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ST.N - Q3 2018 Sensata Technologies Holding PLC Earnings Call

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PRESENTATION

Operator

Hello, and welcome to Sensata Technologies Q3 2018 Earnings Call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to Mr. Joshua Young, Vice President, Investor Relations. Please go ahead.

Joshua S. Young - *Sensata Technologies Holding PLC - VP of IR*

Thank you very much, Keith, and thank you to everybody for joining us this morning. I'd like to welcome you to Sensata's Third Quarter 2018 Earnings Conference Call. Joining me on today's call are Martha Sullivan, Sensata's President and CEO; and Paul Vasington, Sensata's Chief Financial Officer.

In addition to the earnings release we issued earlier today, we will be referencing a slide presentation on today's conference call. The PDF of this presentation can be downloaded from Sensata's Investor Relations website. We will post a replay of today's webcast shortly at the conclusion of today's call.

Before we begin, I'd like to reference Sensata's safe harbor statement on Slide #2. During the course of this conference call, we will make forward-looking statements regarding future events or the financial performance of the company that involve certain risks and uncertainties. The company's actual results may differ materially from the projections described in such statements. Factors that might cause such differences include, but are not limited to, those discussed in our Forms 10-Q and 10-K as well as other subsequent SEC filings.

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On Slide #3, we show Sensata's GAAP results for the third quarter of 2018. We encourage you to review our GAAP financial statements in addition to today's presentation. Most of the subsequent information we will discuss during today's call will be related to non-GAAP financial measures. Reconciliations of our GAAP to our non-GAAP financial measures are included in our earnings release and in our webcast presentation. Additionally, the company provides details of its segment performance on Slides 15 and 16, which are the primary measures management uses to evaluate the business.

Martha will begin today's call with an overview of Q3 results and an update on our electrification strategy. Paul will then cover our financials for the third quarter of 2018 and provide guidance for the fourth quarter as well as update full year 2018 guidance. We will then take your questions after our prepared remarks.

Now I'd like to turn the call over to Sensata's President and CEO, Martha Sullivan.

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Thank you, Joshua, and thanks to everyone on the call for joining us this morning. I'm going to quickly cover Sensata's third quarter operational performance, including strong secular growth in our automotive business, before laying out Sensata's overall electrification strategy, including our acquisition of GIGAVAC.

Sensata generated excellent financial results in the third quarter, and we are poised to have another strong year of financial performance for the full year 2018. We are executing exceptionally well versus the targets we set with investors at our Investor Day last December. We are accelerating our organic revenue growth. We are expanding our margins. We are generating significant EPS growth. And we are delivering on our promise to bring more balance to our capital deployment program through our share repurchases.

On Slide 4, I share some of the key highlights of the third quarter. For the third quarter of 2018, we reported revenues of $873.6 million, accelerating our organic revenue growth to 7.9%, which was above the high end of our guidance and more than double the organic growth rate we generated in the third quarter of 2017. The primary driver of this performance is strong secular growth in all of our businesses as we are significantly outpacing the growth of our end markets. The underlying production volumes in our end markets are in line with the original guidance that we shared with investors last February. We are outgrowing a strong end market in HVOR, while the auto end market is in line with expectations. Our guidance was underpinned by strong secular content growth with flat volume growth in the automotive end market, and that is exactly what is playing out through the first 9 months of the year.

The China auto end market is softening in the second half of 2018, which we anticipated and factored into our guide at the beginning of the year. More importantly, we continue to deliver strong double-digit organic growth in China auto.

Europe auto end market is also soft, driven by new emissions testing from WLTP, which we highlighted on our last earnings call. Our ability to properly plan and respond to changes in the market is part of our differentiated business model and has enabled us to deliver results in line or above our guidance for the past 11 straight quarters.

On the bottom line, we continue to sustain double-digit EPS growth, posting 12% growth in adjusted earnings per share while still making long-term investments.

During the quarter, we strengthened our portfolio by completing the divestiture of our lower-margin, nonstrategic valves business and announcing the acquisition of GIGAVAC, a fast-growing provider of high-voltage contactors. GIGAVAC immediately strengthens our position in electrification and doubles our content per vehicle on battery electric vehicles, which I will discuss in more detail later on the call.

