



Global Real Estate Securities

Market Review | Third Quarter 2015

Region	Index Performance (\$USD) ¹					
	3Q 2015	YTD	1-Year	3-Year	5-Year	10-Year
North America	1.4%	-4.6%	8.1%	8.6%	11.4%	10.4%
Asia Pacific	-9.5%	-7.1%	-5.8%	3.4%	5.6%	7.7%
Europe	3.2%	6.5%	10.1%	13.9%	9.3%	9.0%
Total Return	-2.0%	-3.6%	3.5%	7.6%	8.9%	9.2%

Market Review

Values versus Price

Currently, there exists a disconnect between real estate stock prices and underlying real estate values. The global real estate securities market continued its slump in the 3rd quarter bringing year to date global returns to -3.6%. This adverse performance seems to be a stark contrast to direct global real estate markets which are anticipated to experience another year of solid returns. The valuation gap is bewildering when one views the global components. In the U.S., it is estimated that direct real estate² has returned approximately 10.5% though the end of Q3, yet REITs are down over 4%, a significant disconnect. Valuation estimates show that 80% of the REITs in the U.S. trade below their Net Asset Value (“NAV”). Similarly, about 54% and 34% of the real estate securities in Asia and Europe, respectively, trade at discounts to their NAV. These discounts are surprising given the expectations for returns in the Asian and European private property markets of 14% and 18%, respectively. The series of recent REIT privatizations by major institutional investors in the U.S. are testament to the disconnect between public and private market valuations.

	Public Real Estate Market Returns YTD ¹	Percent of Public Companies (REITs) Trading Below NAV ³
United States	-4.3%	80%
Asia	-7.1%	54%
Europe	6.5%	34%
Global	-3.6%	

As we have previously noted, when it comes to pricing REITs, the markets can be very inefficient. About 85% of the world’s real estate is private and 15% is in the public markets. REIT values are derived by an assessment of the underlying real estate assets in the portfolio and future cash flow growth. The property values are determined by the private market and the cash flow growth is influenced by economic variables driven by local market fundamentals. Private market values are primarily driven by fundamentals (supply and demand, capital availability) while public markets tend to have a

disproportionate weight of market sentiment in the pricing of the securities. Private real estate fundamentals will drive the value of the underlying real estate in REIT portfolios, not stock prices. This disparity can lead to pricing anomalies and compelling investment opportunities.

Over time, the performance of the REIT market will be driven by the underlying real estate fundamentals of the properties and management of company balance sheets. We believe that the current market downturn and the divergence between REIT stock prices and underlying real estate values represents an attractive opportunity to build long-term positions in the REIT market.

What has changed?

Nothing! Ok, on the margin, employment gains in the U.S. have softened (tempered inflation expectations) and the UST 10 yr yield has fallen from 2.42% to 2.04% during the third quarter. We have experienced economic disruption in China which has led to a reduction in global growth estimates, diminished returns for equities and bonds and continued dollar strength. The ECB and BoJ have continued their quantitative easing programs and short rates have extended their declines. China is still facing cyclical headwinds which has contributed to the slide in oil and leading to intensifying strains on the Emerging Markets⁴. Did I happen to mention geopolitical conditions and confrontation in the Mid-East? Yes, the world is experiencing a deceleration in global growth expectations. There is rising uncertainty in both the developed and emerging markets.

However, in the U.S., the fundamental story of supply and demand remains intact. Given these global adverse conditions, most banks still remain reluctant to lend capital for speculative real estate development. Supply remains in check. Job growth continues on an upward trajectory, albeit with a subdued slope. Employment gains are local market dependent and with most markets at full occupancy, moderate economic improvements should put upward pressure on rents. Modest economic growth with limited competition from new supply, in the face of moderately increasing interest rates should continue to benefit real estate markets.

Interest Rates

Yes, we all anticipate that the US Federal Reserve will increase rates, at some point. While rates are projected to increase at a “measured” pace, the Street has been primed by the Federal Reserve that these bumps will be “data dependent” and nominal in nature. We are not in the era where we anticipate a protracted series of future increases. In the short-term, rising bond yields will likely result in a negative market reaction and somewhat lower share prices. However, in a growing economy, increasing demand driven by job growth, and measured new supply, has often resulted in increasing real estate values. Historically, real estate has been an attractive hedge against inflation.

