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Financial Management

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Module 5: Dividend Decisions and Corporate Policy

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1. Concept, Nature, and Significance of Dividend Decisions

Dividend decision represents the third foundational pillar of corporate financial management. After an enterprise completes its annual operations, generates revenues, settles supplier dues, satisfies operating expenses, pays bank interest, and discharges statutory corporate income taxes, the remaining financial balance represents **Net Profit After Tax (PAT)**, legally belonging to equity shareholders. The dividend decision determines what precise proportion of post-tax earnings should be distributed to shareholders as current cash rewards (dividends) versus what proportion should be retained within the enterprise as retained earnings (internal equity) to fund future capital expansions.

The dividend decision operates as a crucial financial balancing act:

- **The Argument for Dividend Retention:** Retained earnings represent the most autonomous, reliable, and cost-effective source of equity financing available to a corporation. Unlike fresh equity share issues that involve underwriting commissions, legal prospectuses, registrar fees, and pricing discounts, retained earnings incur zero flotation costs and create zero ownership dilution for existing shareholders. If the company possesses lucrative investment opportunities yielding returns greater than its cost of capital ($r > k$), retaining earnings maximizes long-term enterprise valuation.
- **The Argument for Dividend Distribution:** Equity investors, particularly institutional pension funds and retail shareholders, value immediate, predictable cash dividends. Dividend receipts eliminate uncertainty, provide liquid income, and resolve investor risk aversion. Furthermore, public capital markets interpret corporate dividend declarations as an authoritative signaling mechanism verifying managerial confidence and balance sheet health.

2. Forms and Classification of Corporate Dividends

Modern corporate enterprises distribute surplus value to equity investors across diverse structural mechanisms:

Dividend Form	Operational Mechanics	Impact on Balance Sheet and Shareholder Equity
Cash Dividend	Direct electronic transfer of currency from the corporate bank account to shareholder bank accounts via ECS / NEFT.	Reduces total corporate cash assets and reduces retained earnings on the equity side; directly contracts overall firm size while providing instant liquidity to shareholders.

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Dividend Form	Operational Mechanics	Impact on Balance Sheet and Shareholder Equity
Stock Dividend (Bonus Shares)	Distribution of additional fully paid ordinary equity shares to existing shareholders in proportion to their current shareholdings (e.g., a 1:1 or 1:2 bonus ratio).	Zero impact on cash balances; represents a capitalization of reserves transferring retained earnings into paid-up equity share capital. Total net worth remains identical, but shares outstanding expand and per-share market price adjusts downward.
Scrip / Note Dividend	Issuance of promissory notes or short-term negotiable debt certificates to shareholders when the firm possesses profits but temporary liquidity shortages.	Commits the enterprise to pay the dividend amount at an agreed future maturity date, often carrying a stated interest rate until redemption.
Property Dividend	Distribution of non-monetary physical assets, operating inventory, or securities of subsidiary corporations to shareholders.	Rare in modern commerce; deployed primarily during corporate restructuring, spin-offs, or divestitures of specialized operational units.

3. Theories of Dividend Policy: Relevance Versus Irrelevance

Academic literature on corporate finance is divided into two major schools of thought concerning the impact of dividend policy on firm valuation: Dividend Relevance Theories and Dividend Irrelevance Theories.

A. Dividend Relevance Theories

Dividend relevance theorists argue that dividend policy exerts a direct, measurable influence on the market price of ordinary shares and overall enterprise valuation. Two seminal mathematical models formulate this relevance:

1. Walter's Valuation Model (Prof. James E. Walter)

James E. Walter posited that the choice of dividend payout ratio directly affects the value of the firm, depending on the relationship between the **Internal Rate of Return on corporate investments (r)** and the **Cost of Capital / Capitalization Rate (k)**:

$$P = [D + (r / k) \times (E - D)] / k$$

Where: P = Market price per share; D = Dividend per share; E = Earnings per share; r = Internal rate of return on invested capital; k = Cost of equity capital / capitalization rate; (E - D) = Retained earnings per share.

Walter classified commercial enterprises into three operational states based on investment opportunities:

1. **Growth Firms (r > k):** The enterprise earns returns higher than what investors can earn independently in the market. The optimal dividend payout ratio is **0% (Zero Payout)**. Retaining

100% of earnings maximizes the market value of shares.