Finally, we continue to execute our returns-driven capital deployment program. As of the end of September, we have substantially completed our $400 million stock repurchase program. Today, we are announcing a new $250 million repurchase authorization, which reflects the confidence of Sensata's management and board in our future performance and our ability to deliver on the long-term guidance we shared with investors last year.

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Slide 5 shows organic revenue growth by end market in the third quarter, beginning with HVOR, which generated 19.8% organic revenue growth in the quarter. The business outgrew its underlying end market by 1,020 basis points in the third quarter of 2018, reflecting the strong, secular growth that exists in HVOR. Over the past few years, we have strategically expanded our overall exposure to the HVOR end market, and these investments are clearly driving strong growth. We expect that the secular demand for cleaner and more efficient engines and the transition to electrified cabins in off-road equipment will sustain HVOR's strong content growth well into 2019 and beyond. Finally, we are winning business and seeing strong customer engagement for new applications in HVOR such as tire pressure monitoring system, steer-by-wire and smart and connected platforms.

Next, our automotive business had a strong quarter, posting 6.8% organic revenue growth and outgrowing the end market by 940 basis points. Despite a lot of negative headlines in the auto sector, we are delivering strong organic growth in auto, as expected, and we will continue to do so. This is the result of healthy secular growth, particularly in North America and China. North America automotive posted very strong year-over-year revenue growth in the third quarter, well above its end market.

Another example of our secular content growth is our China automotive business, which continued to generate robust double-digit organic growth in the quarter despite a decline in production, which we anticipated. Our strong organic revenue growth in China is the result of a sharp rise in content per vehicle, which we expect will increase by 50% between 2017 and 2020. As a result, the magnitude of our content growth in China is far outweighing any incremental changes to underlying production in the region.

As we discussed on the second quarter earnings call, we saw softness in our European auto business as a result of delays associated with WLTP testing. We are confident in our ability to sustain strong, secular growth into 2019. Our confidence in this outlook is the result of incremental catalyst for content growth in 2019. These drivers include the launch of gas particulate filters in Europe, new tire pressure legislation in China and the launch of high-speed transmissions in North America.

Turning to industrial, aerospace and other end markets, which are served by our Sensing Solutions segment. In the third quarter of 2018, the segment generated 4% organic revenue growth as a result of high single-digit organic growth from our industrial sensing and aerospace businesses. The aerospace end market continues to be strong, while North America and China were the fastest-growing regions. While we are seeing a modest slowdown in demand from industrial customers in China, we still expect Sensing Solutions to grow in the low to mid-single digit.

On Slide 6, I show a slide that we first shared at our Investor Day. I want to remind investors that electrification is an important driver of Sensata's performance over the next 3 years and beyond. This means we are not only seeing content growth from business we already won, but we continue to win new business on fast-changing electrical architectures that will lay the foundation for future growth. These growth drivers are occurring not only in auto, but also in the industrial and HVOR end markets.

On Slide 7, I provide an overview of Sensata's unique offerings in electrification. Our strategy is to focus on complex, mission-critical sensors and subsystems, where we are differentiated and can improve the performance and efficiency of electrified products. Our customers are facing a number of difficult challenges. For example, increasing the range of the battery; decreasing charging times and increasing safety as voltages and power increase.

On the past earning calls, I have talked about our progress on electrification for our core sensor portfolio through applications such as regenerative braking, HVAC and thermal management. These applications are driving growth today. The acquisition of GIGAVAC advances our electrification strategy and establishes a leadership position in high-voltage contactors.

Slide 8 is an overview of our recently announced acquisition of GIGAVAC. GIGAVAC immediately extends Sensata's position in electrification across the automotive, HVOR and industrial end markets and is highly aligned to our strategy. Sensata has long enjoyed a leadership position in electrical protection, and GIGAVAC's leadership in high-voltage contactors builds nicely on this core competency and allows us to bring additional content to our customers.

