The Impact of Profit Distribution Policy on Share Price and Cost of Equity: The Bird-in-Hand Theory Perspective

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ABSTRACT

This study examines the association of profit distribution policy with share price and cost of equity among companies listed on the Colombo Stock Exchange (CSE), guided by the Bird-in-Hand Theory. The theory suggests that investors prefer the certainty of dividend income to the uncertainty of future capital gains. Accordingly, a higher dividend payout is expected to be associated with a higher share price and a lower cost of equity. The study adopted a deductive, quantitative approach with a longitudinal design. A balanced panel of 250 firm-year observations for 50 non-financial companies listed on the CSE over 2021–2025 was analysed. Profit distribution policy was measured by the dividend payout ratio (DPO), share price by the year-end market price per share (MP), and cost of equity by the Dividend Growth Model (DG). A modified Wald test indicated groupwise heteroskedasticity, and the Hausman specification test ($p = .327$) did not reject the null hypothesis, so the Random Effects estimator was used with firm-clustered robust standard errors. DPO had positive but statistically insignificant coefficients in both the MP model ($\beta = 0.059$, $p = .689$) and the DG model ($\beta = 0.025$, $p = .594$). Pearson correlations were similarly weak and insignificant (DPO–MP: $r = .053$, $p = .407$; DPO–DG: $r = .034$, $p = .595$). The evidence therefore did not support any of the four hypotheses derived from the Bird-in-Hand Theory. Because the models include no control variables and DPO and DG contain extreme values, the results indicate that no association was detected in this sample; they do not establish that dividend policy is irrelevant. The study contributes evidence from an emerging market by examining both share price and cost of equity within a single Bird-in-Hand framework, and it offers implications for corporate managers, investors, and capital market policy makers.

Keywords: Profit Distribution Policy; Share Price; Cost of Equity; Bird-in-Hand Theory; Colombo Stock Exchange

1. INTRODUCTION

1.1 Background

The main purpose of financial management is to maximise shareholder value by using existing resources efficiently. Dividend policy, also referred to in this study as profit distribution policy, is central in this context because a firm must decide whether to reinvest earnings or distribute them to shareholders as dividends. The decision matters because it affects the firm's cost of financing as well as its credibility with investors (Bahadur Budhathoki & Khadka, 2024).

One of the most debated issues in corporate finance is whether dividends matter for firm value. According to the dividend irrelevance proposition of Miller and Modigliani (1961), in a perfect capital market with no taxes, transaction costs, or information asymmetry, firm value is determined only by the efficiency with which assets are used. Dividend policy therefore has no effect on share price or cost of equity. In contrast, Gordon (1963) advanced the Bird-in-Hand Theory, which holds that risk-averse investors prefer a certain dividend today to an uncertain capital gain in the future. Firms paying higher dividends are therefore perceived as less risky, which implies higher share prices and a lower required rate of return.

Empirical evidence on this issue is mixed. Significant relationships between dividends and share price have been reported for Pakistan (Sharif et al., 2015) and India (Singh & Tandon, 2019), whereas a study of Shariah-compliant firms in Malaysia concluded that dividend policy did not influence the decisions of Shariah-based investors (Raza et al., 2018). Evidence from Sri Lanka is also inconsistent. Mithila and Kengatharan (2025) report that dividend payments are associated with share value among CSE-listed firms, while Margaret (2023) finds no relationship between dividends and market performance. The CSE differs from many developed markets, and the informational content of dividend policy may be higher there because fewer mechanisms exist to identify value stocks (Margaret, 2023).

1.2 Problem Statement

Dividend policy, the decision to retain and reinvest profits or to pay them out to shareholders, is one of the most important decisions a firm makes because it bears on shareholder wealth and firm value (Brealey, 2003). Its influence on

firm value remains contested, particularly in developing economies such as Sri Lanka. Some researchers argue that dividends and firm value are unrelated (Gunarathne et al., 2016), while others argue that dividends enhance value because investors prefer dividends to retained earnings and view them as a signal of lower risk (Gordon, 1963; Lintner, 1956; Raza et al., 2018).

