



May 10, 2010

AQUA AMERICA INC. (WTR)

Rating: **NEUTRAL**
Current Price: **\$17.39**
Target Price: **NA**

Garik Shmois
T: 216-525-8414
E: gshmois@longbowresearch.com

Industry: Water Utilities								Valuation		Valuation	
Fiscal Year: Dec		1Q10A	2Q10E	3Q10E	4Q10E	FY10E	Multiple	FY11E	Multiple		
Market Cap (\$MM):	2,374	EPS:	\$0.16	\$0.21	\$0.30	\$0.23	\$0.90	19.3x	\$0.95	18.3x	
		Prior:	\$0.15	\$0.20	\$0.31	\$0.22	\$0.88	-			
Net Debt (\$MM):	1,302	Consensus:	\$0.21	\$0.28	\$0.22	\$0.87	20.0x	\$0.96	18.1x		
Enterprise Value (\$MM):	3,676	Last Year:	\$0.14	\$0.19	\$0.25	\$0.20	\$0.77				
Shares - FD (MM):	136.5										
		EBITDA:	\$0.61	\$0.70	\$0.86	\$0.75	\$2.92	9.2x	\$3.10	8.7x	
Dividend:	\$0.58	Growth:	8%	9%	16%	13%	12%	6%			
Yield:	3.3%										
Beta:	0.72	Revenue:	\$161	\$179	\$203	\$186	\$729	5.0x	\$776	4.7x	
Rel. P/E (FY2010E):	139%	Growth:	4%	7%	12%	11%	9%	6%			

WTR: Solid Quarter & Solid Outlook, But Maintaining NEUTRAL

SUMMARY

- WTR reported 1Q10 diluted EPS of \$0.16. Revenues were up 4% y/y, mostly in-line with our expectations.
- Operating expenses only increased 1% y/y, improving the O&M exp/revenue ratio 130bp to 42.1% vs. 43.4% in 1Q09. We were expecting 43.3% for the quarter. The company expects to be toward the upper end of its guidance range for a 50-100bp y/y improvement this year.
- WTR has completed eight acquisitions YTD vs. 18 in all of 2009. Management expects to complete 20-25 acquisitions this year and stated that the M&A environment has indeed become more active.
- WTR has received \$12M in rate increases YTD, has \$65M of rate cases currently pending and plans to file for another \$20M of rate requests in the remainder of 2010. In total, we expect rate increases to add \$48M to revenues in FY10 vs. \$56M in FY09 and \$29M in FY08.
- WTR shares closed Friday at \$17.39, which is 19.3x our FY10E EPS of \$0.90 and 18.3x our FY11E EPS of \$0.95. We are increasing our FY10E EPS to \$0.90, but maintaining our FY11E EPS of \$0.95. We remain NEUTRAL-rated on the shares.

DISCUSSION OF DETAILS

WTR reported 1Q10 diluted EPS of \$0.16. Excluding a \$0.01/share benefit from the sale of investments, adjusted EPS of \$0.15 was in-line with both our estimate and consensus. Revenues increased 4% y/y to \$161M vs. our estimate of \$163M and consensus of \$166M. Operating expenses only increased 1% y/y, improving the O&M exp/revenue ratio 130bp to 42.1% vs. 43.4% in 1Q09. This continues the trend of improving the efficiency ratio for the company. We were expecting 43.3% for the quarter.

