

Prada SPA (1913 HK)

Hold

Target price (HKD)	43.00
Share price (HKD)	37.70
Upside/Downside (%)	14.1

Jan	2015 a	2016 e	2017 e
HSBC EPS	0.18	0.18	0.22
HSBC PE	24.4	24.5	19.4
Performance	1M	3M	12M
Absolute (%)	-14.6	-26.9	-32.9
Relative ^A (%)	-12.2	-33.5	-41.8

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This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

Hold: Don't get led into temptation

- ▶ **Caution is well spread on the name but the devil knows what Prada can produce after very poor Q1 results; we resist the temptation of being more constructive for now**
- ▶ **Cutting EPS estimates by 24% and 19% for FY Jan 16/17 on margin collapse, wholesale weakness, FX and higher tax rate**
- ▶ **Cut fair value target price to HKD43 "only" from HKD48 as FX (HKD-denominated shares) and DCF roll-over limit the damage; reiterate Hold rating**

Q1 results a major disappointment with consequences: Q1 to end-April saw sales in line (down 5% at constant FX with same store sales growth down high single digit as we had forecast), but EBIT was a massive miss as margins collapsed (down 910bp). EBIT margin deteriorated to 11% and this was driven by (i) a 150bp gross margin decline as a positive FX impact was more than offset by unfavourable product and geographic mix and (ii) a large 760bp increase in the SG&A ratio as cost containment measures are yet to bear fruit and marketing events were concentrated in the quarter. Although one could argue there were one-offs such as these marketing events, the reality is elements of the mix – underperformance of Greater China, of leather goods and of the Prada brand relative to Miu Miu – could well drag on.

What could make the stock work? Q2 and beyond should sequentially do better but we do not see any rush to become more constructive given the lack of visibility. However, there are factors that could support the stock and notably the second derivative of growth, ie momentum, things getting better or at least not getting worse. This is the reason we had become optimistic on the stock a bit prematurely earlier in the year. Besides, Prada is the least liked stock in our luxury coverage on the sell-side and the most shorted in the market. So whilst the results have been much worse than expected, we doubt the sentiment can become much more negative.

Changes to our estimates and TP: A few elements from Q1 have led us to cut our estimates significantly, notably a much steeper operating de-leverage than we had assessed, a poor wholesale outlook and a higher tax rate. FX has also become less favourable on the P&L than last time we published. We cut FY Jan 16 earnings by 25% but we are cutting our target price less (from HKD48 to HKD43) as we roll over our DCF by a year and FX is favourable at the share price level. With 14% upside to our fair value target price, we reiterate our Hold rating.

Index ^A	HANG SENG INDEX
Index level	26,761
RIC	1913.HK
Bloomberg	1913 HK

Source: HSBC

Enterprise value (EURm)	10,675
Free float (%)	20
Market cap (USDm)	12,443
Market cap (HKDm)	96,468

Source: HSBC

Financials & valuation

Financial statements

Year to	01/2015a	01/2016e	01/2017e	01/2018e
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Profit & loss summary (EURm)

Revenue	3,552	3,865	4,153	4,451
EBITDA	954	965	1,147	1,286
Depreciation & amortisation	-253	-301	-319	-338
Operating profit/EBIT	702	664	829	948
Net interest	-34	0	5	15
PBT	668	664	834	963
HSBC PBT	668	664	834	963
Taxation	-209	-216	-267	-303
Net profit	451	438	554	645
HSBC net profit	451	448	567	660

Cash flow summary (EURm)

Cash flow from operations	505	727	861	972
Capex	-539	-330	-379	-400
Cash flow from investment	-548	-330	-379	-400
Dividends	-281	-281	-357	-357
Change in net debt	108	-115	-199	-214
FCF equity	45	397	481	571

Balance sheet summary (EURm)

Intangible fixed assets	943	943	943	943
Tangible fixed assets	1,865	1,895	1,955	2,017
Current assets	1,900	1,994	2,267	2,556
Cash & others	709	824	1,023	1,238
Total assets	4,739	4,863	5,195	5,547
Operating liabilities	1,011	968	1,015	1,064
Gross debt	519	519	519	519
Net debt	-190	-305	-505	-719
Shareholders funds	3,001	3,157	3,430	3,719
Invested capital	2,988	3,040	3,126	3,215