The same inconsistency appears in the CSE literature. Some studies report that dividend policy significantly affects market value and shareholder wealth (Mithila & Kengatharan, 2025), whereas others report no significant relationship between dividend considerations and share price (Samarawickrema & Rathnasingha, 2016). Developing markets such as Sri Lanka are characterised by market inefficiencies, information asymmetry, and distinctive ownership structures. Investor responses to dividends may therefore differ from those in developed markets, and theories developed in mature markets may not fully capture them (Gordon, 1963; Jensen & Meckling, 1976). This uncertainty about how dividend policy is associated with share price and cost of equity on the CSE motivates the present study.

The research problem is therefore as follows: **Is profit distribution policy associated with share price and cost of equity on the Colombo Stock Exchange, as predicted by the Bird-in-Hand Theory?**

1.3 Research Objectives and Questions

Guided by the Bird-in-Hand Theory, the study pursues two objectives. Each is addressed in two complementary ways: (a) a regression-based test of the association between profit distribution policy and the outcome variable, and (b) a bivariate correlation test of the relationship between the two variables.

1) Objective 1: To examine the association between profit distribution policy and the share price of companies listed on the CSE.
2) Objective 2: To examine the association between profit distribution policy and the cost of equity of companies listed on the CSE.

These objectives correspond to two research questions:

1) RQ1: Is profit distribution policy associated with the share price of CSE-listed companies, in regression and in bivariate correlation?
2) RQ2: Is profit distribution policy associated with the cost of equity of CSE-listed companies, in regression and in bivariate correlation?

In this study, “effect” or “impact” refers to the estimated coefficient from the Random Effects regression, whereas “relationship” refers to the bivariate

Pearson correlation. Because the data are observational and contemporaneous, neither is interpreted as evidence of causation.

1.4 Significance of the Study

The study is significant for corporate finance literature because it evaluates the Bird-in-Hand Theory in an emerging market, where support for the theory has been inconsistent. For corporate managers, it indicates the extent to which profit distribution practice is associated with share price and cost of equity, and thereby informs dividend policy decisions. For policy makers, it offers insights for designing disclosure policies, enhancing transparency, and supporting efficient price discovery on the CSE.

1.5 Scope of the Study

The study was limited to the relationship between profit distribution policy, market price per share, and cost of equity among non-financial firms listed on the CSE. The financial sector was excluded because the economics of banking and financial firms differ from those of non-financial firms. The analysis used only the dividend payout ratio as the proxy for profit distribution policy, excluding special dividends, stock dividends, and share repurchases. Cost of equity was estimated with the Dividend Growth Model rather than alternatives such as the CAPM, because the analysis was restricted to dividend-paying firms. Finally, the study did not develop a firm valuation model integrating all determinants of value. Instead, it evaluated the association of profit distribution policy with market price per share and cost of equity using a sample of fifty firms over five years.

2. LITERATURE REVIEW AND THEORETICAL FRAMEWORK

2.1 Theoretical Background

2.1.1 Bird-in-Hand Theory

The Bird-in-Hand argument, developed by Gordon (1963) and Lintner (1956), rests on investors' preference for certain dividend income over capital gains. Capital gains are likened to “two birds in the bush,” whereas a dividend is “a bird in the hand.” The theory assumes that investors are risk-averse and that the risk attached to capital gains makes them less attractive than certain dividend income. Firms that pay consistent dividends are therefore seen as reliable and are expected to have a lower cost of equity because of the reduced risk (Pelcher & Bolton, 2017; Sharif et al., 2015). The theory is the main

framework of this study because it yields clear expectations about share price and cost of equity as a function of dividend policy.

The theory is not universally supported. A study of Shariah-compliant firms in Malaysia concluded that dividend policy did not influence Shariah-based investors' decisions, making the Bird-in-Hand argument less relevant for them; the authors attributed this to differences in market conditions and to specific constraints in the development of Shariah-based payout ratios (Raza et al., 2018).

2.2 Empirical Findings

2.2.1. Profit Distribution Policy and Share Price

The relationship between dividends and share price is mixed, both in studies of the CSE and internationally. Kengatharan and Ford (2021) examined eighty-one non-financial CSE firms that survived between 2013 and 2017 and found that dividend variables explained only about twenty-five percent of the variation in share price volatility; dividend yield increased volatility, whereas dividend per share decreased it. Sugathadasa (2018) analysed thirty CSE firms over 2014–2017 and concluded that both the payout ratio and dividend yield reduced share price volatility. More recently, Mithila and Kengatharan (2025), using ninety non-financial CSE firms that survived between 2017 and 2021, found that the payout ratio and dividend per share were positively related to market price per share.