- **Improving Efficiency Ratio:** The company expects a 50-100 bp y/y decline in its O&M/revenue ratio in 2010, driven by top-line growth and cost containment, although it admitted that it could come in at the upper end of the range when all is said and done. We believe the company is doing an excellent job in limiting the increase in operating costs, which also gives it more space to increase rates for infrastructure investments. We note that WTR already has the highest efficiency ratio among the large publicly traded water utilities, driven by infrastructure updates that the company has been making over time.
- **Rate Cases:** Year-to date, WTR has received \$12M in rate cases increases, has \$65M of rate cases currently pending and plans to file for another \$20M of rate requests in the remainder of 2010. The ~\$43M rate case in PA is the largest among the pending rate cases and we expect it to be approved in June or July 2010. In total, we expect rate increases to add \$48M to revenues in FY10 vs. \$56M in FY09 and \$29M in FY08.
- **Capex:** Capex for the quarter was \$67M. The company also reiterated its target of \$300M for the year. Almost 90-95% of this is discretionary spending for improving water quality or replacing infrastructure (as opposed to being compliance-driven). This is giving the company greater flexibility with regards to the selection of projects and their timing, with the goal of reducing regulatory lag. Consequently, a large portion of the investment is being made on projects which are eligible for infrastructure surcharges.
- **Acquisition Outlook:** WTR has completed eight acquisitions year-to-date vs. 18 in the whole of 2009 and expects to complete 20-25 acquisitions this year. Overall, the environment for acquisitions is becoming more positive as the EPA is increasing enforcement actions this year after a lull in 2009 and is forcing more cash-strapped utilities to spend on repairs. Also, as the recent AARA funds were mostly distributed through low interest loans, municipal water systems are becoming less optimistic about receiving grants from the federal government (which has usually been the case), forcing them to consider privatization as an option. However, for the next few years, we do not expect more than 1.5-2.0% of customer growth through acquisitions.
- **Water Consumption:** Although there is little variability in water consumption during the winter months, management noted that it is seeing an improvement in demand by commercial and industrial customers and from a reduction in home foreclosures. This bodes well for consumption trends during the summer quarters (2Q and 3Q). We expect increased consumption to contribute \$10M to revenues in 2Q-3Q10 after the \$18M negative impact in 2Q-3Q09.

WTR Summary 1Q10

<i>FY Ends December 31</i>	1Q09A	1Q10A	y/y act.	LBR 1Q10	y/y est.	Actual/LBR
Total Revenue	154.5	160.5	4%	163.5	6%	-2%
Operations & Maintenance	67.0	67.6	1%	70.8	6%	-5%
Depreciation and Amortization	29.1	29.4	1%	29.8	2%	-1%
General Taxes	11.6	12.9	11%	12.3	6%	5%
Total Expenses	107.7	109.8	2%	112.9	5%	-3%
Income from Operations	46.8	50.7	8%	50.6	8%	0%
Other Income & Expenses (net)	0.8	3.5	358%	0.8	11%	314%
EBIT	47.5	54.2	14%	51.4	8%	5%
Interest Expense	16.6	18.4	11%	18.2	10%	1%
Income Before Taxes	30.9	35.7	16%	33.2	7%	8%
Provision for Income Taxes	12.5	14.2	13%	13.3	6%	7%
Net Income	18.4	21.5	17%	19.9	8%	8%
EPS (fully diluted)	0.14	0.16	16%	0.15	8%	8%

Source: Company Reports, LBR Estimates

ESTIMATE REVISIONS

We are increasing our FY10E EPS from \$0.88 to \$0.90 due to the \$0.01 beat in 1Q10 and improved margins offset by a minor change in our expectation of the timing of the rate cases. We are also altering our FY10E and FY11E revenues due to the forecast timing of the rate cases. Our FY10E revenue is now \$729M vs. \$737M prior and our FY11E revenue is now \$776M vs. \$794M prior. Our FY11E EPS remains at \$0.95/share.

INVESTMENT THESIS

We continue to rate WTR shares NEUTRAL. We would potentially become more positive on the shares if we see earnings growth from improved ROEs in systems that were acquired in the southern states in 2003-04 and/or an acceleration of acquisitions. Overall, we see the downside risk potential to WTR as fairly limited as the company is trading at a 21% discount to its historical forward P/E of 23x. While we believe WTR should be valued at a premium given the company's size and operational efficiency (the O&M ratio is currently industry leading), we have difficulty justifying the magnitude of WTR's valuation premium when compared to other names under coverage. We note that the peer group is currently valued at 18.2x FY11E.

VALUATION

WTR shares closed Friday at \$17.39, which is 19.3x our FY10E EPS of \$0.90 and 18.3x our FY11E EPS of \$0.95. The shares are trading at a discount to the company's historical 23x average and normalized range of 20-30x forward P/E.