2. **Declining / Mature Firms (r < k):** The enterprise earns returns lower than the cost of capital. Shareholders can reinvest funds elsewhere at higher yields. The optimal dividend payout ratio is **100% (Complete Payout)**. Retaining earnings destroys shareholder wealth.
3. **Normal Firms (r = k):** The firm earns returns exactly equal to the cost of capital. The dividend payout ratio is completely indifferent; whether the firm pays 0%, 50%, or 100% dividend, the market price per share remains unchanged.

2. Gordon's Dividend Growth Model (Myron J. Gordon)

Myron Gordon established that dividends are relevant due to the **"Bird-in-the-Hand" Fallacy**: investors prefer current, certain cash dividends today over uncertain, distant future capital gains. Investors assign a higher risk discount to distant future capital appreciation. The Gordon valuation formula is expressed as:

$$P_0 = [\ E_1 \times (1 - b)\ ] / [\ k_e - (b \times r)\ ] = D_1 / [\ k_e - g\ ]$$

Where: P_0 = Current market price per share; E_1 = Earnings per share; b = Retention ratio (proportion of earnings retained); (1 - b) = Dividend payout ratio; k_e = Cost of equity capital; r = Rate of return on investment; g = (b × r) = Growth rate of dividends.

B. Dividend Irrelevance Theory: Modigliani-Miller (MM) Hypothesis (1961)

Franco Modigliani and Merton Miller established that under perfect capital market assumptions, dividend policy has zero impact on the market price of ordinary shares or the overall valuation of the enterprise. Firm value is determined solely by its core earning power and investment policy, not by how earnings are partitioned between dividends and retention.

The Core Assumptions of the MM Dividend Hypothesis:

- Perfect capital markets with zero transaction costs, zero floatation expenses, and costless access to information for all market participants.
- Absence of differential taxation: capital gains and dividend income are taxed at identical tax rates (or zero taxes).
- The firm operates an established, rigid capital investment policy that is completely independent of its dividend payout decisions.
- Zero risk or uncertainty: all investors possess identical rational expectations regarding future profits and investments.

The Arbitrage Proof: MM demonstrated that if a company pays a cash dividend, its market price per share drops by the exact monetary amount of the dividend on the ex-dividend date ($P_0 = [\ D_1 + P_1\ ] / [\ 1 + k_e\ ]$). Any wealth gained by the shareholder in cash dividends is perfectly offset by a corresponding loss in share value. If the company needs capital to fund investments after paying dividends, it must issue new equity shares; the value dilution suffered by existing shareholders exactly equals the cash dividend received. Therefore, dividend policy is irrelevant.

4. Determinants of Corporate Dividend Policy

In operational corporate reality, dividend decisions are governed by a complex matrix of internal operational constraints and external market forces:

1. **Corporate Liquidity and Cash Flow Health:** A company may report high accounting net profits on its income statement while being cash-constrained due to large inventory holdings and uncollected trade receivables. Cash dividends require physical bank liquidity, not book profits.
2. **Availability of Profitable Investment Projects:** Rapidly expanding technology and industrial enterprises require massive capital outlays. Such firms maintain low dividend payout ratios to fund profitable projects internally, whereas mature utility firms with stable revenues and few growth projects maintain high payout ratios.
3. **Stability of Corporate Earnings:** Enterprises possessing stable, predictable multi-year revenue streams (such as consumer staples and electricity utilities) can comfortably sustain higher dividend payout commitments than volatile, cyclical commodity producers.
4. **Legal and Statutory Provisions (Companies Act 2013):** Section 123 of the Indian Companies Act mandates that dividends can be declared only out of current operating profits after providing for statutory depreciation under Schedule II, or out of accumulated past reserves after transferring statutory percentages.
5. **Contractual Restrictive Debt Covenants:** Institutional bondholders and term-lending commercial banks routinely insert covenants in loan agreements restricting dividend distributions if the firm's current ratio or debt service coverage ratio (DSCR) breaches minimum safety thresholds.
6. **Access to External Capital Markets:** Well-established, blue-chip corporations with strong credit ratings can raise debt or equity capital on public markets at low cost on short notice, enabling them to pay generous dividends. Smaller, unlisted firms with restricted capital access must rely on retained earnings.