International evidence is also mixed. Singh and Tandon (2019) found that dividend policy had a significant effect on the stock prices of Nifty Fifty firms in India, and Sharif et al. (2015) reported a significant positive relationship between payout ratio and share price for firms listed on the Karachi Stock Exchange in Pakistan. In contrast, Bahadur Budhathoki and Khadka (2024) found a significant negative relationship between payout ratio and share price for microfinance companies in Nepal.

2.2.2. Profit Distribution Policy and Cost of Equity

In contrast to the extensive research on dividends and share price, comparatively little work links profit distribution policy to the cost of equity. Esqueda and O'Connor (2024) found that the spread between the cost of equity and earnings yield significantly predicted the likelihood of adopting a large dividend policy. Mazouz et al. (2023) found that dividend-paying firms had lower systematic liquidity risk, which in turn lowered their cost of equity,

especially where governance was weak or disclosure was limited. Arhinful et al. (2024) analysed non-financial firms listed on the Frankfurt Stock Exchange and found that the cost of equity did not influence dividend decisions, although the cost of debt did. Note that the direction of the relationship examined differs across these studies: Esqueda and O'Connor (2024) and Arhinful et al. (2024) treat the cost of equity as a determinant of dividend policy, whereas the Bird-in-Hand Theory and the present study treat dividend policy as the explanatory variable.

2.3 Research Gap

Prior studies have typically examined the relationship between dividend policy and either share price or cost of equity, not both (Kengatharan & Ford, 2021; Sugathadasa, 2018; Mithila & Kengatharan, 2025; Esqueda & O'Connor, 2024; Mazouz et al., 2023). Moreover, to the authors' knowledge, no study has examined the association of dividend payout with both share price and cost of equity for CSE-listed firms within the same Bird-in-Hand framework. This study addresses that gap by estimating two separate regression models, one for each outcome, under a single theoretical framework. The models are not estimated jointly as a simultaneous system.

2.4 Conceptual Framework and Hypothesis Development

The conceptual framework treats profit distribution policy as the independent variable and share price and cost of equity as the dependent variables, in order to test the Bird-in-Hand Theory. Under the theory, a more generous payout policy reduces the perceived risk of a share, which should be associated with a higher share price and a lower cost of equity. Four hypotheses are derived. H1 and H3 are tested through the Random Effects regressions, and H2 and H4 through Pearson correlations.

H1: Profit distribution policy (DPO) is significantly and positively associated with the share price (MP) of firms listed on the CSE (regression-based test).

H2: DPO has a positive bivariate relationship with MP (correlation-based test).

H3: DPO is significantly and negatively associated with the cost of equity (DG) of firms listed on the CSE (regression-based test).

H4: DPO has a negative bivariate relationship with DG (correlation-based test).

3. METHODOLOGY

3.1 Research Design and Philosophy

The study adopted a positivist philosophy, a quantitative explanatory design, a deductive approach, and a longitudinal time dimension. This design was appropriate because the study tests hypotheses derived from the Bird-in-Hand Theory using objective financial indicators.

3.2 Population and Sample

The population comprised all companies listed on the CSE that provided the necessary financial statements and dividend disclosures. From the 225 listed companies, 50 non-financial companies were selected using convenience sampling. The inclusion criteria were: listing on the CSE during the study period, availability of all required financial statements, availability of dividend information, and availability of the data needed to compute all variables. Banks, insurers, finance companies, and other financial firms were excluded because their capital structures differ markedly from those of non-financial firms. The final sample consists of 250 firm-year observations (50 firms × 5 years, 2021–2025), forming a balanced panel across nine industry sectors.

3.3 Variable Measurement and Operatio3nalisation

The independent variable, profit distribution policy, was operationalised by the dividend payout ratio (DPO), the ratio of dividends to net income. The first dependent variable, share price, was operationalised by the market price per share (MP) at the end of the fiscal year. The second dependent variable, cost of equity, was measured with the Dividend Growth Model (DG), also known as the Gordon Growth Model:

$$re = [D0 \times (1 + g) / P0] + g$$

where re is the cost of equity, D0 is the dividend per share paid in the current period, g is the constant long-term dividend growth rate, and P0 is the current market price per share (Acheampong & Agalega, 2013).