Ratio, growth and per share analysis

Year to	01/2015a	01/2016e	01/2017e	01/2018e
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Y-o-y % change

Revenue	-1.0	8.8	7.4	7.2
EBITDA	-16.5	1.1	18.9	12.1
Operating profit	-25.3	-5.4	24.8	14.4
PBT	-27.6	-0.6	25.6	15.6
HSBC EPS	-28.2	-0.6	26.5	16.4

Ratios (%)

Revenue/IC (x)	1.3	1.3	1.3	1.4
ROIC	17.5	14.9	18.3	20.5
ROE	15.8	14.6	17.2	18.5
ROA	11.2	9.3	11.2	12.1
EBITDA margin	26.9	25.0	27.6	28.9
Operating profit margin	19.8	17.2	20.0	21.3
EBITDA/net interest (x)	28.2			
Net debt/equity	-6.3	-9.6	-14.5	-19.1
Net debt/EBITDA (x)	-0.2	-0.3	-0.4	-0.6
CF from operations/net debt				

Per share data (EUR)

EPS reported (fully diluted)	0.18	0.17	0.22	0.25
HSBC EPS (fully diluted)	0.18	0.18	0.22	0.26
DPS	0.11	0.11	0.14	0.16
Book value	1.17	1.23	1.34	1.45

DCF analysis

HSBC assumptions	DCF, comprising		
Risk-free rate (%)	3.50	EBIT growth15-25e CAGR (%)	9.7
Equity premium (%)	5.00	EBIT growth15-45e CAGR (%)	3.5
Sector beta	1.10	Fade period 2045-2053e	
Specific beta	1.00	WACC	9.00

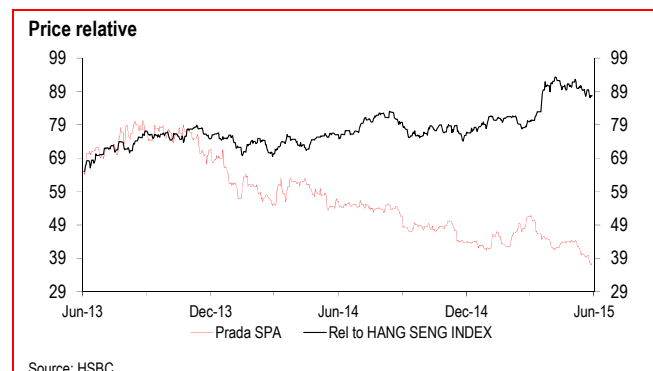
Sensitivity and valuation range (HKD/share)

Cost of capital vs fade period	4 years	8 years	12 years
8.0%	48	49	50
8.5%	45	46	47
9.0%	42	43	44
9.5%	40	41	41
10.0%	38	38	39

Valuation data

Year to	01/2015a	01/2016e	01/2017e	01/2018e
EV/sales	3.0	2.8	2.5	2.3
EV/EBITDA	11.3	11.1	9.1	8.0
EV/IC	3.6	3.5	3.4	3.2
PE*	24.4	24.5	19.4	16.6
P/Book value	3.7	3.5	3.2	3.0
FCF yield (%)	0.4	3.6	4.4	5.2
Dividend yield (%)	2.6	2.6	3.2	3.8

Note: * = Based on HSBC EPS (fully diluted)



Note: price at close of 19 Jun 2015

Resist temptation

- ▶ Poor Q1 results and consequences
- ▶ Some reasons not to sell
- ▶ Steep cuts in earnings, less so on target price

Q1 results and consequences

Very poor results

In spite of sales being in line both with consensus and HSBC estimates (down 5% at constant FX), Q1 EBIT was a massive miss as margins collapsed (-910bp). These lacklustre figures demonstrate that there is still a lot of work-in-progress at the Prada brand and at the Gucci brand within Kering (PRTP.PA, EUR154.70, Hold) compared to the LV brand within LVMH (LVMH.PA, EUR159.95, Buy).