RISKS

Potential downside risks to our investment thesis and estimates include, but are not limited to: 1) a delay in rate case processing or lower rate increases by the regulators than our expectations, 2) a significant revenue loss from lower water demand caused by weather or economic conditions, 3) a significant increase in input costs, including electricity, fuel, chemical and purchase water prices, and 4) large acquisition(s) at excessive valuation(s) (significantly above the rate base).

Potential upside risks to our investment thesis and estimates include, but are not limited to: 1) favorable rate case approvals above our expected ROE, 2) weather conditions leading to near-term revenue increases, and 3) a pullback in input costs.

Aqua America - Annual Income Statement																
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(dollars in millions, except per share data)																
FY ends December 31	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10E	3Q10E	4Q10E	1Q11E	2Q11E	3Q11E	4Q11E
Total Operating Revenue	139.3	150.8	177.1	159.8	154.5	167.3	180.8	167.9	160.5	179.5	203.3	185.9	174.3	195.0	211.9	194.4
Operation & Maintenance	64.3	65.1	66.7	65.9	67.0	68.5	68.5	66.0	67.6	71.8	75.0	71.2	72.3	76.8	76.9	73.3
Depreciation	21.5	20.6	22.8	23.9	26.4	25.0	25.4	26.2	26.2	26.9	27.6	28.5	28.7	28.9	29.1	29.1
Amortization	1.2	1.0	1.8	1.5	2.8	3.1	3.0	3.1	3.2	3.2	3.2	3.2	3.4	3.4	3.4	3.4
General Taxes	12.1	10.8	11.2	10.6	11.6	11.9	12.4	12.2	12.9	12.6	12.2	13.0	13.1	13.6	12.7	13.6
Recovery of restructuring costs																
Total Expenses	99.1	97.6	102.5	102.0	107.7	108.5	109.4	107.5	109.8	114.4	118.0	115.9	117.5	122.8	122.1	119.4
Income from Operations	40.2	53.1	74.6	57.9	46.8	58.9	71.5	60.4	50.7	65.0	85.3	70.0	56.8	72.2	89.8	75.0
Operating Margin (%)	28.9%	35.2%	42.1%	36.2%	30.3%	35.2%	39.5%	36.0%	31.6%	36.2%	42.0%	37.7%	32.6%	37.0%	42.4%	38.6%
All. for Borrowed Funds Used in Const.	1.0	1.1	1.0	0.6	0.6	0.6	0.7	0.9	1.5	0.9	1.0	1.1	1.2	1.1	1.1	1.1
Gain (loss) on sale of other assets		0.6	0.5	0.5	0.1	0.1	0.2	0.1	1.9	0.6	0.7	0.8	1.0	0.8	0.8	0.9
Other																
EBIT	41.2	54.8	76.1	59.0	47.5	59.5	72.4	61.4	54.2	66.5	87.0	72.0	59.0	74.1	91.7	77.0
EBIT (%)	29.6%	36.3%	43.0%	36.9%	30.8%	35.6%	40.0%	36.6%	33.7%	37.1%	42.8%	38.7%	33.8%	38.0%	43.3%	39.6%
Interest Expense	17.1	17.1	17.0	17.4	16.6	16.8	17.3	17.9	18.4	18.6	18.8	18.9	19.6	20.3	21.0	21.5
Income Before Taxes	24.0	37.7	59.1	41.7	30.9	42.7	55.1	43.5	35.7	47.9	68.2	53.0	39.3	53.7	70.7	55.5
Provision for Income Taxes	9.7	15.2	23.7	16.0	12.5	16.9	21.6	16.8	14.2	19.2	27.3	20.7	15.7	21.5	28.3	21.7
Implied Tax Rate	40.4%	40.2%	40.1%	38.4%	40.5%	39.5%	39.3%	39.5%	40.0%	40.0%	40.0%	39.0%	40.0%	40.0%	40.0%	39.0%
Net Income before extraord. Item	14.3	22.6	35.4	25.7	18.4	25.9	33.5	26.7	21.5	28.7	40.9	32.4	23.6	32.2	42.4	33.9
Reclassification adj. for gains reported in net income			(0.2)			0.0										
Unrealized gain on securities									0.9							
Unrealized holding gain on investments	-	0.2	0.0		0.0	0.2	(0.1)	0.2	(1.3)							
Minimum pension liability adjustment																
Comprehensive Income	14.3	22.7	35.2	25.7	18.4	26.1	33.3	26.8	21.1	28.7	40.9	32.4	23.6	32.2	42.4	33.9
Diluted Net Income Per Share	0.11	0.17	0.26	0.19	0.14	0.19	0.25	0.20	0.16	0.21	0.30	0.23	0.17	0.23	0.30	0.24
Weighted Avg. Shares	134.0	134.1	135.3	135.6	135.9	135.9	136.3	136.5	136.8	137.3	137.7	138.2	138.2	138.6	139.1	139.5
Financial Summary (values in %)																
Revenue Growth	1.4%	0.1%	7.0%	7.2%	10.9%	11.0%	2.1%	5.0%	3.9%	7.2%	12.4%	10.7%	8.6%	8.7%	4.2%	4.6%
Operations & Maintenance/Revenue	46.2%	43.2%	37.7%	41.2%	43.4%	41.0%	37.9%	39.3%	42.1%	40.0%	36.9%	38.3%	41.5%	39.4%	36.3%	37.7%
EBIT (% of rev.)	29.6%	36.3%	43.0%	36.9%	30.8%	35.6%	40.0%	36.6%	33.7%	37.1%	42.8%	38.7%	33.8%	38.0%	43.3%	39.6%
General taxes as % of revenue	8.7%	7.2%	6.3%	6.7%	7.5%	7.1%	6.9%	7.3%	8.0%	7.0%	6.0%	7.0%	7.5%	7.0%	6.0%	7.0%
EBITDA	63.8	76.4	100.7	84.4	76.7	87.5	100.8	90.7	83.5	96.6	117.8	103.6	91.0	106.3	124.2	109.5
Net Income Growth	-15.0%	-5.0%	19.9%	3.0%	28.3%	14.6%	-5.4%	3.9%	17.1%	11.2%	22.3%	21.3%	9.7%	12.2%	3.6%	4.7%
EPS Growth	-15.5%	-5.3%	18.6%	1.8%	26.5%	13.0%	-6.1%	3.2%	16.3%	10.1%	21.0%	19.9%	8.6%	11.1%	2.6%	3.7%

