Friday, 21 October 2011

Quickflix Limited (QFX)

Entertainment you want when you want it

- Quickflix today announced that it had entered into a multi-year agreement with Sony Australia to stream its subscription movie service to Sony's game console PlayStation 3 starting later this year. Quickflix will pay Sony a share of revenue generated.
- The announcement is significant in that Quickflix has extended the platforms and audience it can stream its service to, rather than building a subscriber base from scratch. The streaming service will be available to consumers with access to the internet via their PC, a smart Sony "Bravia" IPTV and now the Sony PlayStation 3 (PS3). Additional platforms are expected to follow.
- In a world rapidly moving to providing consumers with the entertainment they want when they want it, today's announcement clearly demonstrates the way Quickflix is building its distribution channels and subscriber base cost-effectively.
- A big clue as to how Quickflix intends to become a significant player in the new era of "over the top" (OTT) internet-delivered video was provided on 13 July when it announced that it had "signed an agreement with Sony Australia to provide a subscription movies streaming service through Sony's next generation internet-connected consumer devices". As part of the same announcement, Quickflix said that Sony had launched 22 Bravia internet protocol television models (IPTVs) into the Australian market and that Sony would add Quickflix to its range of new technology television sets.
- The government-mandated switchover to digital television has commenced, with the analogue signal now switched off in a number of areas, and is now driving the sale of new high definition television sets, which for the major part are smart TVs and can connect directly to the internet. Based on our estimates Quickflix will have an immediately addressable market of more than 1.1 million PS3s and Sony Bravia IPTVs.
- **Recommendation**: Quickflix provides investors exposure to the DVD online and emerging direct-to-home video streaming industry in Australia. The stock is high risk and only suited to investors who are comfortable with high risk-reward stocks. Our short-term price target is $0.20 per share which is 54 percent of our mid-point valuation of $0.37.

Quickflix: Investment Summary

Year to June 30		2010	2011	2012	2013	2014
Revenue	$m	7	11	26	46	70
EBITDA	$m	-1.5	0.0	-1.3	3.2	13.7
EBIT	$m	-3.1	-2.3	-4.9	-1.7	6.6
Reported Profit	$m	-3.1	-2.3	-4.9	-1.8	6.5
Adjusted Profit	$m	-3.1	-2.3	-4.9	-1.8	6.5
EPS (reported)	¢	-1.6	-0.6	-1.3	-0.5	1.7

In Brief

Recommendations

Rating:	Buy
Risk:	High
Price:	**$0.09**
Price Target:	$0.20

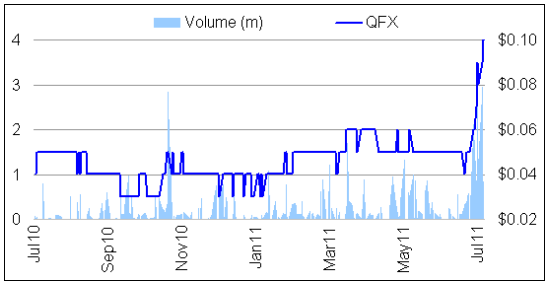
Snapshot

Monthly Turnover	$1.2m
Market Cap	$31m
Shares Issued	426.8m
52-Week High	$0.12
52-Week Low	$0.03
Sector	Consumer Discretionary

Business Description

Quickflix Limited (QFX) is Australia's only publicly listed, independent virtual video store, with the country's largest range of feature-length latest release and classic movies, TV programs, sport music and documentaries. Quickflix operates a simple online selection and ordering system under several subscription payment plans.

12-Month Price and Volume



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Disclosure: The author owns no shares in QFX. E. L. & C. Baillieu Stockbroking Limited has acted in a corporate advisory role for Quickflix Limited and earned fees in relation to that activity in the past 12 months.