Q1 2015 sales rose 6.5% on a reported basis to EUR828m but declined 5% at constant FX. On the positive side, significant FX tailwinds (+12%) contributed positively to sales. Retail net sales declined 5% at constant FX. SSSG was down “high single digit” in Q1 (vs HSBC -8.5%) compared to c -10% in Q4 (ended January). Wholesale (only 8% of sales now) declined by 13%.

Retail sales by region at constant FX were as follows: Europe (+10%) was supported by tourist flows (Asian but also the US) except in the UK due to the strong GBP. Asia Pacific (-17%) was penalised by Greater China (-23%). The Americas (-5%) suffered from unfavourable FX affecting tourism. Japan was only down 2% in spite of the tough basis of comparison. The Middle East (down 8%) lacked tourists.

By brand at constant FX (retail): Prada sales (-7%) were impacted by the weakness in Greater China and the tough basis of comparison in Japan. On the other hand, Miu Miu sales (+5%) grew at a double-digit pace in the US, Europe and the Middle East.

By product category at constant FX (retail): Leather goods (-10%) presented different trends among brands: the poor performance of Prada in Asia Pacific was offset by Miu Miu, which shows signs of resilience in Asia Pacific. The footwear category was the best performer (up 19% at constant FX) with double-digit performances across regions and brands.

Q1 EBIT plummeted to EUR91m (vs HSBC EUR150m), a 42% y-o-y decrease. The 910bp EBIT margin deterioration to 11% was driven by (i) a 150bp GM decline as a positive FX impact was more than offset by unfavourable product and geographic mix; and (ii) a 760bp increase in the SG&A ratio as cost containment measures are not yet bearing fruit and marketing events were concentrated in Q1 2015.

It is worth noting that the unfavourable geographic mix resulted in a higher tax rate (up 480bp to 33.2%).

Issues may continue

We see three negative elements continuing to weigh on the Prada group over the next few months:

- ▶ Geographic mix: we see limited reasons for Greater China to rebound in the short term with Japan and Europe attracting more Chinese tourists. Hong Kong and Macau metrics could suffer from recent or upcoming big openings at Prada at a time when footfall is very low (eg Times Square 1,320m2 flagship in Hong Kong, The Promenade at Galaxy in Macau).
- ▶ The product mix (strong footwear, weak handbags and accessories) could well carry on. The Prada brand is trying to have a more balanced product offering, notably by bringing more innovation in the EUR1,000-2,000 price segment for which management acknowledged innovation had been lacking. But this could take more than one or two quarters.
- ▶ There has been a stark contrast between the Prada brand (-7% organic sales decline, impacted by the weakness in Greater China and the tough basis of comparison in Japan) and Miu Miu (+5% organic sales growth, with double-digit growth in the US, Europe and the Middle East). Looking at issues of ubiquity and the underpenetrated nature of Miu Miu, we believe this brand will continue to perform better than the core Prada one.

Reasons not to sell

Beware the second derivative

Q2 and beyond should sequentially do better than Q1: management commented that retail growth including new stores was so far flat in Q2 compared to -5% in Q1. There are factors that could support the stock and notably the second derivative of growth, ie momentum, things getting better or at least not getting worse. Note that we expect most luxury players to show a sequential acceleration in the top line in Q2 as the basis of comparison in Japan gets easier and what we call the “zero sum game” (ie Chinese consumption lost in Hong Kong being recouped at other destinations) becomes more visible. This is the reason we had become optimistic on the stock a bit prematurely earlier in the year. We believe that Q3 last year (ended October 2014) was probably the low in terms of same store sales growth.

Prada at a cross-road: can growth pick up later this year?



Source: HSBC at Landmark mall in Hong Kong

Miu Miu is gold for now



Source: HSBC at Landmark mall in Hong Kong

Prada shoes: The very successful category currently



Source: HSBC, Landmark street side window display

A tartan twist for Fall from Prada



Source: HSBC, Landmark street side window display

Expectations still need to come down but sentiment cannot

Prada is the least liked stock in our luxury coverage on the sell-side and the most shorted in the market with very few holders (two institutions hold about 60% of the free float). So whilst the results have been much worse than expected, we doubt the sentiment can become much more negative from here.