Source: Company reports and Longbow estimates



Aqua America - Annual Income Statement						
Garik Shmois/ Vishal Khetriwal, CFA						
Longbow Research						
216-525-8414						
<i>(dollars in millions, except per share data)</i>						
<i>FY ends December 31</i>	FY06A	FY07A	FY08A	FY09	FY10E	FY11E
Total Operating Revenue	533.5	602.5	627.0	670.5	729	776
Operation & Maintenance	219.6	253.1	262.1	270.1	285.6	299.4
Depreciation	70.9	83.2	88.8	103.0	109.2	115.7
Amortization	4.1	4.8	5.5	11.9	12.8	13.6
General Taxes	33.3	45.4	44.7	48.1	50.6	53.0
	-	-	-	-	-	-
Total Expenses	327.9	386.5	401.2	433.1	458.2	481.7
Income from Operations	205.6	216.0	225.8	237.5	271.0	293.8
Operating Margin (%)	38.5%	35.9%	36.0%	35.4%	37.2%	37.9%
Allow. for Borrowed Funds Used in Const.	3.9	3.0	3.7	2.9	4.7	4.4
Gain (loss) on sale of other assets	1.2	3.5	1.6	0.5	4.0	3.4
Other	-	-	-	-	-	-
EBIT	210.7	222.5	231.1	240.8	279.7	301.7
EBIT (%)	39.5%	36.9%	36.9%	35.9%	38.4%	38.9%
Interest Expense	58.4	66.9	68.6	68.6	74.8	82.4
Income Before Taxes	152.3	155.5	162.5	172.2	204.9	219.3
Provision for Income Taxes	60.2	60.5	64.6	67.8	81.3	87.2
Implied Tax Rate	39.6%	38.9%	39.7%	39.4%	39.7%	39.7%
Net income	92.0	95.0	97.9	104.4	123.5	132.1
Reclassification adj. for gains reported in net incom	-	(1.3)	(0.2)	-	-	-
Unrealized gain on securities	-	-	-	-	-	-
Unrealized holding gain on investments	0.2	1.1	0.2	0.3	(1.3)	-
Minimum pension liability adjustment	3.1	-	-	-	-	-
Comprehensive Income	95.3	94.8	97.9	104.7	122.2	132.1
Diluted Net Income Per Share	0.70	0.71	0.73	0.77	0.90	0.95
Weighted Avg. Shares	131.8	133.6	134.7	136.1	137.5	138.8
Financial Summary (values in %)						
Revenue Growth	7.4%	12.9%	4.1%	6.9%	8.8%	6.4%
Operations & Maintenance/Revenue	41.2%	42.0%	41.8%	40.3%	39.2%	38.6%
Dep/Net Fixed Asset	3.1%	3.3%	3.2%	3.4%	3.4%	3.4%
Depreciation Growth	16.7%	17.3%	6.7%	16.0%	6.0%	6.0%
General taxes as % of revenue	6.2%	7.5%	7.1%	7.2%	6.9%	6.8%
Interest Exp/ Average Net Debt	5.8%	5.9%	5.2%	5.0%	5.0%	5.1%
Interest Expense/Revenue	11.0%	11.1%	10.9%	10.2%	10.3%	10.6%
EBITDA	285.7	310.5	325.4	355.7	401.6	431.1
Net income growth	0.9%	3.3%	3.1%	6.6%	18.4%	7.0%
Average ROE	10.6%	10.0%	9.6%	9.6%	10.8%	10.9%
EPS Growth (exspecial items and FAS 123)	-1.0%	1.9%	2.2%	5.5%	17.2%	5.9%

