31 August
Dividend paid	February
Launch date	March 1995
Continuation vote	None

Capital structure

Ongoing charges	1.04%
Net cash	9.4%
Annual mgmt fee	0.75%
Performance fee	Yes (see page 7)
Trust life	Indefinite
Loan facilities	None (see page 7)

Fund details

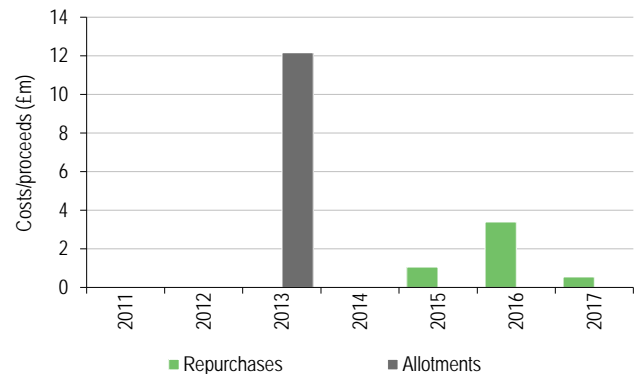
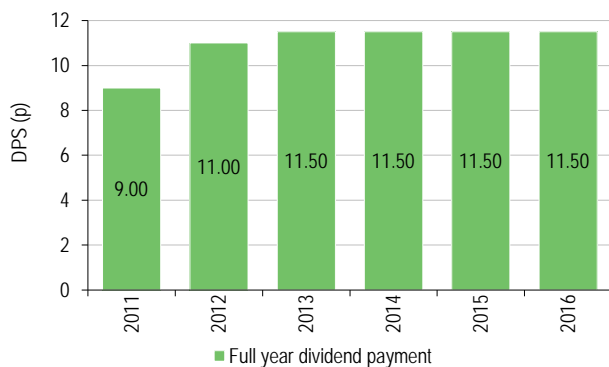
Group	First State Stewart Asia
Manager	Vinay Agarwal
Address	10 St Colme Street, Edinburgh, EH3 6AA
Phone	+44 (0) 131 473 2200
Website	www.scottishoriental.co.uk

Dividend policy and history (financial years)

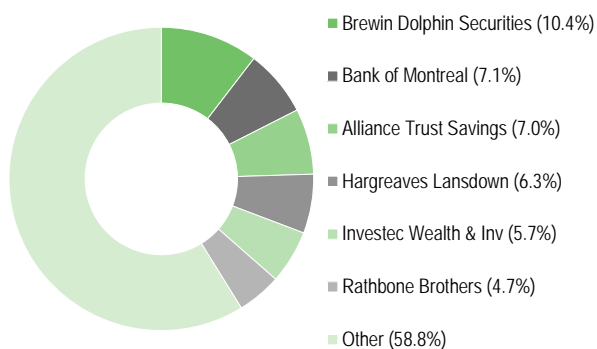
One annual dividend paid in February. The board intends to at least maintain this level of dividend, using reserves if necessary, unless company distributions fall sharply.

Share buyback policy and history (financial years)

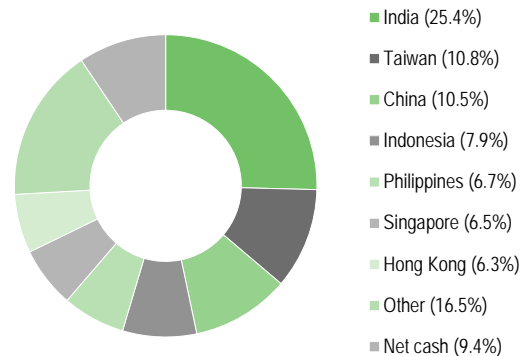
Renewed annually, the board has authority to repurchase up to 14.99% and allot up to 10% of shares outstanding.