5. Procedural Aspects of Dividend Payment under Indian Companies Act 2013

The distribution of dividends by public and private corporate entities in India must adhere strictly to statutory procedural milestones:

- **Board Recommendation:** The Board of Directors proposes the dividend percentage at a formal board meeting. Shareholders at the Annual General Meeting (AGM) can approve the recommended rate or reduce it, but cannot increase it.
- **Interim Versus Final Dividend:** Final dividends are declared by shareholders at the AGM after audited financial statements are presented. Interim dividends can be declared by the Board of Directors during any fiscal quarter out of current surplus profits.
- **Mandatory Separate Bank Account Deposit:** Section 123(4) mandates that within **5 days** of dividend declaration, the total dividend sum must be deposited into a separate scheduled bank account.

- **Payment Timeline:** The dividend must be paid to entitled registered shareholders within **30 days** of formal declaration.
- **Unpaid Dividend Account:** Any dividend remaining unpaid or unclaimed after 30 days must be transferred within **7 days** into a specialized "Unpaid Dividend Account". If funds remain unclaimed for **7 consecutive years**, the principal sum along with accrued interest must be compulsorily transferred to the statutory **Investor Education and Protection Fund (IEPF)** managed by the Central Government.

6. Worked Numerical Problem: Walter's Model Valuation Across Three Business Scenarios

Managerial Case Problem: Cochin Industrial Ventures Ltd. has an earnings per share (EPS) of Rs. 10. The company's capitalization rate (cost of equity, k) is 10%. The Board of Directors is evaluating two alternative dividend payout proposals: Payout 1 (40% dividend, D = Rs. 4) and Payout 2 (80% dividend, D = Rs. 8). Determine the market price per share using Walter's Model under three distinct corporate investment scenarios:

1. Growth Scenario: Internal Rate of Return (r) = 15% (r > k)
2. Normal Scenario: Internal Rate of Return (r) = 10% (r = k)
3. Declining Scenario: Internal Rate of Return (r) = 8% (r < k)

Step-by-Step Resolution via Walter's Valuation Formula:

$$P = [D + (r / k) \times (E - D)] / k$$

Scenario 1: Growth Scenario (r = 15%, k = 10%)

- Under Payout 1 (D = Rs. 4, Retained = Rs. 6):

$$P = [4 + (0.15 / 0.10) \times (10 - 4)] / 0.10 = [4 + (1.5 \times 6)] / 0.10$$
$$= [4 + 9] / 0.10 = 13 / 0.10 = Rs.\ 130$$

- Under Payout 2 (D = Rs. 8, Retained = Rs. 2):

$$P = [8 + (0.15 / 0.10) \times (10 - 8)] / 0.10 = [8 + (1.5 \times 2)] / 0.10$$
$$= [8 + 3] / 0.10 = 11 / 0.10 = Rs.\ 110$$

Conclusion for Growth Firm: Higher retention (lower dividend payout) maximizes share price (Rs. 130 vs Rs. 110), proving Walter's rule for growth firms.

Scenario 2: Normal Scenario (r = 10%, k = 10%)

- Under Payout 1 (D = Rs. 4):

$$P = [\ 4 + (0.10 / 0.10) \times (10 - 4)\ ] / 0.10 = [\ 4 + (1.0 \times 6)\ ] / 0.10 = 10 / 0.10 = \text{Rs. } 100$$

- Under Payout 2 (D = Rs. 8):

$$P = [\ 8 + (0.10 / 0.10) \times (10 - 8)\ ] / 0.10 = [\ 8 + (1.0 \times 2)\ ] / 0.10 = 10 / 0.10 = \text{Rs. } 100$$

Conclusion for Normal Firm: Market price remains unchanged at Rs. 100 regardless of payout ratio, proving dividend indifference.