Recommendations
Buy: The stock's total return is expected to increase by at least 10-15 percent from the current share price over the next 12 months.
Hold: The stock's total return is expected to trade within a range of ±10-15 percent from the current share price over the next 12 months.
Sell: The stock's total return is expected to decrease by at least 10-15 percent from the current share price over the next 12 months.

Key points (continued)

- Baillieu has published three reports on QFX and we refer readers to those reports for additional background and status updates on a number of issues. The reports are as follows:
  1. Quickflix Limited – "*Next generation virtual home entertainment – online DVD rental and streaming*," 30 June 2011;
  2. Quickflix Limited – "*Market consolidation provides major boost to Quickflix*," 5 July 2011;
  3. Quickflix Limited – "*Strategy, people and market consolidation provide boost,"* 13 July 2011.
- QFX has taken several steps to build subscriber numbers quickly. In the physical part of its business, QFX is purchasing Telstra's BigPond Movies (BPM) DVD library and has entered into an agreement whereby for every BPM subscriber that switches to QFX, Telstra's BigPond will receive a fee. Telstra closed its service at the end of September. We believe QFX is on track to increase the number of paying subscribers to its physical rental business to in excess of 100,000 by the end of December this year.
- In the soon-to-be launched streaming component of its business, Sony has agreed to allow QFX to subscription stream video on demand (SVOD) not only to Sony Bravia Internet Video (SBIV) connected TVs, but also to any TV connected to SBIV-capable Blu-ray players and home theatres, as well as Sony VAIO computers in Australia. Sony will also offer a pay-per-view service. It already has some 20 content providers which are detailed at: http://www.sony.com.au/microsite/iptv/index.html. However, QFX will be the only SVOD supplier on the platform.
- In a previous report on QFX (5 July 2011) we suggested that a subscriber base of at least 100,000 customers would be required before a number of potential partners, including Sony, would be prepared to engage with QFX. Sony is obviously the first cab off the rank and further announcements relating to carriage agreements with other leading brands of television and gaming consoles can be expected.
- Sony's agreement to carry QFX on its PS3 is an endorsement of QFX's business model as it continues to develop into a pure play in the provision of movies to consumers.
- Each low cost distribution channel and carriage agreement that QFX announces increases the probability of QFX achieving its stated aim of having 1 million paying subscribers in five years' time.

Addressable market announced to date

PCs and video viewing over the internet

- Australia has 8.4 million households of which 80 percent have access to the internet. However, video viewing on PCs still accounts for an average of only 20 minutes per week. This is expected to change dramatically with the advent of affordable high speed downloads. Until that happens, the readily addressable market for QFX is up to 6.7 million households.
- Obviously consumers still prefer to obtain their viewing pleasure in front of a TV. Based on the two Sony carriage announcements made to date – PS3 and Sony Bravia IPTV – what is the addressable market (household eyeballs) that QFX can reach?
- Over the top video is being made possible as a result of substantially increased data allowances which have become available over the past 12 months. For example, just 18 months ago a consumer would only get 20-40 GB of data for $75 per month, while for the same price today a consumer can get up to unlimited data loads.
- In its recent comparison of Australian and US video markets ("*The future of video*", September 2010), Credit Suisse reported that 1 percent of households had internet-connected TVs in Australia compared with 14 percent in the United States.
- So while the Australian internet-connected TV market is still in its infancy, it is expected to grow rapidly. The limitation to internet-connected TVs is the number of households able to access fast download speeds. We estimate that a standard definition data stream and simultaneous internet access requires a minimum of 6 Mbps. We further estimate that only 60 percent of the 8.4 million Australian households (that is, only 5 million homes) have access to internet speeds greater than 6 Mbps.
- Similarly, the number of homes with high speed internet access required for high definition is a minimum download speed greater than 8 Mbps. We estimate that currently only an estimated 2.9 million homes could access data speeds of this rate or greater. However, with the advent of the National Broadband Network, consumers will have access to faster download speeds at some future date.