Shareholder base (as at 28 April 2017)



Portfolio exposure by geography (as at 30 April 2017)



Top 10 holdings (as at 30 April 2017)

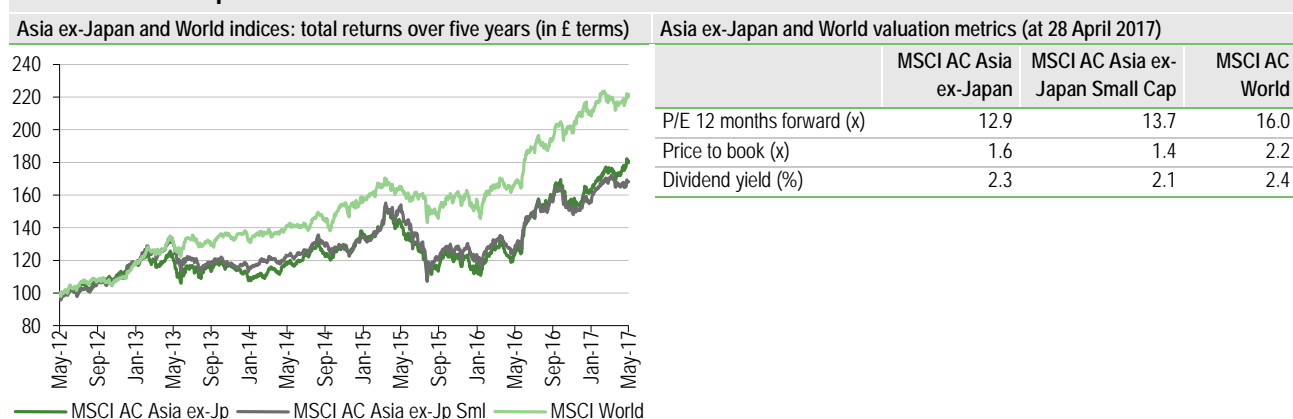
Company	Country	Sector	Portfolio weight %	
			30 April 2017	30 April 2016*
Tong Ren Tang	China	Healthcare	2.9	2.8
SKF India	India	Industrials	2.8	N/A
Blue Star	India	Industrials	2.7	N/A
Delta Electronics	Thailand	Industrials	2.7	N/A
Towngas China	China	Utilities	2.7	2.0
Concepcion Industrial	Philippines	Industrials	2.4	N/A
Godrej Industries	India	Materials	2.4	N/A
Mitra Adiperkasa	Indonesia	Consumer discretionary	2.4	N/A
Vitasoy International	Hong Kong	Consumer staples	2.3	N/A
Delfi**	Singapore	Consumer staples	2.1	2.8
Top 10			25.4	25.8

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in April 2016 top 10. **Formerly Petra Foods.

Market outlook: Relative valuation more attractive

As shown in Exhibit 2 (left-hand side), the total returns from Asian equities (both large and small cap) have trailed those of world equities over the last five years, primarily due to the strength of US equities; the US now represents c 60% of the MSCI World Index. It should be noted that absolute returns from overseas equities for UK-based investors have been meaningfully boosted by sterling weakness since mid-2016. Over the last six months, the relative valuation of Asian versus world indices has become more attractive. At end-October 2016, the 12-month forward P/E multiple discounts of the MSCI AC Asia ex-Japan Index and MSCI AC Asia ex-Japan Small Cap Index versus the MSCI AC World Index were 2.4 points and 1.9 points, respectively. At end-April 2017, they were 3.1 points and 2.3 points, respectively. In its April 2017 World Economic Outlook, the International Monetary Fund (IMF) forecasts GDP growth of 6.4% for emerging and developing Asia for both 2017 and 2018. This is higher than forecasts for world output of 3.5% and 3.6%, respectively. Factors contributing to the higher growth outlook include a rising middle class, high levels of education and relatively low levels of debt. For investors seeking exposure to the Asia-Pacific region, a fund investing in quality, higher-growth small-cap companies may be of interest.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, MSCI, Edison Investment Research

Fund profile: Long-term investment in small-cap stocks

SST was launched in March 1995, aiming to generate long-term capital growth from a portfolio of Asian equities excluding Japan and Australasia. It is managed by First State Stewart Asia (FSSA), which has c £18bn of assets under management. FSSA is an autonomous team within First State Investments, which is owned by Commonwealth Bank of Australia and has c £126bn of assets under management.