The Fundamental Story

Declining real estate values due to market expectations for rate increases in the current macroeconomic environment is counter to the direct real estate fundamentals: 1) supply is still limited and increasing rates will serve to further diminish new supply; 2) there is abundant capital in queues and on the sidelines to invest from both domestic institutions and foreign capital sources to purchase real estate assets in the U.S.; 3) tenant demand for new space continues to outstrip new supply; 4) real estate returns are very competitive and look attractive versus equities and bonds; and 5) most institutional markets are currently at full occupancy, on average.

Commercial real estate fundamentals remain very healthy. Commercial construction is still modest, as it has been since the financial crisis. Given that vacancy rates are at or near all-time lows for many sectors, we would anticipate more supply at this point in the cycle. However, banks have remained disciplined and capital for new construction is sparse. Commercial real estate development is still 25% below its pre-crisis peak.

While we remain cautious of property prices that have hit historic highs in some sectors of the real estate market, many sectors still offer compelling valuations for long-term investors. Property prices have been bolstered by the search for yield and competitive returns, relative to stretched stock and bond valuations. Although the excessive leverage we have seen in past cycles is largely absent and buyers have increased equity investments in the assets, we are watchful about events that could our thesis to adjust.

United States Market Review

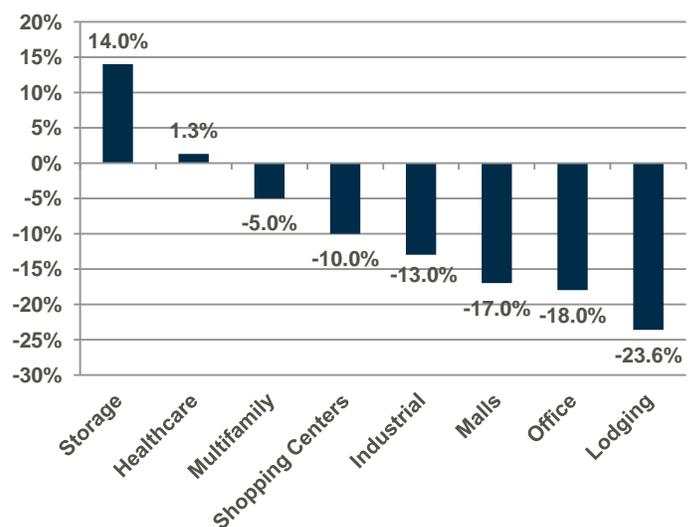
US REITs delivered a 2.1% total return in the third quarter of 2015.⁵ Despite real estate fundamentals remaining strong, investors continue to focus on the impact and timing of interest rate increases as well as slowing economic growth. Investors typically worry about one or the other, but not both at the same time. This dual wall of worry is creating very attractive public

market real estate pricing versus private market real estate pricing. In fact, in many property types, the valuation gap between public and private real estate values are at the most attractive levels since the global financial crisis. Investors appear to be classifying REITs as a yield only investment in their haste to sell first and ask questions later and seem to be assigning little or no value to the cash flow growth characteristics of real estate investments. REIT investment characteristics are hybrids of stocks and bonds with yield + growth features. We are at the point in the real estate cycle where landlords have pricing power and rent growth exceeds inflation in most property types and geographies in the US. This, combined with little additional supply, should lead to cash flow growth from REITs above historical averages.

The economic backdrop remained not too hot and not too cold for REIT fundamentals in the third quarter of 2015, with the economy averaging approximately 167,000 jobs per month, a significant deceleration from last year’s third quarter average of 237,000 jobs. This deceleration in jobs growth has raised concerns over slowing economic growth, but has kept interest rates in check.

Year to date jobs growth has averaged 198,000 compared to 238,000 for the same period last year. The level of jobs growth continued to create ample real estate demand to absorb vacancies and create pricing power in a growing number of property types and markets. However, it was not so much that it created material supply additions, with the exception of apartments, select industrial markets and select hotel markets. REIT aggregate occupancy remains near peak levels at 94.6% at the end of 2Q15, up slightly from 94.2% a year ago⁶. Office and malls are the only property sectors below record levels. New supply, while trending up, hovers near historical lows at 1.2% of existing supply compared to a historical average of approximately 2%. Additionally, REIT dividend payout ratios

EXHIBIT 2: US SECTOR P/NAV⁷



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remain near historical lows at 72% versus a long term average of 81%, providing the potential for double-digit dividend growth again in 2016.