Because P0 appears in the denominator of DG and is also the dependent variable in Model 1, and because dividends enter both DPO and DG, the two measures are mechanically related to the variables they are compared with. This potential mechanical dependence is acknowledged as a limitation in Section 7.3.

3.4 Data Collection and Analysis Techniques

Secondary data were collected from the sample firms' annual reports and financial statements. The data were cleaned and imported into STATA as a balanced panel, with firm identifier and year as the panel indicators. Descriptive statistics (mean, standard deviation, minimum, and maximum) were generated for DPO, MP, and DG, and Pearson correlation analysis was used to assess pairwise relationships. A modified Wald test was used to test for groupwise heteroskedasticity, and the Hausman specification test was used to choose between the Fixed Effects and Random Effects estimators. Given the heteroskedasticity detected, Random Effects regressions with cluster-robust standard errors at the firm level were estimated. Clustering by firm also accommodates serial correlation of errors within firms.

The two models estimated were:

Model 1: $MP(it) = \alpha 0 + \beta 1\ DPO(it) + u(i) + \varepsilon(it)$

Model 2: $DG(it) = \gamma 0 + \gamma 2\ DPO(it) + u(i) + \varepsilon(it)$

where (i) indices' firms, t indexes years, u(i) is the firm-specific random effect, and ε(it) is the idiosyncratic error. Both models were estimated separately; they do not form a simultaneous system. The models contain DPO as the only explanatory variable, which is consistent with the study's aim of testing the Bird-in-Hand prediction in its simplest form, but it means that omitted firm characteristics may bias the estimates.

4. RESULTS AND DISCUSSION

4.1 Descriptive Statistics

Table 1 reports descriptive statistics for the 250 firm-year observations. DPO, the independent variable, has a mean of 28.622 and a standard deviation of 178.946, with values ranging from −2,638.325 to 500.727. This wide range indicates considerable heterogeneity in payout behaviour. A negative DPO arises where a firm reported negative net income but still paid a dividend, and very high values arise where dividends are large relative to small positive earnings. MP has a mean of 205.538 (SD = 465.362; range = 5 to 5,390), reflecting the wide spread of firm sizes and valuations on the CSE. DG has a mean of 40.013 (SD = 132.146; range = −100 to 1,080.573), indicating very large variation in the estimated cost of equity across firms and years. Some of these DG values are economically implausible as required returns and most likely reflect extreme estimated growth rates in the Dividend Growth Model

rather than genuine differences in risk.All 250 observations were retained in the estimations reported below; no trimming or winsorisation was applied**.**

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
DPO	250	28.622	178.946	−2,638.325	500.727
MP	250	205.538	465.362	5	5,390
DG	250	40.013	132.146	−100	1,080.573

Note. DPO = Dividend Payout Ratio; MP = Market Price per Share; DG = Dividend Growth Model (cost of equity). **[Author to state the units of DPO, MP (LKR) and DG.]** Source: STATA output.

4.2 Diagnostic Tests

Table 2 presents the diagnostic results. The modified Wald test for groupwise heteroskedasticity rejected the null hypothesis of homoskedasticity for both the market price model ($\chi^2 = 1.22 \times 10^{10}$, $p < .001$) and the cost of equity model ($\chi^2 = 74{,}950.98$, $p < .001$). The extremely large statistic for the market price model is consistent with the very wide dispersion in the data. Standard errors were therefore clustered at the firm level.

The Hausman specification test produced a chi-square of 0.96 with $p = .327$. Because this p-value exceeds the 5 per cent level, the null hypothesis that the Random Effects estimator is consistent is not rejected. The unobserved firm effects are therefore not significantly correlated with DPO, and the Random Effects estimator, which is both consistent and more efficient under the null, was adopted. (The earlier wording that the null was rejected was incorrect.) The Hausman statistic in Table 2 is reported for both models together.

Table 2: Diagnostic Test Results

Test	Model	Statistic	Value	p-value
Modified Wald (heteroskedasticity)	Market Price (MP)	Chi-square	1.22×10^{10}	0.000
Modified Wald (heteroskedasticity)	Cost of Equity (DG)	Chi-square	74,950.98	0.000
Hausman specification test	Both models	Chi-square	0.96	0.327

Note. Source: STATA output.