The trust generally invests in small-cap stocks (market cap below \$1.5bn at the time of first investment), although up to 20% may be in companies between \$1.5-3.0bn. There are no absolute limits for the size of individual sector or geographic exposure, but no more than 15% of total assets may be invested in any one company or group of companies. Since 2003, SST has been benchmarked against the MSCI AC Asia ex-Japan Index. While not an ideal comparator as it is dominated by larger companies, it is the most widely recognised regional index and pre-dates SST's inception. The MSCI AC Asia ex-Japan Small Cap Index (created in 2007) is also used for comparative purposes as it covers the relevant markets with the exception of Bangladesh, Sri Lanka and Vietnam. Performance versus the FTSE All-Share Index is also considered, given most of SST's shareholders are UK-based. Gearing of up to 50% of net assets is permitted, although in practice it has been much lower. At end-April 2017, SST had a net cash position of 9.4%.

On 27 April 2017, SST announced changes to its investment management arrangements. Current lead manager Vinay Agarwal will continue in his role on a permanent basis; he is based in Singapore. When his predecessor Wee-Li Hee returns from maternity leave in July, she will assume the role of co-portfolio manager and Scott McNab will remain deputy manager; both Hee and McNab are based in Edinburgh. Martin Lau, joint managing partner of First State Stewart Asia, will no longer have a formal role with SST, but will continue to provide company analysis and oversight.

The fund manager: Vinay Agarwal

The manager's view: Waiting for more attractive valuations

The manager comments that the consensus view is that the economic growth outlook in Asia is improving, and suggests that stock markets in the region are already reflecting this as they have continued to appreciate year-to-date. However, he says that so far, he has only observed a few corporate profit upgrades and he is not yet convinced of a broad-based improvement in the earnings growth outlook. Agarwal notes that there have been some important political developments in the region, such as the election of President Moon Jae-in in South Korea following the impeachment and dismissal of incumbent Park Geun-hye, and in India, where Prime Minister Narendra Modi's political party won a landslide victory in India's largest state, Uttar Pradesh.

Agarwal comments that his overall message is similar to that in our [November 2016](#) report; on a bottom-up basis, he is still finding it hard to find quality growth companies on attractive valuations, hence SST's cash position is higher than its historical average. He notes that in recent years earnings have disappointed significantly versus expectations at the start of the year; this was particularly evident in 2015 and 2016 and he suggests that recently reported Q117 earnings are also not particularly exciting.

Asset allocation

Investment process: Bottom-up stock selection

SST employs a bottom-up approach to stock selection; focusing on high-quality companies with robust financials, a sustainable franchise and strong management. The manager has high-conviction positions that he is confident in holding for the long term. SST also aims to preserve capital in both absolute and real terms; hence the manager considers the potential downside as well as upside when making investment decisions. The portfolio is constructed without reference to the benchmark; as a result SST's exposure by sector and geography can differ markedly from that of the MSCI AC Asia ex-Japan Index. As part of the thorough proprietary fundamental research that the manager and his team undertake, they meet with c 1,000 company managements each year. The team focuses on a company's history, as they view this as a more reliable guide to the future than analysts' forecasts. With regard to valuation, the manager prefers to invest in companies that he believes can grow steadily for the foreseeable future, rather than buying companies that are temporarily mispriced. He believes that if he has to pay a slightly higher multiple for a good-quality company, it will likely grow into its valuation over time. However, he will not buy "growth at any price".