Private market real estate fundamentals remain strong and investor demand for commercial real estate properties remains robust.

Small capitalization REITs underperformed large capitalization REITs by 680 basis points in the third quarter as the valuation gap between small and large cap REITs that we identified in our first quarter 2015 report widened. We still believe small and mid cap REITs appear relatively attractive in 2015. Growth outperformed value for the quarter as well as year to date. We would expect cash flow growth to continue to be highly valued by investors; however, we are distinguishing our investments by focusing on growth at reasonable prices and sticking to a value discipline versus chasing growth at any price.

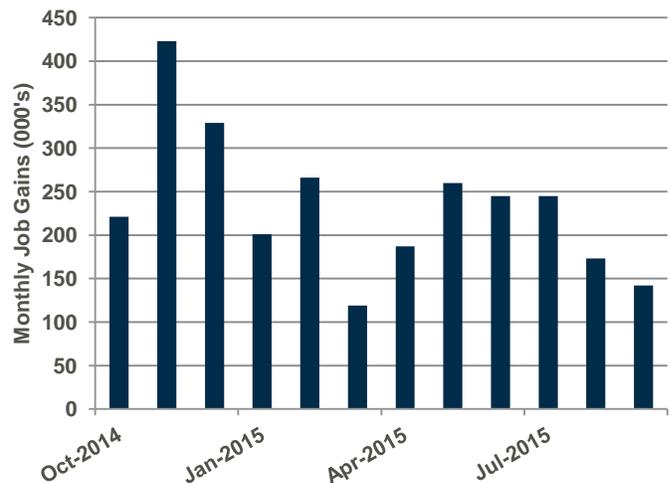
REITs continued to take advantage of the availability and relatively low cost of capital. REITs issued \$43 billion in equity and debt capital so far in 2015. The pace has slowed considerably in the third quarter considering the increase in equity cost of capital as REIT share prices have moved lower. In fact, as a result of the disconnect between private and public market pricing, many REITs announced share buyback programs totaling \$8 billion, which will reduce the equity share base. Additionally, debt spreads on CMBS as well as senior unsecured debt have widened on concerns over global economic growth. We are now on track to reach similar levels of capital issuance as last year.⁸ With REIT balance sheets in good shape, the majority of equity issuance is focused on funding acquisitions, funding re-development pipelines and funding development pipelines. REIT development pipelines currently aggregate \$42 billion and position REITs well to deliver additional mid-cycle growth.

Fund flows from US individual investors were negative in the third quarter at approximately -\$3.5 billion of net flows, including those from exchange traded funds. Fund flows from Japanese investors into US focused real estate funds were strong at \$1.9 billion.⁹

The best performing sectors during the quarter were the apartment and self-storage sectors. Apartment and self-storage fundamentals continue to improve as the economy further expands and landlord pricing power increases. Guidance updates for 2015 apartment and self-storage earnings growth was well received by investors and early 2016 leasing trends show continued landlord pricing power.

The hotel sector was the worst performing sector during the quarter. A few hotel companies lowered their third quarter and annual earnings guidance as third quarter Revenue Per Available Room came in softer than expected. The hotel sell off was further exacerbated by concerns of a global economic slowdown. Supply across most hotel markets remains in

EXHIBIT 3: MONTHLY GAINS ('000) FOR OFFICE/NON-OFFICE USING JOBS¹⁰



check. We would expect 4th quarter earnings results to improve over 3rd quarter results. As long as there is no significant economic slowdown in 2016, we believe the sector presents an attractive valuation opportunity.

Outlook

In the 6th year of an elongated economic cycle, REITs continue to improve operating fundamentals and are again poised to deliver double-digit dividend and high single digit cash flow growth in the next 12 months.