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Over the past 5 years, GIGAVAC has grown its revenues by 34%, and we expect the business to generate $80 million in revenue for 2018. Nearly 75% of GIGAVAC's revenues are generated in the United States, and most of its revenues are generated outside of the automotive sector. This provides Sensata the opportunity to leverage our global scale, manufacturing capabilities and leadership in auto to further scale the business.

The addition of GIGAVAC doubles Sensata's content and battery electric vehicles, which I show in more detail on Slide 9. On the left-hand side of the slide, I show that the global average for our content for battery electric vehicles prior to the GIGAVAC acquisition was approximately $20, which includes the lower, but fast-growing content in China and is equivalent with combustion engine vehicles. GIGAVAC will bring between 2 and 5 high-voltage contactors per vehicle and add approximately $20 of additional content to bring our total content on battery electric vehicles to around $40. With this additional content, Sensata is a clear beneficiary of a structural shift to electrification.

On the right-hand side of the slide, I show the potential for our future content. With high-value applications such as wireless battery management and motor position sensing, we have the potential to add $175 of incremental content per vehicle over the long term.

Next, I want to move to Slide 10. The automotive industry is transforming, and Sensata is well-positioned to capitalize on some of the fastest-growing parts of the automotive market. Today, we have more than 50% of our revenues in the most growthful parts of the automotive market. As you know, major technology and semiconductor companies are making significant investments to participate in the growth and transformation that will occur in the automotive industry. The attractiveness of these long-term growth opportunities far outweighs concern about the end market's cyclicality. As demand grows for highly efficient and connective subsystems, cleaner and more electrified engines and as solutions for new energy vehicles emerge, Sensata will continue to be a key beneficiary of these trends.

More than 40% of Sensata's revenues are derived from the HVOR, industrial and aerospace end markets. These end markets are being influenced by electrification. A core part of our business model is leveraging technologies across multiple end markets. On Slide 11, I show some of the electrification opportunities that exist for Sensata in these end markets. We see similar electrification growth drivers and opportunities in the HVOR, industrial and aerospace markets that we see in auto. Sensata sits in a unique and differentiated position to help drive transformation around key trends such as electrification, autonomy and smart and connected products. We believe that we will be a critical partner to help customers drive these initiatives, and this will help us to continue to drive attractive growth in these markets.

On Slide 12, I sum up our discussion of electrification with several key takeaways: Electrification is a net content tailwind for Sensata. It is driving growth today and will represent a larger part of our future growth as we bring new innovations across all of our businesses. We are delivering mission-critical, customized solutions to meet our customers' most challenging problem. And we are adapting and evolving our portfolio to meet new electrification demand. Finally, our acquisition of GIGAVAC is a positive catalyst for Sensata's electrification strategy, and we will leverage our industry expertise, manufacturing capabilities and strong position in automotive and electrical protection to scale GIGAVAC's business globally and sustain our attractive growth rate.

Let me conclude my remarks with an updated scorecard of our performance versus the goals and long-term guidance we laid out at our Investor Day last December. These are explicit metrics, which investors can use to measure our progress. In the first 3 quarters of 2018, we have demonstrated solid execution against each of these priorities. We are accelerating our growth, delivering 6.9% organic revenue growth on a year-to-date basis, which is well above the high end of our 3-year CAGR target of 4% to 6%. We are increasing our margins, expanding our adjusted EBIT margins by 70 basis points organically against the long-term target of 250 basis points improvement. We're delivering double-digit bottom line growth, posting 14.2% organic growth in adjusted EPS, higher than our long-term guidance of 10% to 13%. And we are executing on value-creating capital initiatives by substantially completing our $400 million share repurchase program; establishing a new $250 million stock repurchase authorization; and finally, acquiring a profitable, fast-growing business in GIGAVAC.

I'm very pleased with our progress, and our entire management team is focused on attaining our goals and 3-year financial targets. The first 3 quarters of this year demonstrate our ability to deliver high single-digit organic revenue growth and mid-teens EPS growth. As we look ahead, our growth in 2019 and our 3-year guidance is built on the strength of underlying secular growth.

I'd now like to turn the call over to Paul to review our third quarter financial results in more detail and to provide financial guidance for the fourth quarter and update our guidance for the full year 2018. Paul?