Since assuming his position as lead manager in July 2016, Agarwal has been reducing the number of holdings, while adopting broadly the same investment strategy as the previous lead manager. As a result, portfolio turnover is currently running at an annual rate of c 50%, which is around double the historical average; however, the manager says that the portfolio restructuring is now largely complete. The number of positions has been reduced from more than a 100 and is now in the low 60s. The manager has been selling some of the smaller positions and companies that are

reasonably valued but have low growth prospects. As stock markets have been very strong over the last year, Agarwal states that it has been easier to sell positions than to buy, hence the net cash level is higher than average. He is waiting for the chance to buy companies that can be held for the next 10 years, and argues that a number of newer holdings may be topped up to bigger positions if their share prices fall by 15-20%.

Current portfolio positioning

At end-April 2017, the top 10 positions comprised 25.4% of SST's portfolio, which was broadly similar to end-April 2016; three holdings were common to the top 10 in both periods.

Exhibit 3: Portfolio sector exposure vs Asia ex-Japan indices (% unless stated)						
	Portfolio end-April 2017	Portfolio end-April 2016	Benchmark weight	Active weight vs benchmark (pp)	MSCI AC Asia ex-Japan Small Cap	Active weight vs small-cap index (pp)
Industrials	17.8	13.4	7.9	9.9	14.7	3.1
Consumer staples	15.2	19.1	4.6	10.6	5.2	10.0
Consumer discretionary	15.1	16.3	9.6	5.5	18.3	(3.2)
Information technology	10.1	12.1	29.1	(19.0)	18.2	(8.1)
Financials	7.8	12.9	23.5	(15.7)	8.8	(1.0)
Healthcare	6.9	7.8	2.2	4.7	8.9	(2.0)
Utilities	6.5	3.3	3.3	3.2	2.5	4.0
Materials	6.1	5.2	4.6	1.6	9.0	(2.9)
Real estate*	3.0	N/A	6.0	(3.0)	11.7	(8.7)
Telecom services	2.1	3.3	5.1	(3.0)	1.0	1.1
Energy	0.0	0.7	4.3	(4.3)	1.6	(1.6)
Net cash	9.4	5.9	0.0	9.4	0.0	9.4
	100.0	100.0	100.0		100.0	

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research. Note: *Before 1 September 2016, real estate exposure was included in the financials sector.

Exhibits 3 and 4 showing SST's sector and geographic exposure are for illustrative purposes only as its portfolio is constructed on a bottom-up basis without regard for benchmark weightings. Of note are SST's high exposure to the consumer sectors (c 30%) and India (c 25%).

Exhibit 4: Portfolio geographic exposure vs benchmark (% unless stated)						
	Portfolio end-April 2017	Portfolio end-April 2016	Change (pp)	Benchmark weight	Active weight vs benchmark (pp)	Trust weight/benchmark wgt (x)
India	25.4	22.7	2.7	10.3	15.1	2.5
Taiwan	10.8	13.3	(2.5)	14.3	(3.5)	0.8
China	10.5	15.9	(5.4)	31.5	(21.0)	0.3
Indonesia	7.9	3.5	4.4	2.9	5.0	2.7
Philippines	6.7	2.2	4.5	1.4	5.3	4.8
Singapore	6.5	16.2	(9.7)	4.5	2.0	1.4
Hong Kong	6.3	6.5	(0.2)	12.2	(5.9)	0.5
Sri Lanka	5.4	2.9	2.5	0.0	5.4	N/A
Thailand	4.6	4.0	0.6	2.6	2.0	1.8
South Korea	3.3	4.0	(0.7)	17.4	(14.1)	0.2
Malaysia	1.4	2.9	(1.5)	2.9	(1.5)	0.5
Bangladesh	1.2	0.0	1.2	0.0	1.2	N/A
Vietnam	0.6	0.0	0.6	0.0	0.6	N/A
Net cash	9.4	5.9	3.5	0.0	9.4	N/A
	100.0	100.0		100.0		