From a relative valuation perspective, REITs ended the quarter trading at a 9% discount to their underlying real estate value, well below the historical average premium of 2%.¹¹

However, there are large variances across property types with Mall, Office and Hotel companies trading at discounts of 14%, 18% and 24% respectively. These property types have not seen sustained discounts this high since the global financial crisis. These discounts are being validated by company share buybacks. Holding property level income steady, pricing implies that cap rates would need to expand by 70-150 bps in these property types just to reach fair private real estate value. Implied cap rate spreads of REITs relative to the 10-year Treasury remain wide at roughly 370 bps.¹² That level of spread provides REITs with a cushion if interest rates increase, as spreads could contract without any deterioration in real estate value. Additionally, REIT cash flow multiples are slightly higher than the S&P 500 multiple, an attractive level relative to the 2010-2013 period and to where we are in the cycle.

REIT occupancies and rental rates are expected to continue to improve in 2015. At this point in the cycle, we would expect the majority of revenue growth to come from rental growth versus occupancy gains. Supply is expected to remain muted in most

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markets and property types, with the exception of apartment, industrial and select hotel markets. Employment centers that focus on technology, healthcare, and media/entertainment are expected to deliver relatively strong jobs growth. We are seeing a bottoming of real estate fundamentals in markets dependent on government employment like Washington DC and are beginning to find some attractive opportunities there. Markets that are dependent on the financial sector also continue to improve in 2015, with New York City surpassing peak employment levels.¹³ We are underweight energy related markets as the impact of lower oil prices weighs on demand and keeps private real estate investors on the sidelines. We are seeing an impact in hotel revenue growth in energy dependent cities like Houston where revenue growth has turned flat to down. We have not yet seen a material negative impact in apartment rents in Houston, but we are seeing some deceleration and moderation of rent growth and continue to monitor current rent trends for signs of weakness.

With a dividend yield of 4.2% and estimated earnings growth of 6-8% over the next 12 months, REITs are poised to deliver a consensus return of approximately 11%, assuming no expansion or contraction in the earnings multiple. However, given continued economic concerns, volatility spikes remain likely.

As we get deeper into the real estate cycle, we expect more of a stock pickers market as we head into 2016. Given the uncertainty around the direction of interest rates and global economic growth, we would expect that sector rotation or large sector bets could be tempting but not likely to consistently pay off for investors. We will focus our strategy on picking the best names within sectors.

Additionally, we will not chase cash flow growth at any price and remain focused on a disciplined value investment approach. We believe M&A and privatization activity will continue to heat up as we are coming off \$21 billion in deals in 2014, the highest level since 2007. One of our largest holdings, Strategic Hotels and Resorts, announced that it would be acquired by Blackstone for a price 28% above our cost basis. We are in an environment where Net Asset Value matters and discounts are likely to get resolved or arbitrated. There continues to be a wall of private real estate capital focused on acquiring high quality US real estate. The US REIT market provides a nice shopping list for those investors. Media reports also indicate that another of our large overweight positions, Parkway Properties, is pursuing strategic alternatives including a sale of the company.

We are positioned to focus on companies with strong relative internal cash flow growth and select re-development and or development opportunities that trade at reasonable valuations relative to their private market value. In many cases, we are finding companies with undervalued re-development and development pipelines. We have increased exposure to high quality shopping center companies and storage as revenue trends remains favorable.

Europe¹⁴

Market Review

The European public real estate market returned 3.9% (USD gross total return) for the quarter. Year to date, Europe returned 7.3% USD gross total return.

Currency movements played little role in USD returns this quarter with the EUR and SEK basically unchanged against the dollar. However the USD did strengthen 3.7% against the GBP in the quarter, pushing down returns in the UK.

Germany was the best performing market in Europe in the third quarter with an impressive USD gross total return of 12.9%. The German multifamily residential sector had a very strong reversal of performance after a disappointing first half of the year as consolidation in the sector continued with the announcement of a friendly merger proposal of two leading players. For the year to date period, Germany has returned a strong 9.9%, ahead of the European year to date average of 7.3%.