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Paul S. Vasington - *Sensata Technologies Holding PLC - CFO, CAO & Executive VP*

Thank you, Martha. Key highlights for the third quarter, as shown on Slide 14, include: revenue of $873.6 million in the quarter, an increase of 6.7% from the third quarter of 2017. Of this growth, changes in foreign currency exchange rates had a negligible effect on revenue growth in the quarter. The divestiture of our valves business reduced revenue by 1.2%. The net result was 7.9% organic revenue growth in the quarter.

Adjusted EBIT was $204.9 million in the quarter and grew 8% compared to the third quarter of 2017 or 6.3% organically. This EBIT growth was tempered by increased investment to drive and support sustainable top line growth and from the impact of recently enacted U.S. tariffs, which are in line with our expectations and which we expect to offset in 2019. On an organic basis, adjusted EBIT margins declined by 30 basis points compared to the third quarter 2017.

Adjusted net income was $154 million in the quarter and grew 11% compared to the third quarter of 2017 or 8.7% organically. Adjusted net income margins were 17.6% of revenue, an increase of 70 basis points compared to the third quarter of 2017.

Adjusted EPS was $0.91 in the third quarter of 2018, a $0.10 increase from the prior year quarter, primarily due to higher volume, acquisition cost synergies, lower integration spend and favorable changes in foreign currency exchange rates. Changes in foreign currency exchange rates added $0.03 to adjusted EPS in the quarter. And the divestiture of our valves business reduced adjusted EPS by $0.01 as compared to the prior quarter.

During the quarter, we repurchased 6.4 million Sensata shares and have substantially completed the $400 million share repurchase authorization.

Now I'd like to comment on the performance of our 2 business segments in the third quarter of 2018. I will start with Performance Sensing on Slide 15. Our Performance Sensing business reported revenues of $649.6 million for the third quarter of 2018, an increase of 7.6% compared to the same quarter last year or 9.3% organic revenue growth in the same period. The heavy vehicle and off-road business, which reported organic revenue growth of 19.8% in the third quarter, once again had the strongest revenue growth in the segment. HVOR is benefiting from significant content growth, and all of its end markets remain very strong.

Our automotive business reported organic revenue growth of 6.8% in the third quarter, outpacing the end market and led by China, which posted another quarter of strong double-digit organic revenue growth as our content per vehicle steadily rises, as expected, in the region. North America automotive also posted very strong year-over-year revenue growth in the third quarter and significantly outgrew its end market.

Foreign currency exchange rates had a negative 0.1% impact on third quarter revenues, and the valves divestiture reduced revenues by 1.6%.

Performance Sensing profit was $178.4 million in the third quarter of 2018, an increase of 9.7% as compared to the same quarter last year. Excluding the impact of foreign currency, Performance Sensing profit as a percentage of revenue was 26.6% in the third quarter of 2018. After adjusting for the divestiture of the valves business, segment margin declined 40 basis points from the same quarter last year, primarily due to the impact of new business launches, recently enacted U.S. tariffs and increased design and development effort to intersect emerging mega trends and executing design wins.

As shown on Slide 16, Sensing Solutions reported revenues of $223.9 million in the third quarter of 2018, an increase of 4.1% as compared to the same quarter last year or 4% organic revenue growth in the same period, reflecting high single-digit organic growth in our aerospace and industrial sensing businesses as demand from our China and North America customers remains strong. Sensing Solutions profit was $73.3 million in the third quarter of 2018, an increase of 1.3% from the same quarter last year. Excluding the impact of foreign currency, sensing Solutions profit as a percentage of revenue was 31.9% in the third quarter of 2018, a 170 basis point decline when compared to the prior year quarter. This decline in segment margin was primarily due to broad-based investments to drive sustainable growth in the business.

Corporate and other costs not included in segment operating income were $48.2 million in the third quarter of 2018, down approximately $4.9 million year-over-year, due primarily to costs incurred in the prior year quarter related to our successful effort to redomicile the company to the United Kingdom. Excluding charges added back to our non-GAAP results, corporate and other costs were $43.5 million in the third quarter of 2018.