Source: Company reports and Longbow estimates

WATER INDUSTRY PEER VALUATION

(\$ in millions, except per share data)

Company	Ticker	FY End	Rating	Target	% Upside	Share Price	52 Week		Mkt Cap	Revenue Last	Last FY	Earnings per Share		P/E		Dividend Rate	Price/Book
							Hi	Lo				Current FY	Next FY	Current FY	Next FY		
U.S. WATER UTILITIES																	
AMER STATES WATER	AWR	Dec.	Neutral			\$36.14	\$39.61	\$30.82	\$ 678	\$ 361	1.63	1.83	2.11	19.8x	17.1x	2.8%	1.8x
AMERICAN WATER WORKS	AWK	Dec.	BUY	\$24	16%	\$20.71	\$23.77	\$16.55	\$ 3,739	\$ 2,337	1.25	1.39	1.60	14.9x	13.0x	3.9%	1.3x
AQUA AMERICA	WTR	Dec.	Neutral			\$17.39	\$18.94	\$15.39	\$ 2,419	\$ 671	0.77	0.90	0.95	19.4x	18.3x	3.3%	2.2x
CALIFORNIA WATER	CWT	Dec.	BUY	\$43	18%	\$36.29	\$40.65	\$33.49	\$ 772	\$ 449	1.95	1.99	2.40	18.2x	15.1x	3.2%	1.8x
ARTESIAN RESOURCES	ARTNA	Dec.	NR			\$17.80	\$19.33	\$14.25	\$ 138	\$ 61	0.97	1.07	1.11	16.6x	16.0x	4.1%	1.5x
CONNECTICUT WATER	CTWS	Dec.	NR			\$21.39	\$26.44	\$19.31	\$ 189	\$ 59	1.19	1.05	1.12	20.4x	19.1x	4.2%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			\$16.29	\$18.32	\$12.61	\$ 225	\$ 91	0.72	0.91	0.92	17.9x	17.7x	4.3%	1.7x
PENNICHUCK	PNNW	Dec.	NR			\$21.75	\$24.80	\$19.00	\$ 104	\$ 33	0.55	0.73	0.78	29.8x	27.9x	3.2%	1.8x
SIW	SIW	Dec.	NR			\$23.80	\$28.24	\$19.45	\$ 459	\$ 216	0.81	1.04	1.12	22.9x	21.3x	2.7%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			\$13.17	\$17.95	\$13.04	\$ 170	\$ 37	0.64	0.64	0.69	20.6x	19.1x	3.8%	2.1x
Average														20.0x	18.5x	3.6%	1.8x
EQUIPMENT/ FILTRATION/ TREATMENT SECTOR																	
PENTAIR	PNR	Dec.	BUY	\$41	28%	\$32.05	\$39.32	\$23.20	\$ 3,246	\$ 2,692	1.47	1.96	2.38	16.4x	13.4x	2.3%	1.6x
WATTS WATER TECH	WTS	Dec.	Neutral			\$32.20	\$36.77	\$19.50	\$ 1,222	\$ 1,234	1.54	1.81	2.14	17.8x	15.1x	1.3%	1.3x
AMERON INT'L	AMN	Nov.	NR			\$63.84	\$91.66	\$49.31	\$ 626	\$ 547	3.05	2.86	4.16	22.3x	15.3x	1.8%	1.1x
BADGER METER	BMI	Dec.	NR			\$38.46	\$44.90	\$32.58	\$ 591	\$ 250	1.80	1.78	2.05	21.6x	18.8x	1.2%	4.1x