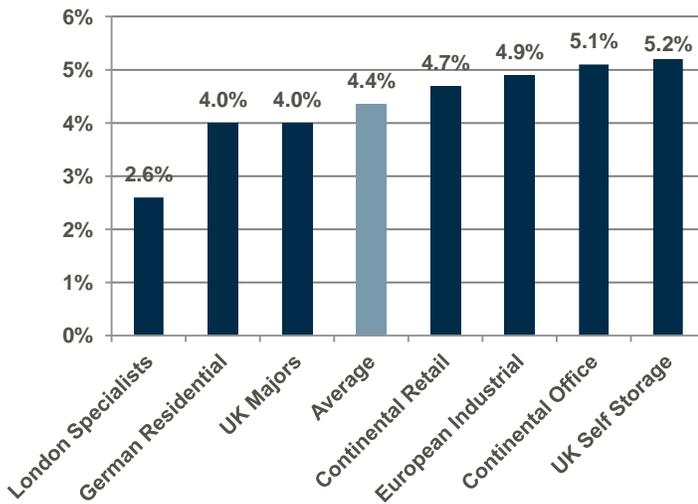
Sweden was the next best performing market with a 7.5% gross total return in the quarter as the central bank monetary policy stance was relaxed further and solid company results illustrated the strong underlying real estate market. However, lagging first half performance due in large part to a decline in the SEK against the USD meant that Sweden trailed the European benchmark year to date with a total return of 4.2%. Italy (+4.8%), Finland (+4.1%) and France (+3.5%) were the next best performing markets in 3Q and all turned in a good quarter.

The UK trailed slightly behind the European benchmark in the third quarter with a gross USD total return of +2.2%. Returns here were depressed by the 3.7% decline in the GBP against the USD in the quarter, and the UK equity market was somewhat more impacted by the China correction in August than many continental European markets. However, direct real estate market evidence and quarterly results from the listed real estate companies continue to point to strong underlying growth trends in the UK. For the year to date period, the UK was within the top three major European markets in terms of performance with a total return of 11.2%.

Market Outlook

European equity markets weathered the Greek crisis earlier this summer but experienced another correction on weak economic data and equity market turbulence originating from China in August. Valuations have returned to attractive levels, particularly in the UK and Ireland where the near-term growth dynamics in the economy and real estate markets remain the strongest.



EXHIBIT 4: EUROPE SECTOR/COUNTRY IMPLIED CAP RATES¹⁵

The ECB's quantitative easing program running to September 2016, combined with the still significant amount of foreign and domestic capital seeking real estate yield, has produced significant cap rate compression across the wider Eurozone, and we expect this trend to continue at a reduced pace in many markets. While evidence of rental growth has been limited in many continental markets, rents have at least stabilized and are exhibiting positive early indicators of a modest return to rental growth in most of the lagging continental markets (with the exception of France).

As real estate investors, we would look through short term market volatility and focus instead on the fundamental health of the core European real estate markets both outside and inside the euro zone. If anything, interest rates will stay lower for longer within the eurozone, extending the positive conditions for owning real estate further. We maintain our major overweight positions in the UK and Ireland and will be alert to opportunities to add attractive eurozone positions on short-term market volatility.

Asia Pacific Market Review

In the Asia Pacific region, high volatility was the main theme for the equity markets in the September quarter, led by the Chinese stock market. The Shanghai Composite Index (SHCOMP) fell by 30.4%.¹⁶ Singapore developers corrected by 19.1%, followed by Hong Kong (-16.2%) and Japan (-6.9%). In the REIT space, Singapore REITs fell by 15.8%, followed by Australia (-8.8%) and Japan (-5.1%).

The market sell-off was triggered by the Chinese government's decision to devalue the Chinese yuan against the USD by

1.9% on 11 August. The currency fell by another of 3% in the next two days.¹⁷ The yuan devaluation has also caused a wave of weakness among other Asian currencies against the US dollar. In the third quarter, the Australian dollar fell by 4.9%, followed by the Singapore dollar (-4.4%), the Thai Baht (-4.2%), the Vietnamese Dong (-3.1%) and the Korean Won (-2.7%).¹⁸

The yuan devaluation increased the market's concern over the Chinese economy, which is showing more evidence of slower growth. Corporate results from Fanuc in Japan (a manufacturer of factory automation systems and robots), Hang Lung Properties in Hong Kong (a retail mall landlord) and CapitaLand Retail China Trust in Singapore, have all reported weaker business or leasing demand in the mainland. The economic growth slowdown in China is also reflected by the net profit decline posted by Chinese corporates such as Gome (a seller of household appliances and consumer electronic products in China) and Want Want (a manufacturer and seller of rice cracker, snack food and beverages in China). Another sign is the decline of industrial profits in China, by 8.8% year over year in August, or 1.9% for the first eight months of the year. Perhaps the most prominent victim was Glencore Plc which saw its share price plummet by 29% on 28 September and about 77% year to date.¹⁹