Scenario 3: Declining Scenario (r = 8%, k = 10%)

- Under Payout 1 (D = Rs. 4, Retained = Rs. 6):

$$P = [\ 4 + (0.08 / 0.10) \times (10 - 4)\ ] / 0.10 = [\ 4 + (0.8 \times 6)\ ] / 0.10 = [\ 4 + 4.8\ ] / 0.10 = 8.8 / 0.10 = \text{Rs. } 88$$

- Under Payout 2 (D = Rs. 8, Retained = Rs. 2):

$$P = [\ 8 + (0.08 / 0.10) \times (10 - 8)\ ] / 0.10 = [\ 8 + (0.8 \times 2)\ ] / 0.10 = [\ 8 + 1.6\ ] / 0.10 = 9.6 / 0.10 = \text{Rs. } 96$$

Conclusion for Declining Firm: Distributing higher dividends maximizes share price (Rs. 96 vs Rs. 88), validating Walter's prediction that mature firms should return surplus capital to shareholders.

7. Comprehensive Worked Numerical Problem: Modigliani-Miller Arbitrage Mechanism Proof

Managerial Case Problem: Demonstrating the mathematical mechanics of MM dividend irrelevance through an arbitrage proof across dividend payment versus non-payment scenarios.

Kerala Marine Engineering Ltd. currently has 1,00,000 outstanding ordinary shares trading at a market price of Rs. 100 per share. The company's capitalization rate (cost of equity, k_e) is 10%. The firm expects net profits of Rs. 10,00,000 during the upcoming year and has planned a capital expenditure investment of Rs. 20,00,000. The Board of Directors is considering two alternative policies: (1) Declaring a cash dividend of Rs. 5 per share; or (2) Declaring no dividend (Rs. 0 payout). Show that the market value of the firm remains identical under both alternatives.

Step-by-Step Resolution via MM Valuation Model:

$$P_0 = [\ D_1 + P_1\ ] / (1 + k_e) \Rightarrow P_1 = P_0 \times (1 + k_e) - D_1$$

Step 1: Computation of Share Price at Year-End (P_1)

- **Alternative 1 (Dividend Paid = Rs. 5 per share):**

$$P_1 = 100 \times (1 + 0.10) - 5 = 110 - 5 = \text{Rs. } 105 \text{ per share}$$

- **Alternative 2 (No Dividend Paid = Rs. 0 per share):**

$$P_1 = 100 \times (1 + 0.10) - 0 = 110 - 0 = \text{Rs. } 110 \text{ per share}$$

Step 2: Computation of New Shares to be Issued to Fund Investment (m)

Total Capital Expenditure Required (I) = Rs. 20,00,000; Total Net Profits (E) = Rs. 10,00,000.

- **Alternative 1 (Dividend Paid):** Total dividend payout = 1,00,000 shares × Rs. 5 = Rs. 5,00,000. Retained earnings = Net Profit (Rs. 10,00,000) - Dividend (Rs. 5,00,000) = Rs. 5,00,000. External funds required = Rs. 20,00,000 - Rs. 5,00,000 = Rs. 15,00,000.

$$\text{Number of New Shares (m)} = \text{External Funds} / P_1 = 15,00,000 / 105 = 14,285.71 \text{ Shares}$$

- **Alternative 2 (No Dividend):** Total dividend payout = Rs. 0. Retained earnings = Full Net Profit = Rs. 10,00,000. External funds required = Rs. 20,00,000 - Rs. 10,00,000 = Rs. 10,00,000.

$$\text{Number of New Shares (m)} = \text{External Funds} / P_1 = 10,00,000 / 110 = 9,090.91 \text{ Shares}$$

Step 3: Valuation of the Enterprise at Year-End and Present Value Verification (nP_0)

$$nP_0 = [\ (n + m) \times P_1 - I + E\ ] / (1 + k_e)$$

- **Under Alternative 1 (Dividend Paid):**
  - Total shares at Year-end (n + m) = 1,00,000 + 14,285.71 = 1,14,285.71 shares
  - Total equity value at Year-end = 1,14,285.71 × Rs. 105 = Rs. 1,20,00,000
  - Less Investment (I) = Rs. 20,00,000; Add Net Profits (E) = Rs. 10,00,000 ⇒ Net Sum = Rs. 1,10,00,000
  - Present Value of Enterprise: nP_0 = *1,10,00,000 / (1 + 0.10)* = ***Rs. 1,00,00,000 (Rs. 1 Crore)***
- **Under Alternative 2 (No Dividend):**
  - Total shares at Year-end (n + m) = 1,00,000 + 9,090.91 = 1,09,090.91 shares
  - Total equity value at Year-end = 1,09,090.91 × Rs. 110 = Rs. 1,20,00,000
  - Less Investment (I) = Rs. 20,00,000; Add Net Profits (E) = Rs. 10,00,000 ⇒ Net Sum = Rs. 1,10,00,000