IPTV

- The four leading brands selling high definition TVs in Australia are Samsung, LG, Sony and Panasonic and it is a fair assumption that each of these TV sets is IPTV-enabled. Based on our research TV manufacturers are expecting to sell 1.68 million IPTV units in the current calendar year. The individual break-up by brand, including our forecasts out to 2016, are contained in Table 1 below.
- Out of the 8.9 million TVs expected to be sold during the current and next five years, we estimate that approximately 1.7 million of those units will be Sony IPTVs.

Table 1: Sales of digital internet protocol TVs in Au. ('000)

Brand	2011	2012	2013	2014	2015	2016	Total
Samsung	650	600	600	550	550	550	3500
LG	480	480	430	380	380	380	2530
Sony	300	350	300	250	250	250	1700
Panasonic	250	250	200	150	150	150	1150
	1680	1680	1530	1330	1330	1330	8880
Cumulative	1680	3360	4890	6220	7550	8880	

- Based on our estimates the total number of OTT devices currently stands at approximately 2.95 million of which 1.4 million are Sony PlayStations (refer to Table 2 below). However, the installed base of PS3 is estimated at 800,000 units and approximately the same number of households. We forecast that the number of PS3s will grow to 2 million by 2016 (refer to Table 1 in the Appendix).

Table 2: Potential over the top devices (mn)

Platform	2011 Est.
Sony Playstation	1.40
Microsoft Xbox	1.10
Foxtel IP set-top boxes	0.30
Other (T-Box, Tivio, other)	0.15
Total	2.95

**All models*

- On the assumption that current viewing trends continue for some time and that TVs remain the dominant means of watching movies (regardless of whether the delivery mechanism is via a physical DVD received in the mail, or via streaming), we estimate that come the launch of its streaming business later this year, QFX will have available to it between 1.1 million and 4.0 million devices on which consumers will be able to watch QFX movies. By 2017, the number of addressable devices is conservatively estimated at between 5.8 and 15 million (refer to Table 1 in the Appendix).
- According to QFX, its IPTV streaming service will also be launching on PCs/Macs, iPads and iPhones. The number of these additional devices is expected to be both substantial and growing and have not been included in the above estimates.
- The business model being pursued by QFX will enable a subscription streaming service through to three devices simultaneously and connections to up to seven or eight devices to access the service – at no additional fee. While this facilitates receiving the streaming services across multiple platforms and therefore consumers getting "what they want when they want it", to remain competitive with Telstra's T-Box QFX will need to provide consumers with a very compelling pricing structure.
- QFX will pursue carriage on the broadest range of platforms as possible. Consequently, Baillieu believes that for competitive reasons it may be only a matter of time before QFX obtains carriage on Microsoft's Xbox, which on our estimates would add a further 1.1 million devices (refer to Table 2 above).
- While QFX will initially offer a limited range of movie titles from major studios the offering will grow over time. The titles being streamed by QFX will be complemented by a library of 50,000 DVD and Blu-ray movie and TV titles.
- To maximise growth in subscriber numbers, QFX will need to obtain carriage on as many devices as it can. Baillieu's QFX financial model incorporates both the acquisition of BigPond Movies' subscriber base and the increased level of marketing that QFX is proposing to accompany the launch of its streaming business.
- Baillieu has also updated its QFX model for the FY2011 result which was as follows.