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research

New purchases in the portfolio include Jubilant Foodworks, which the manager has monitored for a long time. The company has exclusive rights to operate the Domino's Pizza brand in India, Nepal, Bangladesh and Sri Lanka (c 1,000 stores versus c 500 in 2012) and it also has c 70 Dunkin' Donuts franchises in India. Due to Jubilant's aggressive expansion over the last five years, its net margins fell from c 10% to less than 4%, which caused its share price to practically halve between mid-2015 and late-2016. Given its depressed earnings, Jubilant's forward P/E multiple of c 75x looks expensive, but the manager says that its EV/sales multiple of c 2.5x is very attractive

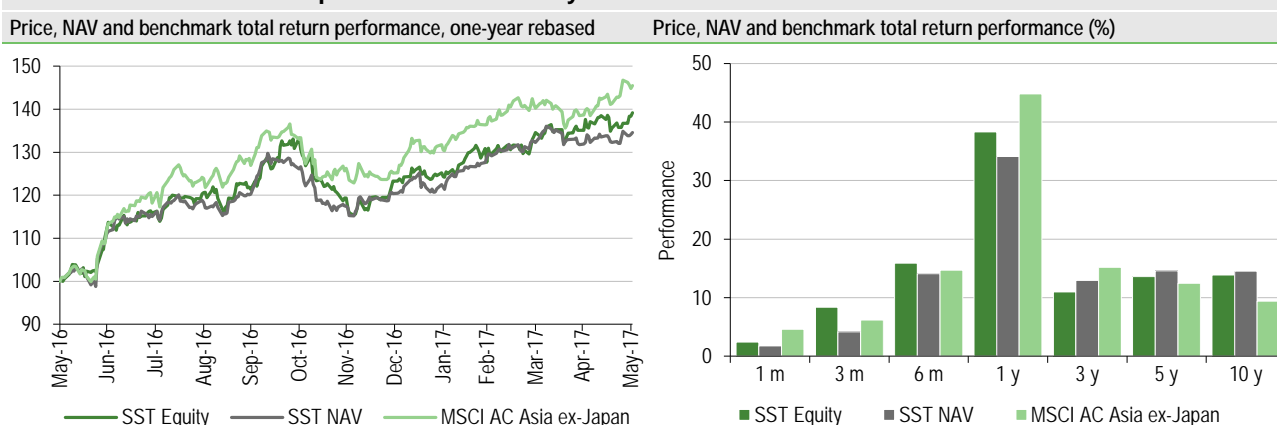
compared to other Domino's listed businesses that are trading on EV/sales multiples of 4-5x. Agarwal suggests that Jubilant can double or treble sales over the next five to seven years and can increase its margins, providing the scope for the shares to re-rate higher.

Performance: Outperformance over five and 10 years

As shown in Exhibit 5 (right-hand side), over the last 12 months absolute returns have been particularly strong, boosted by sterling weakness. SST's share price and NAV total returns of 38.3% and 34.1%, respectively, have trailed the benchmark's 44.8% total return, but are ahead of the 31.6% total return of the MSCI AC Asia ex-Japan Small Cap Index. The manager comments that large-cap technology stocks have performed strongly over the period (technology is the largest sector in the benchmark) and SST is unable to gain similar exposure in its small-cap fund.

Considering SST's longer-term track record, since inception on 28 March 1995 to end-March 2017 the trust has outperformed the MSCI AC Asia ex-Japan Index in 55% of months (36% of months when the market rallied and 77% where the market fell). Given that SST outperforms more frequently in a down market, the manager suggests it is not surprising that the trust lagged the performance of the benchmark over the last 12 months, a period characterised by strong equity returns (in local as well as sterling-adjusted terms).

Exhibit 5: Investment trust performance to 31 May 2017



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures annualised.

SST's relative returns are shown in Exhibit 6; its NAV total return has outperformed the benchmark over five and 10 years, while lagging over one and three years. Of interest to UK shareholders, SST has meaningfully outperformed the FTSE All-Share Index over one, three, five and 10 years.