- Present Value of Enterprise: nP_0 = *1,10,00,000 / (1 + 0.10)* = ***Rs. 1,00,00,000 (Rs. 1 Crore)***

Both dividend payment and non-payment yield an identical enterprise valuation of exactly Rs. 1,00,00,000, mathematically confirming Modigliani and Miller's dividend irrelevance proposition.

8. Share Buybacks (Stock Repurchases) as an Alternative to Cash Dividends

A share buyback involves a corporation purchasing its own outstanding equity shares from existing shareholders using accumulated surplus cash reserves. In contemporary capital markets, buybacks operate as an effective alternative or complement to cash dividends.

Operational Mechanics and Methods of Share Buyback

- **Tender Offer Method:** The corporation announces a formal public offer to repurchase a fixed number of shares at a specified premium price (typically 15% to 25% above prevailing market price) within a fixed statutory window.
- **Open Market Purchase Method:** The enterprise repurchases shares directly through stock exchange trading terminals over an extended period (up to six months) without paying a premium, acquiring shares whenever prices dip.
- **SEBI Regulatory Compliance:** Governed by the SEBI (Buy-back of Securities) Regulations 2018 and Section 68 of the Companies Act 2013: maximum buyback limit is 25% of aggregate paid-up equity capital and free reserves; post-buyback debt-equity ratio must not exceed 2:1; and shares repurchased must be compulsorily extinguished within seven days.

Strategic and Financial Motivations for Share Buybacks

1. **Signaling Undervaluation:** Demonstrates executive conviction that prevailing market prices severely undervalue the company's real operational worth and future earnings power.
2. **Enhancement of Financial Ratios:** Reducing outstanding shares permanently increases Earnings Per Share (EPS), Cash Flow Per Share (CFPS), and Return on Equity (ROE), driving stock price appreciation.
3. **Defense Against Hostile Takeovers:** Absorbing circulating "free-float" shares consolidates voting power in the hands of supportive promoter groups, elevating the financial cost of hostile takeovers for external predators.
4. **Capital Structure Optimization:** Returning excess non-earning liquidity to shareholders prevents managerial empire-building and lowers the firm's equity capitalization base.

9. Evolution of Corporate Dividend Taxation in India: The 2020 Shift

The taxation of corporate dividends exerts a direct influence on investor preferences, payout ratios, and capital allocation across Indian capital markets. The legislative framework underwent a historic structural overhaul under the **Finance Act 2020**:

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Dimension	Historical Regime (Pre-April 1, 2020)	Modern Classical Regime (Post-April 1, 2020)
Statutory Tax Mechanism	**Dividend Distribution Tax (DDT)** under Section 115-O of the Income Tax Act 1961.	**Classical System of Taxation:** Direct taxation in the hands of individual shareholders.
Tax Levying Entity	The distributing domestic corporation paid DDT directly to the Central Government before remitting dividends.	The company pays zero distribution tax; dividends are added to the shareholder's gross income.
Effective Tax Burden	Effective flat rate of approximately 20.56% (inclusive of statutory surcharge and cess), regardless of shareholder income.	Taxed at the recipient shareholder's personal progressive income tax slab rates (ranging from 0% to 39%).
Tax Deducted at Source (TDS)	Zero TDS; dividends were fully exempt in the hands of shareholders up to Rs. 10 lakhs under Section 10(34).	Mandatory **10% TDS under Section 194** on dividend payouts exceeding Rs. 5,000 per financial year.
Inter-Corporate Dividends	Governed by Section 115-O cascaded offsets.	**Section 80M Deduction:** A domestic holding company receiving dividends from a subsidiary can deduct dividend payouts made to its own shareholders, eliminating cascading double taxation.