FY2011 result

- During the 12 months to 30 June 2011, QFX increased subscriber numbers to 70,250 paying subscribers and 11,945 triallists. Paying subscribers were up 78 percent year on year and total subscribers were up 48 percent.
- At the FY2011 year-end, gross marketing and trial cost per sign-up or cost per acquisition (CPA) was down from $44 to $31 per new customer acquired. Customer churn, however, increased to 6.4 percent as a result of the increased number of first time subscribers and triallists.
- Revenue for FY2011 climbed by 53 percent to $10.9 million, outpacing operating expenses which led to an improvement in operating profit before marketing costs of 351 percent. As a result of the increase in number of subscribers the revenue run-rate in the last quarter of FY2011 was $12.6 million annualised.
- Quickflix also introduced simplified subscription plans during the year as follows: *Light*, $9.99; *Regular*, $14.99; *Movie Lover*, $19.99 and *Ultimate*, $29.99.
- Based on our calculation of average number of subscribers over the two periods, the average revenue per subscriber (ARPS) fell by 3.2 percent from $18.52 in FY2010 to $17.93 per subscriber in FY2011.
- QFX produced an operating loss of $2.96 million for the year, down from a loss of $3.1 million for the previous corresponding period. Revenue growth drove a 67 percent increase in gross contribution to $4.8 million. However, a 43 percent and 44 percent increase in direct service and indirect costs respectively, and a 21 percent increase in marketing and trial service costs, brought total operating expenses to $13.8 million.
- Investment in content to service the growing subscriber base doubled to $3.0 million for the year, which was 28 percent of revenue.
- During FY2011, QFX also issued 166.68 million shares to raise $6.15 million. A further 57.76 million shares were issued post balance date, thereby raising a further $4.81 million for the period following 30 June 2010.

Strategic implications

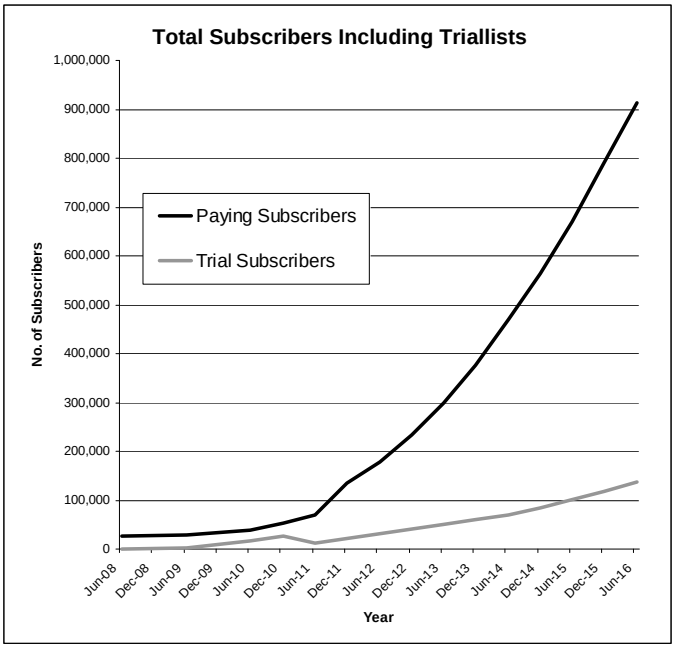
- Over the next two years, QFX has a window of opportunity to aggressively ramp up its level of activities and to establish an unassailable position as a pure online provider of entertainment.
- Baillieu envisages that over the next 18 months, QFX will:
  - complete the acquisition of BigPond Movies' library of DVDs and Blu-rays as well as its customer base;
  - market to and migrate Bigpond Movies' DVD subscribers to the QFX service offerings;
  - undertake the launch of its digital streaming platform;

- undertake brand marketing to secure its first-mover advantage;
- undertake acquisition marketing to rapidly expand its subscriber base beyond the level achieved after consolidating its subscribers from BigPond Movies.

- Baillieu also believes that the threat from pay TV and OTT video streaming services to the mail delivery portion of QFX's business over the medium term has been exaggerated. The perceived threats fail to allow for the substantial long tail revenues associated with a DVD library. While generally speaking up to 80 percent of revenues might be associated with the top 20 items, in the case of movies the top 100 movies would generally account for less than 36 percent of total revenues, implying substantial value outside the first 100 movies.