4.3 Correlation Analysis

Table 3 reports the Pearson correlations. DPO has a very weak positive correlation with MP (r = .053, p = .407) and with DG (r = .034, p = .595). The correlation between MP and DG is close to zero (r = −.001, p = .991). None of the correlations is statistically significant, so the correlation results do not support the Bird-in-Hand predictions.

Table 3: Pearson Correlation Analysis

	DPO	MP	DG
DPO	1		
MP	0.053 (p = .407)	1	
DG	0.034 (p = .595)	−0.001 (p = .991)	1

Note. DPO = Dividend Payout Ratio; MP = Market Price per Share; DG = Dividend Growth Model (cost of equity). Source: STATA output.

4.4 Random Effects Regression

Table 4 presents Model 1 (market price) and Table 5 presents Model 2 (cost of equity). In Model 1, the DPO coefficient is positive but close to zero and statistically insignificant (β = 0.059, SE = 0.147, z = 0.40, p = .689, 95% CI [−0.230, 0.347]). In Model 2, the DPO coefficient is also positive and insignificant (β = 0.025, SE = 0.047, z = 0.53, p = .594, 95% CI [−0.067, 0.117]). The wide confidence intervals include zero and values of both signs, so the data are compatible with a negative, zero, or positive association.

Table 4: Random Effects Regression Results – Model 1 (Market Price)

Variable	Coefficient	Std. Err.	z	p-value	95% CI
DPO	0.059	0.147	0.40	0.689	[−0.230, 0.347]
Constant	203.854	45.099	4.52	0.000	[115.461, 292.247]

Note. Dependent variable: Market Price per Share. Cluster-robust standard errors (firm level). N = 250. Source: STATA output.

Table 5: Random Effects Regression Results – Model 2 (Cost of Equity)

Variable	Coefficient	Std. Err.	z	p-value	95% CI
DPO	0.025	0.047	0.53	0.594	[−0.067, 0.117]
Constant	39.299	8.476	4.64	0.000	[22.685, 55.912]

Note. Dependent variable: Dividend Growth Model (cost of equity). Cluster-robust standard errors (firm level). N = 250. Source: STATA output.

4.5 Hypotheses Testing

Table 6 summarises the hypothesis tests. None of the four hypotheses was supported. H1 predicted a significant positive association between DPO and share price; the Random Effects coefficient was positive but not statistically significant ($\beta = 0.059$, $p = .689$), so H1 was not supported. H2 predicted a positive bivariate relationship between DPO and MP; the correlation was positive but insignificant ($r = .053$, $p = .407$), so H2 was not supported. H3 predicted a significant negative association between DPO and the cost of equity; the coefficient was positive, opposite to the predicted sign, and insignificant ($\beta = 0.025$, $p = .594$), so H3 was not supported. H4 predicted a negative bivariate relationship between DPO and DG; the correlation was positive and insignificant ($r = .034$, $p = .595$), so H4 was not supported. A failure to find statistical significance means the evidence does not support the hypotheses; it does not prove that the true association is zero.

Table 6: Hypotheses Testing Summary

Hypothesis	Test	Estimate	p-value	Decision
H1: DPO is significantly and positively associated with share price	Random Effects regression	$\beta = 0.059$	0.689	Not supported
H2: DPO has a positive relationship with share price	Pearson correlation	$r = 0.053$	0.407	Not supported
H3: DPO is significantly and negatively associated with cost of equity	Random Effects regression	$\beta = 0.025$	0.594	Not supported (sign opposite to prediction)
H4: DPO has a negative relationship with cost of equity	Pearson correlation	$r = 0.034$	0.595	Not supported (sign opposite to prediction)

Note. DPO = Dividend Payout Ratio. Source: STATA output.

5. DISCUSSION

The results do not support the Bird-in-Hand Theory in this sample. They differ from the positive dividend–share price relationships reported by Mithila and Kengatharan (2025) for the CSE, by Sharif et al. (2015) for the Karachi Stock Exchange in Pakistan, and by Singh and Tandon (2019) for Nifty Fifty firms in India. They also differ from Esqueda and O'Connor (2024) and Mazouz et al. (2023), who reported significant links between dividend policy and the cost

of equity, although the first of these treats the cost of equity as a predictor of dividend policy and so is only indirectly comparable.