In a further attempt to stimulate the economy, the Chinese government adopted additional monetary easing in the third quarter. The Chinese central bank reduced the interest rate by 25 bps in August, the fifth time and totaling 140 bps since November 2014. The central bank also cut the banks' reserve requirement ratio (RRR) by 50 bps in August, the fourth reduction. With the U.S. Fed interest rate increase on the horizon, the yuan devaluation and the interest rate cut in China have deepened the risk of further capital outflow from the mainland. Approximately US\$142 billion outflow was recorded in August, up from US\$125 billion in July.²⁰ For the Chinese domestic companies, an increase in the U.S. interest rate, exacerbated by a weakening yuan, will raise the repayment cost of their US\$ denominated loans.

In Japan, the world's third largest economy remained feeble, with an unexpected 1.2% GDP contraction in the second quarter of this year. The government's inflation target of 2% will likely take a longer time to achieve as the core consumer price index actually fell by 0.1% in August, after zero growth in July. The inflationary environment that was seen in the first quarter at around 2% appears to be unsustainable. The Japanese government therefore needs to do more to boost consumption so that its 2% inflation target becomes more achievable.

Notwithstanding these challenges, there are several bright spots that are worth highlighting. Tourist arrivals in Japan so far this year have seen robust growth, especially arrivals from China. In the first eight months of the year, total arrivals increased by 49% year over year to 12.9 million.²¹ The number of mainland Chinese tourists expanded even more with an

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increase of 117% for the same period. In the office market, the vacancy in Tokyo's central 5 wards improved to 4.72%²² in August, from 4.89% in July. This is the second month that vacancy stayed below 5%, which was last seen in January 2009. Office rents have improved by 3.2%²³ in the first eight months of this year and further growth is expected going forward.

In Hong Kong, the Central office market remains a bright spot, with the vacancy improving to 1.3% in August²⁴, the lowest level since June 2008. Office demand in Central is mainly supported by mainland Chinese financial companies. On the other hand, the retail market continues to face headwinds. Large retail landlords, with the likes of Hysan, Wharf and Swire Properties, are seeing tenant sales declining at their flagship retail malls. This is attributed to the drop in Chinese tourist arrivals as well as their spending. High street retail shop rents have already fallen in popular locations such as Causeway Bay and Mongkok. Luxury branded goods or jewelers who previously paid top rents for these shop spaces have either terminated the lease or renewed the lease at significantly lower rents.

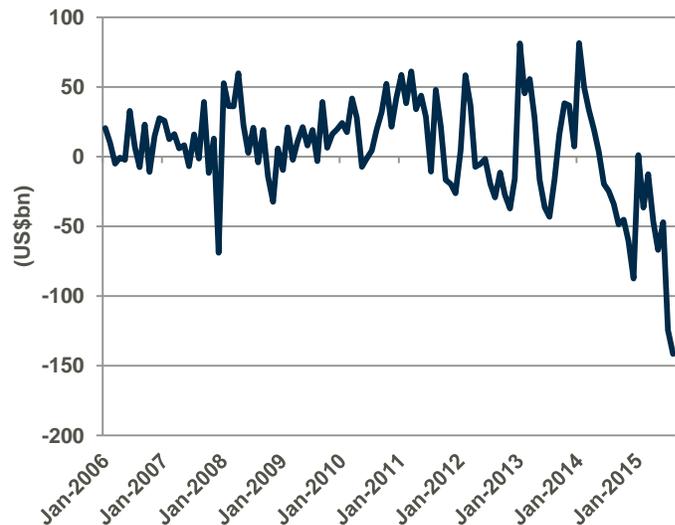
Share price correction may have been overdone for the Singapore office sector and thus present a trading opportunity. We are cognizant of the impending supply coming onto the market in mid-2017 but the 20%+ year-to-date correction in share prices is implying earnings contraction of 15%-18% which is materially higher than our estimate of 3.5% decline in DPU. At 6.8% yield for the next 2 years, the sector is offering some 400 bps spread above the 10-year bond.