Subscriber numbers

- In the year to 30 June 2011, Quickflix delivered more than 3.2 million DVD and Blu-ray discs to Australian households.
- On the assumption that 80 percent of BigPond Movie subscribers migrate to Quickflix and that the removal of a competitor from the marketplace will reduce cancellations by 5 percent, we expect that Quickflix will pass through 100,000 paying subscribers in the coming months.
- We also forecast that subscriber growth will accelerate to more than 150,000 paying subscribers by June 2012. This is on the assumption that Quickflix successfully launches its digital streaming service and increases its marketing activity to capitalise on the consolidation.
- After adjusting our Quickflix model to reflect the post BigPond Movies acquisition environment, we forecast that Quickflix will have 1.0 million subscribers by the fourth quarter of 2016, of which more than 910,000 will be paying subscribers (refer to the chart below). The big change in subscribers since our last commentary is the drop in the number of triallists forecast which is down from just under 200,000 to 137,000 in FY2016.



- Our modelling is based on conservative assumptions and our forecast paying subscriber numbers is at least 10 percent below QFX's stated target of 1 million customers. Assuming that only 12,000 BigPond Movie subscribers migrated to QFX prior to 30 September 2011, and a further 20,000 are yet to follow, we estimate that QFX will be operating cash flow-positive over the second half of the current financial year.

Valuation

- Based on our forecast of unleveraged free cash flows (refer to Table 2 in the Appendix), and utilising an enterprise value to EBITDA multiple of 7.8 times for the terminal value and a weighted average cost of capital of 13.8 percent, we arrive at a valuation range for QFX shares of $0.25 to $0.49 per share and a mid-point valuation of $0.37 cents per share.
- As we have discussed previously, there are few directly comparable companies operating in a similar space, or which have been associated in corporate transactions either in Australia or overseas, by which to make comparisons and thereby arrive at a valuation of Quickflix based on market transactions.

Foxtel acquisition of Austar

- Pay TV operator Foxtel recently announced that it had proposed to purchase rival Austar (AUN:ASX) for $1.52 per share, which values Austar at $1.92 billion.
- Austar has approximately 764,200 subscribers paying $711 million per annum, which is $77.53 per subscriber per month, or approximately four times the monthly revenue per Quickflix subscriber. Based on these numbers, Foxtel is proposing to pay $2,512 per Austar subscriber. However, pay TV subscribers are subject to longer-term contracts and revenue is therefore essentially "locked in" for a longer term. Based on our revenue forecasts QFX is expected to earn only $142.50 per subscriber per annum at approximately twice the net margin, which implies a valuation of $769.50 per QFX subscriber and a value per share of $0.31.

Netflix valuation per subscriber

- Netflix in the USA has approximately 24.0 million subscribers and a current market capitalisation of US$5.86 billion, which represents US$244.17 (A$239) per subscriber. Looking out to the end of the current financial year, on the assumption that every QFX subscriber is worth the same amount as a Netflix subscriber this equates to $0.12 per share. The Netflix share price has, however, suffered a 60 percent drop in value very recently as a result of management stumbling on a number of initiatives. Nonetheless, we have included its value per share in our overall consideration of what QFX shares are worth.

Valuation summary

- We have used three valuation approaches: one based on a discounted free cash flow valuation with a enterprise value to EBITDA terminal value of 7.8 times and two others with reference to market data relating to one acquisition (Foxtel/Austar) and one currently listed US company (Netflix). From that we have arrived at a valuation range of $0.25 to $0.49 per share and a blended or average valuation of $0.37 per share.

Appendix

Table 1: Quickflix addressable market

Year		FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
No. of Australian households	mn	8.4	8.5	8.7	8.8	8.9	9	9.2
No. of homes with access to high speed internet & IPTVs	mn	2.9	4.6	6.1	7.4	8.8	9.9	9.2
No. of Sony Bravia homes	mn	0.3	0.7	1	1.2	1.5	1.7	3.4
Sony PS3	mn	0.8	1	1.2	1.4	1.7	2	2.4
Addressable market - Low	**mn**	**1.1**	**1.6**	**2.1**	**2.6**	**3.1**	**3.7**	**5.8**
Addressable market - High	**mn**	**4**	**6.2**	**8.2**	**10**	**11.9**	**12.7**	**15**