The results are more consistent with studies that found weak or limited explanatory power of dividend variables, but comparisons should be made with care. Kengatharan and Ford (2021) and Sugathadasa (2018) examined share price volatility rather than the level of share price, and both found some significant dividend effects on volatility, so their evidence is not directly comparable. Likewise, Arhinful et al. (2024) examined whether the cost of equity influences dividend payments in a European market, which is the reverse direction of the relationship tested here.

One possible explanation for the present results is that CSE investors consider many factors in addition to dividends, such as earnings outlook, growth prospects, capital structure, earnings stability, governance quality, and overall market conditions, so dividend policy may be only one of several considerations. This explanation is speculative, because none of these factors was included in the models. The high heterogeneity in payout, including extreme negative and very high DPO values, and the extreme DG values may also have weakened any underlying association by adding noise. The wide confidence intervals in Tables 4 and 5 show that the study has limited precision.

These findings must be interpreted carefully with respect to the theoretical debate. The absence of a significant association between payout and either share price or cost of equity is not inconsistent with the Dividend Irrelevance proposition of Miller and Modigliani (1961), but it cannot be taken as proof of that proposition. The models contain no control variables, the sample is small and was selected by convenience, and the two outcome measures are mechanically related to dividends and price. The results therefore indicate that this study could not detect a Bird-in-Hand effect with the data and specification used, and they should not be read as evidence that dividend policy is irrelevant on the CSE.

6. IMPLICATIONS

6.1 Conclusion

This study tested the predictions of the Bird-in-Hand Theory by examining whether the dividend payout ratio is associated with market price per share and cost of equity. Using Random Effects panel regressions on data for fifty non-financial firms listed on the CSE from 2021 to 2025 (250 firm-year

observations), the study found no statistically significant association between dividend payout and either share price or cost of equity. The DPO coefficients were positive but insignificant in both models, and the Pearson correlations were weak and insignificant. The four hypotheses were therefore not supported. Given the absence of controls, the extreme values in DPO and DG, and the convenience sample, the conclusions are limited to this sample and specification.

6.1.1 Recommendations

The findings have tentative implications for corporate finance practice. For managers, the results do not show that changing the payout ratio alone is associated with a higher share price or lower cost of equity, so dividend decisions may be considered together with profitability, growth prospects, and risk. For investors, the results suggest caution in treating dividend payout alone as a signal of value or risk, and a wider analysis of liquidity, leverage, and growth outlook is advisable. For regulators and policymakers, the results underline the importance of high-quality financial reporting for investors' decision-making. These implications should be confirmed through studies with control variables and larger samples.

6.1.2 Limitations and Suggestions for Future Research

The study has several limitations. First, the sample consists of fifty non-financial firms selected by convenience over five years, so the results may not generalise to all CSE-listed firms or to other markets. Second, each model includes only DPO and an intercept. No firm-level controls (for example size, profitability, leverage, and growth) or year effects were included, so omitted-variable bias is likely and the estimates must not be read causally. Third, DPO and DG contain extreme values, including negative payout ratios for firms that paid dividends despite reporting losses, and these may have unduly influenced the results. Fourth, the Dividend Growth Model is sensitive to the estimated growth rate, and the extreme DG values raise questions about its validity as a measure of the cost of equity. Further, share price enters DG in the denominator and dividends enter both DPO and DG, creating possible mechanical dependence and endogeneity. Fifth, the data are contemporaneous and observational, so reverse causality cannot be excluded. Sixth, the standard Hausman test is not robust to heteroskedasticity and was reported jointly for both models. Seventh, the data rely only on annual reports, and the five-year period includes marked macroeconomic variation that was not modelled.

Future research could expand the sample and period, include control variables and year effects, apply winsorisation or robust estimation methods, and use alternative cost of equity measures such as the CAPM or implied cost of capital approaches. Researchers could also use alternative dividend policy proxies such as dividend yield, dividend per share, or changes in payout, test non-linear specifications, and examine mediating firm-level and market-level factors. Finally, survey or interview evidence from CSE investors and managers could complement these archival findings.

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