In Australia, the office leasing market in Sydney saw incentives moderate to 20% from 25%. At the same time, cap rate compression continued to play out in the third quarter. For example, in July it was reported that Chinese Sovereign Fund China Investment Corp (CIC) purchased Investa Property Trust (in Australia) for A\$2.45 billion, reflecting an initial yield of 6% of its portfolio of nine premium and Grade-A office properties²⁵, compared to about 6.5% for prime office yield reported in June²⁶. In September, GIC and Frasers Property Australia disposed of its logistics portfolio in Australia (Sydney, Melbourne and Brisbane) at an exit yield of about 6.5%, versus market prime industrial yields of about 6.75% in Sydney and Brisbane and 7.0% in Melbourne back in June²⁷.

Market Outlook

Asia has led the recent stock market correction and is likely to continue to set the tone for global equity markets. Within Asia, China and Hong Kong have borne the brunt of the market correction. At current valuation levels, Hong Kong looks attractive, particularly those stocks with China exposure; they are trading at GFC valuation levels. Unless we see China's slowdown triggering a financial crisis, stocks are trading at attractive levels. However, near term news flow is likely to continue to be negative.

EXHIBIT 5: CHINA MONTHLY CAPITAL FLOW²⁸



The most robust market in the Asia Pacific region is Australia. High absolute yields, a weakened currency, a benign to softening interest rate environment and healthy industry fundamentals all add up to make Australia an attractive real estate investment market, particularly for international capital. Hence cap rates are likely to be supported at current levels or may even compress further.

Japan continues to report improved real estate fundamentals with good potential for further rent increase and consumption growth. It's the only region globally that has reported positive corporate earnings revision despite slower growth in China. Nonetheless economic numbers continue to fall short of Abe's target which could prompt further policy measures to boost the economy.

Our overweights in Asia Pacific continue to be Japan and Australia. However any further correction in prices is likely to prompt a switch into the more undervalued markets.



Disclosures

¹Factset. S&P Developed Property Index. 30-Sep-2015.

²NCREIF NFI-ODCE Preliminary, 12-Oct-2015.

³Prudential Real Estate Investors. Evercore/ISI, EPRA/NAREIT, Bloomberg. 30-Sep-2015

⁴Cornerstone Macro, Global GDP Outlook, October 1, 2015.

⁵US REITs total return taken from MSCI US REIT Index (RMZ). As of 30-Sep-2015.

⁶Citi. As of 30-Sep-2015.

⁷ISI, GreenStreet Advisors. As of 30-Sep-2015.

⁸Citi. As of 30-Sep-2015.

⁹Evercore ISI. 30-Sep-2015.

¹⁰Bloomberg, 30-Sep-2015

¹¹Green Street. 30-Sep-2015.

¹²Citigroup. 30-Sep-2015.

¹³New York State Department of Labor. 30-Sep-2015.

¹⁴All performance data appearing in this “Europe” section is sourced from the S&P Developed Property Gross Total Return Index and regional constituent indices. The country returns quoted below in this section are quoted from the individual country indices within the S&P Developed Property Index using gross total returns (ie S&P United Kingdom Property Index, etc.). Investors cannot invest directly in an index. Please see end of document for index definitions.

¹⁵Green Street Advisors. As of 31-Jul-2015.

¹⁶Bloomberg (in USD terms). 30-Sep-2015.

¹⁷Bloomberg. 30-Sep-2015.

¹⁸Bloomberg. 30-Sep-2015.

¹⁹Bloomberg. 30-Sep-2015.

²⁰Bloomberg. 30-Sep-2015.

²¹Japan National Tourism Organization. 30-Sep-2015.

²²Miki Shoji. 30-Sep-2015.

²³Miki Shoji. 30-Sep-2015.

²⁴JLL data. 30-Sep-2015.

²⁵Private Equity Real Estate. 30-Sep-2015.

²⁶JLL data. 30-Sep-2015.

²⁷JLL data. 30-Sep-2015.

²⁸Bloomberg. 30-Sep-2015.

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Data shown in the narrative section of the report is presented on a gross net. Data for property companies is drawn from the S&P BMI Global Property Total Return index, various regional and country-specific sub-indexes. Data on the equities market is drawn from S&P BMI Global Total Return index, various regional and country-specific sub-indexes. The S&P Global Indexes include both developed and emerging markets.

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