CALGON CARBON	CCC	Dec.	NR			\$14.17	\$18.35	\$10.93	\$ 851	\$ 412	0.69	0.80	0.94	17.7x	15.1x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			\$4.28	\$8.74	\$4.89	\$ 277	\$ 47	0.07	0.12	0.22	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			\$30.59	\$36.59	\$22.36	\$ 746	\$ 626	1.29	1.72	2.07	17.8x	14.8x	1.6%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			\$27.51	\$29.79	\$18.44	\$ 466	\$ 266	1.15	1.17	1.37	23.5x	20.1x	1.5%	2.6x
ITRON	ITRI	Dec.	NR			\$71.99	\$81.95	\$46.00	\$ 2,970	\$ 1,687	2.09	3.25	3.9	22.2x	18.5x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			\$24.35	\$35.14	\$17.53	\$ 495	\$ 866	0.81	0.96	1.42	25.4x	17.1x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			\$4.57	\$5.99	\$2.52	\$ 750	\$ 1,428	-0.29	(0.01)	0.15	NM	NM	1.4%	1.9x
NORTHWEST PIPE	NWPX	Dec.	NR			\$22.35	\$41.98	\$19.44	\$ 210	\$ 440	0.46	1.13	1.6	19.8x	14.0x	0.0%	1.3x
PALL	PLL	Jul.	NR			\$35.18	\$41.82	\$24.00	\$ 4,340	\$ 2,329	1.77	2.15	2.15	16.4x	16.4x	1.7%	3.2x
SMITH (A.O.)	AOS	Dec.	NR			\$47.74	\$56.64	\$28.03	\$ 1,507	\$ 1,991	2.85	3.54	3.91	13.5x	12.2x	1.6%	1.7x
Average														19.8x	16.1x	0.9%	2.0x
WATER RESOURCES/ INFRASTRUCTURE																	
INSITUFORM TECH	INSU	Dec.	NR			\$22.00	\$28.38	\$13.03	\$ 887	\$ 727	1.04	1.47	1.72	15.4x	13.1x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			\$35.95	\$47.45	\$29.71	\$ 457	\$ 336	1.11	1.29	1.78	23.9x	22.0x	0.9%	2.5x
TETRA TECH	TTEK	Sept.	NR			\$22.45	\$32.00	\$19.51	\$ 1,422	\$ 2,287	1.22	1.17	1.37	20.0x	17.2x	0.0%	2.5x
Average														18.2x	16.2x	0.8%	2.3x
Relevant Indices																	
Dow Jones Industrials	DJ30	Share Price															
S&P 500	SPX	\$1,128.15															
Nasdaq Composite	NDX	\$1,893.75															

Source: Baseline; Company reports and LBR Estimates. EPS reflects diluted EPS, excluding extraordinary items. Numbers in italics reflect consensus estimates.

** Time period for annual estimates may vary based on reporting date.



APPENDIX

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Covered Companies Mentioned In This Report:

Aqua America Inc.	WTR	\$17.39	Neutral
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