Earnings, valuation and risks

Why we are cutting estimates so much

Although sales in Q1 were relatively in line with our estimates, we have cut our assessment for sales over the full year by 5% as the guidance for wholesale sales is weaker than we had anticipated (mid-single digit decline in reported terms) and also we are now taking into account a less favourable FX situation (EUR/USD at 1.14 vs 1.07 last time we published). We see same store sales growth being down 2% over the FY (vs up 1% previously and the current guidance of management at flat). At the margin level, we see reasons for the gross margin to stabilise (FX, retail outperforming wholesale, a few price increases) but see steep operating de-leverage at the SG&A level, implying a 260bps EBIT margin deterioration to 17.2%. As the regional mix is more skewed to high tax geographies, we have also increased the tax rate. All in, we are lowering our FY Jan 16 EPS estimate by 24%.

Changes in our estimates and relative to consensus (FY Jan n+1)

(EURm/ EUR)	2016e					2017e					2018e				
	HSBC New	HSBC Old	Cons	Chg	HSBC vs Cons	HSBC New	HSBC Old	Cons	Chg	HSBC vs Cons	HSBC New	HSBC Old	Cons	Chg	HSBC vs Cons
Sales	3,865	4,050	3,825	-5%	1%	4,153	4,350	4,020	-5%	3%	4,451	4,642	4,259	-4%	5%
EBITDA	965	1,124	982	-14%	-2%	1,147	1,303	1,071	-12%	7%	1,286	1,485	1,156	-13%	11%
EBIT	664	853	707	-22%	-6%	829	1,014	785	-18%	6%	948	1,175	858	-19%	11%
EPS	0.18	0.23	0.19	-24%	-8%	0.22	0.27	0.20	-19%	11%	0.26	0.32	0.22	-20%	16%

Source: HSBC estimates, Bloomberg consensus

Why our target price cut is more subtle

As the shares are listed in HKD, the EUR to HKD translation with a EUR/USD going from 1.07 to 1.14 actually increases by 6.5% all things being equal. Rolling over our DCF by one year adds another c8%. As a result, despite cutting our estimates by a low 20% CAGR, we cut our target price by close to 10% from HKD48 to HKD43. Please see the table on page 2 showing our DCF assumptions. Our target price of HKD43 implies upside of 14%. Therefore we reiterate our Hold rating.

Risks

Key downside risks include a further deterioration of a less successful than expected performance of handbags at Prada this year, important re-investments as more limited barriers to entry make the cost of growth higher in the soft luxury sector as well as pressure to lower prices in Asia. Key upside risks include better-than-expected same store sales growth implying better operating leverage at the group level, a more efficient than expected cost control programme and the group opening fewer stores and/or renegotiating rents on the existing base more efficiently.

Peer-group comparison Luxury (priced at 19 June 2015)

	RIC	Rating	Currency.	Price	TP	Market cap (m)	PER 2014a	PER 2015e	PER 2016e
Soft luxury									
LVMH	LVMH.PA	Buy	EUR	159.95	200.0	81,239	14.3	19.7	17.0
Christian Dior	DIOR.PA	Buy	EUR	181.55	210.0	32,993	17.4	15.3	13.9
Hermès	HRMS.PA	Buy	EUR	344.40	375.0	36,358	42.1	34.1	29.6
Kering	PRTP.PA	Hold	EUR	154.70	178.0	19,534	19.3	16.5	13.7
Prada	1913.HK	Hold	HKD	37.70	43.0	96,468	24.3	24.4	21.6
Coach*	COH.N	Buy	USD	35.90	46.0	10,185	15.5	17.6	15.3
Burberry*	BRBY.L	Buy	GBP (p)	1,646.46	2100.0	7,304	21.5	20.5	18.6
Hugo Boss	BOSSn.DE	Buy	EUR	100.75	131.0	7,093	20.8	18.1	16.0
Ferragamo	SFER.MI	Hold	EUR	26.91	32.0	4,532	28.9	24.1	19.4
Tod's	TOD.MI	Hold	EUR	87.20	90.0	2,669	27.5	26.7	22.9
Moncler	MONC.MI	Buy	EUR	16.94	21.0	4,235	32.6	24.0	19.4
Jimmy Choo	CHOO.L	Buy	GBP (p)	153.00	205.0	578	26.1	20.2	15.6
Average soft							24.2	21.8	18.6
Hard luxury									
Richemont*	CFR.VX	Buy	CHF	76.65	100.0	44,012	27.2	20.1	16.5
Swatch Group	UHR.VX	Hold	CHF	365.40	430.0	19,336	14.3	15.0	13.6
Tiffany	TIF.N	Buy	USD	92.47	106.0	11,798	22.0	22.0	18.3
Pandora	PNDORA.CO	Buy	DKK	687.50	740.0	88,079	27.8	22.0	16.6
Average CFR/UHR/TIF							21.2	19.0	16.1