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Slide 17 shows Sensata's third quarter 2018 non-GAAP results. Adjusted gross profit increased 7.4% year-over-year to $319 million, primarily from higher volumes, favorable foreign currency and acquisition cost synergies. Adjusted gross profit margins were 36.5%, up 20 basis points versus the same period last year and benefited from favorable movements in foreign currency exchange rates.

R&D costs were higher due to increased design and development effort to intersect emerging mega trends and executing new design wins.

Adjusted EBIT margins expanded 30 basis points as compared to the prior year quarter, benefiting from favorable movements in foreign currency exchange rates and efficient management of SG&A costs. Excluding the favorable impact of foreign currency exchange rates, adjusted EBIT margins declined 30 basis points compared to the prior year quarter, primarily due to higher investment to drive and support sustainable top line growth and from the impact of recently enacted U.S. tariffs.

Finally, adjusted EPS increased by 12.3% in the third quarter 2018 compared to the prior year quarter.

On Slide 18, I show our financial guidance for the fourth quarter of 2018. Overall, we expect to report revenues between $853 million and $877 million, representing reported revenue growth of 2% to 4%. At the midpoint of our guidance, we expect that current -- foreign currency exchange rates will lower revenues year-over-year by approximately $4 million in the fourth quarter of 2018. Excluding the effect of foreign currency exchange rate differences, we expect to report organic revenue growth of 6% to 8% in the fourth quarter of 2018.

Our current fill rate is approximately 85% of the revenue guidance midpoint for the fourth quarter of 2018.

We expect to report adjusted EBIT between $215 million and $221 million, which will represent organic growth of 10% to 12%. On the bottom line, we expect to report adjusted net income between $161 million and $167 million and adjusted EPS between $0.97 and $1.01, which will represent organic growth of 16% to 18%. Changes in foreign currency exchange rates are expected to increase adjusted EPS by approximately $0.01, and we expect a $0.03 benefit from share repurchases.

Now let me turn to our guidance for the full year 2018, shown on Slide 19. Based on the strong results through the first 9 months of the year, we are raising our guidance for revenue while maintaining our guidance for EPS. We expect revenue to be in a range of $3.527 billion to $3.551 billion for the full year 2018, a 7% increase on a reported basis.

We expect foreign currency exchange rates to increase revenues by 1.3%. The impact of the valves divestiture offsets most of this positive foreign currency impact, so we expect revenue growth will be approximately 7% for the full year, in line with our reported growth rate.

We expect adjusted EBIT between $827 million and $833 million, which will represent organic growth of 10% to 11%.

On the bottom line, we expect adjusted net income between $623 million and $629 million and adjusted earnings per share between $3.66 and $3.70 for the full year 2018, which would represent organic growth of approximately 15%.

We are lowering our full year guidance for free cash flow. We now expect to generate free cash flow between $460 million and $480 million, and this performance excludes any potential impact on the pending acquisition of GIGAVAC. There are 3 primary reasons for this reduction: first, inventory levels remain higher than expected; second, customer shipments are more concentrated in the latter half of Q4 than originally anticipated; and third, during the quarter, we decided to repatriate a significant amount of cash from our China business and incurred a $10 million withholding tax. We expect to deploy this cash from China to much higher return investments such as GIGAVAC to reduce our economic exposure to the volatile Chinese renminbi and significantly reduce our cost of hedge foreign currencies. Our new free cash flow guidance also assumes capital expenditures of approximately $155 million to $160 million.

I'd like to conclude our formal comments with the following key messages: First, Sensata is performing to promise, and we are executing exceptionally well against the operational targets we established at our last Investor Day. Second, our top line performance is being driven by strong, secular growth but is independent of underlying production in our end markets. And third, the automotive end market offers tremendous future growth opportunity, and we are strengthening our position in electrification to capitalize on this growth.

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Now I'd like to turn the call back to Joshua.

Joshua S. Young - *Sensata Technologies Holding PLC - VP of IR*

Keith, please assemble the Q&A roster.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question comes from Samik Chatterjee with JPMorgan.