Table 2: Valuation based on unleveraged free cash flow and WACC

Year		Jun-11	Jun-12	Jun-13	Jun-14	Jun-15	Jun-16	Jun-17
EBITDA	**$'mn**	**-0.71**	**-0.91**	**3.70**	**14.13**	**23.26**	**36.28**	**52.61**
Tax	**$'mn**	**0.89**	**1.42**	**0.49**	**-1.96**	**-3.71**	**-6.37**	
Increase in working capital	**$'mn**	**-1.54**	**-0.13**	**4.20**	**-2.91**	**-8.04**	**-11.96**	
Capital expenditure	**$'mn**	**-3.53**	**-4.77**	**-6.75**	**-10.02**	**-14.00**	**-19.30**	
Unleveraged free cash flow	**$'mn**	-4.90	-4.39	1.64	-0.76	-2.49	-1.35	
EBITDA growth yoy	**$'mn**			505%	282%	65%	56%	45%
Next year's EV/EBITDA multiple	**$'mn**	7.80						
Total debt	**$'mn**	0.00	0.03	0.03	0.03	0.03	0.03	
Equity	**$'mn**	4.76						
Cost of debt - long term	**%**	6.5%						
Cost of equity long term	**%**							
Risk free rate long term	**%**	6.5%						
Market premium - long term	**%**	6.5%						
Beta	**x**	1.10						
Cost of equity - long term	**%**	13.7%						
WACC	**%**	13.7%						
Enterprise Value = (Market Capitalisation) + (Debt + Preferred Stock + Minority Interest) - (Cash & Equivalents)								
Free cash flows	**$'mn**	-4.90	-4.39	1.64	-0.76	-2.49	-1.35	
Terminal value	**$'mn**						282.99	
Total free cash flows	**$'mn**	-4.90	-4.39	1.64	-0.76	-2.49	281.65	
Probability-adjusted free cash flows	**$'mn**	-4.90	-4.39	1.64	-0.76	-2.49	281.65	
Enterprise valuation	**$'mn**	122.35	143.94					
Net debt	**$'mn**	-3.29	-3.02					
Preferred stock	**$'mn**	0.00	0.00					
Minority interest	**$'mn**	0.00	0.00					
Equity value	**$'mn**	125.64	146.96					
Number of shares on issue	**$'mn**	379.35	437.11					
Valuation per share (rolling 12 mth)	**¢**	**33.12**	**33.62**					
Low case	**¢**	33.12	33.62					
High case	**¢**	48.70	48.99					
Mid-point to range of valuation	**¢**	40.91	41.30					

E.L. & C. Baillieu Stockbroking Ltd

Quickflix Limited (QFX)

Analyst:	Vincent Pepe
Date:	21 October 2011
Share Price: ($A)	$0.09
Issued Shares:	427.1m
Market Cap:	$36.7m

Recommendation:	
Rating:	Buy
Risk:	High
Valuation:	$0.37
Price Target	$0.20

Financial Performance ($m)

Year End: June 30	2010 (A)	2011 (E)	2012 (E)	2013 (E)
Sales Revenue	7.1	11.0	26.0	45.9
EBITDA	-1.5	0.0	-1.3	3.2
Depreciation	1.2	2.0	3.2	4.5
EBITA	-2.6	-1.9	-4.5	-1.3
Amortisation	0.4	0.4	0.2	0.4
EBIT	-3.1	-2.3	-4.9	-1.7
Net Interest	0.0	0.0	0.0	-0.1
Other Non-Oper Inc/(Exp)				
Pre-tax Profit	-3.1	-2.3	-4.9	-1.8
Tax	0.0	0.0	0.0	0.0
Associates				
Outside Equity Int.				
Reported NPAT	-3.1	-2.3	-4.9	-1.8
Significant Items				
Adjusted Profit	-3.1	-2.3	-4.9	-1.8

Cash Flow ($m)