* Based on calendar data
Source: HSBC estimates

Prada simplified P&L (EURm)

	FY 10	FY 11	FY 12	FY 13	Q1 14	FY 14	Q1 15	FY 15e	FY 16e	FY 17e
Net sales	2,017	2,523	3,256	3,548	768	3,513	817	3,824	4,109	4,404
Royalties	30	32	41	39	9	38	11	41	44	47
Net revenues	2,047	2,556	3,297	3,587	778	3,552	828	3,865	4,153	4,451
Gross profit	1,388	1,828	2,377	2,649	575	2,551	600	2,776	3,066	3,317
Gross margin (%)	67.8%	71.5%	72.1%	73.8%	74.0%	71.8%	72.5%	71.8%	73.8%	74.5%
Product and development as a % of sales	(97) 4.7%	(103) 4.0%	(111) 3.4%	(130) 3.6%	(29) 3.7%	(133) 3.7%	(30) 3.6%	(139) 3.6%	(145) 3.5%	(151) 3.4%
Advertising and promotion as a % of sales	(85) 4.2%	(129) 5.1%	(151) 4.6%	(172) 4.8%	(41) 5.3%	(171) 4.8%	(55) 6.6%	(186) 4.8%	(199) 4.8%	(214) 4.8%
Selling expenses as a % of sales	(643) 31.4%	(803) 31.1%	(1,040) 31.5%	(1,212) 33.8%	(302) 38.8%	(1,341) 37.8%	(369.5) 44.6%	(1,555) 40.2%	(1,649) 39.7%	(1,748) 39.3%
General and admin as a % of sales	(145) 7.1%	(164) 6.7%	(185) 5.6%	(196) 5.5%	(47) 6.1%	(205) 5.8%	(56) 6.7%	(232) 6.0%	(243) 5.9%	(256) 5.7%
SG&A as a % of sales	47.4%	46.9%	45.1%	47.7%	53.9%	52.1%	61.6%	54.6%	53.9%	53.2%
EBIT	414	629	890	939	156	702	91	664	829	948
EBIT margin (%)	20.2%	24.6%	27.0%	26.2%	20.1%	19.8%	10.9%	17.2%	20.0%	21.3%
Interest, net	(21)	(26.0)	(7.1)	(16.3)	(5.6)	(33.8)	(0.4)	-	5.0	15.0
Depreciation and amortisation as a % of sales	118 0	130.0 5.1%	162.7 4.9%	203.9 5.7%	57.9 7.4%	252.7 7.1%	72.2 8.7%	300.7 7.8%	318.8 7.7%	337.9 7.6%
EBITDA	541	759.0	1,052.5	1,143.2	213.9	954.2	162.7	964.7	1,147.4	1,286.3
EBITDA margin (%)	26.4%	29.7%	31.9%	31.9%	27.5%	26.9%	19.6%	25.0%	27.6%	28.9%
PBT	388	603	884	923	150	668	90	664	834	963
Taxation	(135)	(166)	(250)	(285)	- 41.30	(209)	- 30	(216)	(267)	(303)
Tax rate	34.7%	27.6%	28.3%	30.9%	27.5%	31.2%	33.3%	32.5%	32.0%	31.5%
Net profit	254	437	633	638	109	459	60	448	567	660
Net margin (%)	12.4%	17.1%	19.2%	17.8%	14.0%	12.9%	7.3%	11.6%	13.7%	14.8%
Prof. attrib. to non-controlling interests	(3)	(4.5)	(7.6)	(10.0)	(4.1)	(8.5)	(1.6)	(10.5)	(12.5)	(14.5)
Net profit group	251	432	626	628	105	451	59	438	554	645
Weighted shares (m)	2,528	2,536	2,559	2,559	2,559	2,559	2,559	2,559	2,559	2,559
EPS (Basic) (EUR)	0.10	0.17	0.24	0.25	0.04	0.18	0.02	0.17	0.22	0.25