Exhibit 6: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to MSCI AC Asia ex-Japan	(2.1)	2.1	1.0	(4.5)	(10.6)	5.3	49.6
NAV relative to MSCI AC Asia ex-Japan	(2.7)	(1.9)	(0.5)	(7.4)	(5.7)	9.9	58.4
Price relative to MSCI AC Asia ex-Japan Small Cap	0.9	6.8	5.2	5.1	(0.1)	12.6	76.9
NAV relative to MSCI AC Asia ex-Japan Small Cap	0.3	2.6	3.5	1.9	5.4	17.6	87.3
Price relative to FTSE All-Share	(1.9)	3.0	2.1	11.1	9.0	6.6	114.2
NAV relative to FTSE All-Share	(2.5)	(1.0)	0.5	7.7	15.0	11.3	126.8

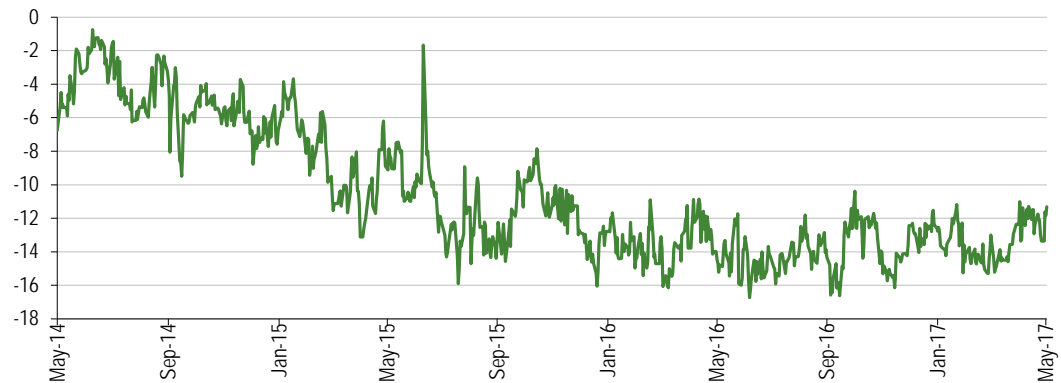
Source: Thomson Datastream, Edison Investment Research. Note: Data to end-May 2017. Geometric calculation.

Discount: Remains wider than longer-term averages

SST's current 11.3% share price discount to cum-income NAV is narrower than the 13.7% average of the last 12 months. Over the last year the discount has ranged from 10.4% to 16.7% (16.7% is the widest discount over the last five years and occurred following the result of the UK's EU

referendum). The current discount is wider than the averages of the last three, five and 10 years (range of 7.3% to 10.6%). As shown in Exhibit 8, SST has a similar discount to its closest peer, the Aberdeen Asian Smaller Companies Investment Trust.

Exhibit 7: Share price premium/discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

SST is a conventional investment trust with one class of share; there are currently 31.0m ordinary shares in issue. The trust has no formal discount control mechanism, but will repurchase shares opportunistically and issue new shares at a modest premium to NAV when in the interests of shareholders. As shown in Exhibit 1, share repurchases have been modest – 0.5m in FY16 at a cost of £3.4m (average price of 713.6p) and so far in FY17, less than 0.1m shares have been repurchased (average price of 898.3p). On 1 June 2017, SST announced that its £20m fixed-rate 3.135% loan with National Australia Bank has been repaid in full out of its cash resources. The manager is waiting for share prices to pull back before investing the balance of SST's cash.

First State Investment Management (UK) is paid an annual management fee of 0.75% of net assets. In addition a performance fee is payable if SST's share price total return exceeds that of the benchmark by 10% over a rolling three-year period. The fee is 10% of the excess return and is capped at 1.5% of net assets. No performance fee was payable for FY16 versus £107k in FY15. For FY16, the ongoing charge was 1.04% versus 1.01% (excluding performance fees) and 1.05% (including performance fees) in FY15.