Year End: June 30	2010 (A)	2011 (E)	2012 (E)	2013 (E)
Receipts from customers	7.8	12.2	28.5	50.0
Payments to suppliers	-0.9	0.2	2.3	7.0
Other	-7.8	-12.2	-28.5	-50.0
Operating Cash Flow	-0.9	0.2	2.3	7.0
Capital Expenditure	-1.6	-3.3	-4.3	-6.2
Other	-0.3	-0.3	-0.4	-0.4
Investing Cash Flow	-1.9	-3.6	-4.6	-6.6
Proceeds from Issues	2.3	5.7	0.1	0.0
Net Borrowings	0.0	-0.1	0.0	0.0
Dividends				
Other	0.0	0.0	0.0	0.0
Financing Cash Flow	2.3	5.6	0.1	0.0
Net Change in Cash	-0.5	2.2	-2.3	0.3
Cash at Begin. of Year	0.8	0.4	2.6	0.4
Exchange Rate Adj.				
Cash at End of Year	0.4	2.6	0.4	0.7

Balance Sheet ($m)

Year End: June 30	2010 (A)	2011 (E)	2012 (E)	2013 (E)
Cash	1.0	2.7	0.4	0.7
Receivables	0.2	0.2	0.4	0.6
Inventories	0.1	0.1	0.2	0.4
Other	0.0	1.1	2.1	1.9
Current Assets	1.3	4.1	3.0	3.6
Investments				
Prop, Plant & Equip	1.5	2.8	3.9	5.6
Intangibles (net)	0.5	0.5	0.4	0.4
Other	0.1	0.2	0.2	0.2
Non-current Assets	2.1	3.5	4.5	6.2
Total Assets	3.4	7.5	7.6	9.8
Payables	2.2	2.5	6.3	10.3
Borrowings	0.0	0.0	0.0	0.0
Provisions & Other	0.0	0.0	0.0	0.0
Current Liabilities	2.2	2.5	6.3	10.3
Payables				
Borrowings	0.0	0.0	0.0	0.0
Provisions & Other	0.0	0.0	1.1	1.2
Non-current Liabilities	0.0	0.0	1.1	1.2
Total Liabilities	2.3	2.6	7.4	11.5
Share Capital	19.4	25.5	25.6	25.6
Reserves	0.4	0.4	0.4	0.4
Retained Profits	-18.7	-21.0	-25.9	-27.7
Shareholders Equity	1.1	5.0	0.1	-1.7
Outside Equity Int.				
Total Equity	1.1	5.0	0.1	-1.7
Total Funds Employed	1.1	5.0	0.2	-1.6

Ratios

Year End: June 30	2010 (A)	2011 (E)	2012 (E)	2013 (E)
EBITDA Margin (%)	-20.5%	0.2%	-4.9%	7.0%
EBIT Margin (%)	-35.7%	-21.1%	-17.8%	-4.0%
NPAT Margin (%)	-43.2%	-21.3%	-18.8%	-3.9%
Return on Assets (%)	-90.9%	-30.8%	-64.0%	-17.5%
Return on Equity (%)	-275.9%	-47.1%	-	108.7%
Net Debt to Equity (%)	-88.1%	-54.1%	-235.9%	41.6%
Net Interest Cover (x)				
Fixed Charges Cover (x)				

Valuation

Year End: June 30	2010 (A)	2011 (E)	2012 (E)	2013 (E)
Basic EPS ¢	-1.6	-0.6	-1.3	-0.5

Recommendations

Buy: The stock's total return is expected to increase by at least 10-15 percent from the current share price over the next 12 months.
Hold: The stock's total return is expected to trade within a range of ±10-15 percent from the current share price over the next 12 months.
Sell: The stock's total return is expected to decrease by at least 10-15 percent from the current share price over the next 12 months.

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Analysts' stock ratings are defined as follows:

Buy: The stock's total return is expected to increase by at least 10-15 percent from the current share price over the next 12 months.

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