Source: Company data, HSBC estimates

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), and/or strategist(s) who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and/or any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Erwan Rambourg, Antoine Belge and Anne-Laure Jamain

Important disclosures

Equities: Stock ratings and basis for financial analysis

HSBC believes an investor's decision to buy or sell a stock should depend on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations and that investors utilise various disciplines and investment horizons when making investment decisions. Ratings should not be used or relied on in isolation as investment advice. Different securities firms use a variety of ratings terms as well as different rating systems to describe their recommendations and therefore investors should carefully read the definitions of the ratings used in each research report. Further, investors should carefully read the entire research report and not infer its contents from the rating because research reports contain more complete information concerning the analysts' views and the basis for the rating.

From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

Prior to this date, HSBC's rating structure was applied on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Rating distribution for long-term investment opportunities

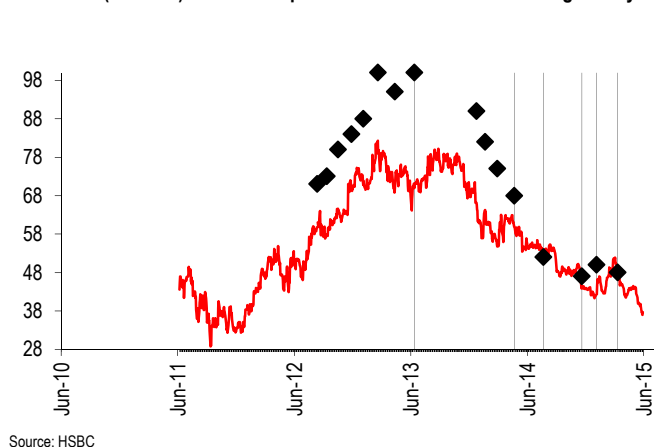
As of 22 June 2015, the distribution of all ratings published is as follows:

Buy	40%	(29% of these provided with Investment Banking Services)
Hold	43%	(28% of these provided with Investment Banking Services)
Sell	17%	(21% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see “Stock ratings and basis for financial analysis” above.

Share price and rating changes for long-term investment opportunities

Prada SPA (1913.HK) Share Price performance HKD Vs HSBC rating history



Recommendation & price target history

From	To	Date
Overweight (V)	Overweight	03 July 2013
Overweight	Neutral	12 May 2014
Neutral	Underweight	12 August 2014
Underweight	Neutral	10 December 2014
Neutral	Overweight	25 January 2015
Overweight	Hold	01 April 2015
Target Price	Value	Date
Price 1	71.00	01 September 2012
Price 2	73.00	02 October 2012
Price 3	80.00	06 November 2012
Price 4	84.00	18 December 2012
Price 5	88.00	24 January 2013
Price 6	100.00	11 March 2013
Price 7	95.00	03 May 2013
Price 8	100.00	03 July 2013
Price 9	90.00	14 January 2014
Price 10	82.00	10 February 2014
Price 11	75.00	20 March 2014
Price 12	68.00	12 May 2014
Price 13	52.00	12 August 2014
Price 14	47.00	10 December 2014
Price 15	50.00	25 January 2015
Price 16	48.00	01 April 2015

Source: HSBC

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