Dividend policy and record

In FY16, revenue per share of 9.50p was a c 40% decline versus 15.58p in the prior financial year; however, FY15 benefited from a 6.08p special dividend from Asia Satellite Telecom. Excluding this special dividend, year-on-year revenue per share growth was flat. The board desires to increase or maintain the annual dividend, which is paid in February each year, using revenue reserves when necessary. The FY16 annual dividend of 11.50p (83% covered) has been held steady for the last four financial years. At H117 (end-February 2017), the revenue reserve was c 1.8x last year's dividend. Based on the current share price, SST has a dividend yield of 1.1%.

Peer group comparison

SST is a member of the AIC Asia Pacific ex-Japan sector. In Exhibit 8 we show the peers with a market cap above £50m; they have differing mandates including income and small-cap exposure

and only some of the peers are able to invest in Australia. SST's NAV total return is behind the peer group weighted average over one and three years but ahead over five and 10 years, ranking fourth and second respectively out of 15 funds. Its closest peer is Aberdeen Asian Smaller Companies Investment Trust, which has lower NAV total returns than SST over one, three and five years. SST has one of the widest discounts in the group, although it is broadly comparable with its closest peer. It has a below-average ongoing charge, although it is one of only three funds that charge a performance fee. SST is one of four trusts with a net cash position and, befitting its focus on capital growth, its dividend yield is lower than the peer group average.

Exhibit 8: Selected peer group as at 1 June 2017*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Performance fee	Net gearing	Dividend yield (%)
Scottish Oriental Smaller Cos	318.9	34.1	44.2	97.7	288.7	(11.3)	1.0	Yes	91	1.1
Aberdeen Asian Income	388.9	35.8	32.4	58.1	191.6	(6.6)	1.2	No	108	4.5
Aberdeen Asian Smaller	365.9	34.0	35.8	76.6	289.1	(11.5)	1.8	No	109	1.0
Aberdeen New Dawn	257.5	45.9	38.7	65.4	157.9	(12.0)	1.1	No	109	1.8
Edinburgh Dragon	661.3	42.6	44.2	67.1	172.7	(11.3)	1.1	No	107	0.9
Fidelity Asian Values	268.8	36.3	66.7	112.3	188.7	(0.5)	1.3	No	95	1.1
Henderson Far East Income	418.5	32.9	39.3	70.7	131.5	(0.1)	1.2	No	99	5.7
Invesco Asia	225.7	45.7	65.4	111.3	208.0	(9.5)	1.0	No	97	1.4
JPMorgan Asian	304.4	52.2	66.0	92.2	108.4	(10.6)	0.8	No	100	4.0
Martin Currie Asia Unconstrained	139.4	43.0	48.2	64.6	75.2	(11.4)	1.1	No	102	2.0
Pacific Assets	308.8	27.7	52.2	100.6	120.3	2.3	1.3	No	100	1.0
Pacific Horizon	138.9	48.2	49.1	75.0	106.2	(10.3)	1.1	No	106	0.1
Schroder Asia Pacific	681.6	51.7	69.3	96.1	187.9	(10.3)	1.1	No	104	1.2
Schroder Asian Total Return	225.5	41.3	68.2	82.0	132.6	(3.0)	1.0	Yes	104	1.3
Schroder Oriental Income	601.0	31.8	49.8	91.6	192.9	2.1	0.9	Yes	106	3.6
Weighted average		39.9	51.0	84.0	178.9	(6.6)	1.1		103	2.2
SST rank in sector	7	11	10	4	2	12	11		15	11

Source: Morningstar, Edison Investment Research. Note: *Performance data to 31 May 2017. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

SST's board now comprises five directors; all are non-executive and independent of the manager. Chairman James Ferguson and Alexandra Mackesy were appointed in 2004, Dr Janet Morgan in 1995 and Anne West in 2010. The newest member of the board is Jeremy Whitley (appointed March 2017); prior to his appointment he had been head of UK and European equities at Aberdeen Asset Management since July 2009. All five directors hold shares in SST, ensuring that their interests are aligned with other shareholders.

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