Managerial Implications of the 2020 Reform: The abolition of DDT shifted the tax incidence from corporations to high-net-worth individual promoters and retail investors. Promoters in the highest 39% personal tax bracket faced heavy tax liabilities on cash dividends, creating powerful corporate incentives to utilize **Share Buybacks** (taxed at the corporate level under Section 115QA) or retain earnings for internal capital compounding.

10. Critical Evaluation of Walter's and Gordon's Theoretical Assumptions

While Walter's and Gordon's valuation models provide foundational insights into the relevance of dividend decisions, corporate finance scholars have identified critical theoretical assumptions that limit their direct application in real-world capital markets:

1. **Assumption of Perpetual Internal Financing:** Both Walter and Gordon assume that the firm finances all capital investments exclusively through retained earnings, completely excluding external debt and new equity issues. In modern commerce, corporations routinely deploy syndicated bank credit, bond issues, and follow-on equity offerings.
2. **Assumption of Constant Internal Rate of Return (r):** The models assume that the return on corporate investments remains constant regardless of the quantum of investment. In economic

reality, the **Law of Diminishing Marginal Returns** dictates that as an enterprise expands its capital budget, it exhausts its most lucrative projects, causing internal return (r) to decline.

3. **Assumption of Constant Cost of Capital (k):** The models assume that the firm's capitalization rate (k) remains fixed and unaffected by its risk profile. However, as an enterprise retains higher proportions of earnings and commits to massive capital expansions, business and financial risks increase, prompting investors to demand a higher capitalization rate.
4. **Assumption of Perpetual Enterprise Life:** Both models assume an infinite operational horizon with static business conditions, abstracting away from technological disruptions, competitive threats, and macroeconomic business cycles.

11. John Lintner's Behavioral Model of Corporate Dividend Payout

In his landmark empirical study of corporate dividend practices across major US industrial enterprises, John Lintner (1956) observed that corporate executives do not set annual dividends in a vacuum based purely on current net income. Instead, managers exhibit strong behavioral resistance to cutting dividends, viewing dividend stability as an indicator of corporate stability.

Lintner formulated three core behavioral propositions governing dividend decisions:

- Enterprises establish long-term **Target Dividend Payout Ratios** based on long-run sustainable earnings power rather than volatile annual profits.
- Dividends are adjusted gradually toward the target payout ratio over time to avoid abrupt disruptions, governed by a fractional **Speed of Adjustment Coefficient (c)**:

$$\Delta Div_t = Div_t - Div_{t-1} = a + c \times [(r \times EPS_t) - Div_{t-1}]$$

Where: Div_t = Dividend per share in year t; r = Target dividend payout ratio; c = Speed of adjustment factor ($0 < c \leq 1$); EPS_t = Current earnings per share; a = Constant drift factor.

- Managers increase dividends only when they are highly confident that future earnings will permanently sustain the higher payout. They are extremely reluctant to reduce dividends, cutting payouts only under severe existential financial distress.

12. Stock Dividends (Bonus Shares) Versus Stock Splits: Comprehensive Comparison

Both bonus share issuances and stock splits expand the total number of circulating equity shares without injecting fresh cash capital into the company. However, their accounting and legal mechanics differ fundamentally under the Indian Companies Act 2013:

Comparison Parameter	Bonus Share Issue (Stock Dividend)	Stock Split (Sub-Division of Shares)
Statutory Accounting Impact	Capitalization of accumulated free reserves; transfers accumulated Retained Earnings and Securities Premium into Paid-up Share Capital.	Zero impact on reserves or surplus; merely reduces the nominal face value of existing shares (e.g., splitting a Rs. 10 face value share into five Rs. 2 shares).
Face Value of Share	Nominal face value remains completely unchanged (e.g., stays at Rs. 10 per share).	Nominal face value decreases proportionately in accordance with the split ratio.
Statutory Legal Prerequisites	Governed strictly by Section 63 of Companies Act 2013; requires authorized article provisions, board recommendation, and shareholder approval; cannot be issued from revaluation reserves.	Governed by Section 61(1)(d); requires altering the capital clause of the Memorandum of Association (MoA) via shareholder resolution.
Market Liquidity Impact	Increases floating shares in market; lowers per-share market price proportionately, enhancing affordability for retail investors.	Substantially lowers market price per share, dramatically boosting daily secondary market liquidity and trading velocity.

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