Joseph Lima Cardoso - *JP Morgan Chase & Co, Research Division - Analyst*

This is Joe Cardoso on for Samik Chatterjee. Just 2 questions for me. First, how are you thinking about content growth opportunities for Sensata in 2019 relative to 2018, particularly around automotive where you've seen seeing a pretty nice step-up as we've gone through the year? And then in a similar vein, can you outline the content growth opportunities for GIGAVAC in both automotive and industrial? And how should we think about like the time required to integrate GIGAVAC products into your low-cost manufacturing footprint?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Sure, Joe. Relative to 2019 and our content growth, we are very confident of our ability to extend secular growth in auto into 2019 and frankly, across our businesses. So we've been providing a lot of visibility on how we're performing versus overall end markets, and you can see what that looks like. So confidence remains high. We expect that's going to be an important element as we think about 2019. Relative to GIGAVAC, on the automotive side, it is really a content growth story. We talk about the fact that this is a business that's growing around 30% -- has, if you looked back. We expect to be able to extend strong organic growth given what's available in terms of contactors on electric vehicles, and we laid that out for you in the slide decks. I hope you take a look there. We're excited about how this extends into the industrial market. At this point, primarily what's driving that growth is, again, content growth. So it's a transition, for example, to lithium ion batteries in things like material handling. It's the move of electrification into the HVOR on road segment, very familiar things for Sensata, probably playing out a little bit longer from a growth perspective. Relative to integration, this is not going to be a heavy investment for moving and lifting when you think about GIGAVAC. The challenge that we have to see our return on investment is really to extend that contactor portfolio into automotive and globally across our businesses, and we're very confident about our ability to do that.

Operator

And the next question comes from Wamsi Mohan with Bank of America Merrill Lynch.

Wamsi Mohan - *BofA Merrill Lynch, Research Division - Director*

It looks like Performance Sensing EBIT declined 40 bps organically, but you also absorbed $3 million in tariffs and ex that impact, you would have been flat despite the investments that you seem to be making. So can you share some color on what you think the ongoing impact from tariffs will be? I think you said it will offset in 2019. Is that a comment about the full year? Or will you have some headwinds in the first half and you'll offset in the second half. And maybe you can just talk a little bit about some of the remediation steps that you are taking. And secondarily, should we expect to see expansion in Performance Sensing margins once this tariff impact is worked through? Or will you still be investing at sort of a higher level? And are you just investing at a lower level given the tariffs right now? Or are you investing at the pace that you want to?

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Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes, I think the first thing to point out is to look at the overall organic growth rate in Performance Sensing at 9.3%., that's actually higher than where we called it and expected it, and it's really being driven by new product launches. So a really important theme to understand. In any particular quarter, there are operational expenses associated -- onetime expenses associated with a new product launch, and we're seeing some of that, it's having a small impact on the overall margin. As that evens out, we do expect that, that would not be a headwind in any particular quarter. Relative to the tariff, we have been successful in mitigating a pretty significant piece of it. As we get to 2019, we expect that to be offset and we don't need to wait till the second half of the year for that to happen. And we're doing the mitigation in a number of ways. In some cases, we're passing on that pricing to our customers. In other cases, given the global nature of our supply chain network, we're providing alternative paths to receive products from Sensata. Those are pretty natural discussions that we've had with customers, and we're seeing that mitigation as we play out through the year.

Wamsi Mohan - *BofA Merrill Lynch, Research Division - Director*

And if I can just follow up. There is a lot of concern around a broader slowdown in China, everything from cars, appliances, smartphones, seem to be seeing some of this slowdown. So as you think about going into 2019 and sort of how would you handicap the risks related to China that pertains to both segments of your business? And how should we think of overall profitability in China in '19 versus '18?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes, I think the thing to point out is we're seeing a slowdown right now and you're seeing our overall performance right now. So we grew very strong double digit in China automotive, for example, on what was a down market. So it's important to recognize that one of the advantages of Sensata is that we've got a secular growth overlay to whatever is going to happen in the end market. I think, secondly, your question about profitability, and I really appreciate that question, Sensata's cost structure is important for our investors to understand. We have a highly variable cost structure. And so we are able to size our cost and reduce our cost and spend in the quarter aligned with where our overall growth is performing. If you look back to prior downturns, 2008, 2009, we've been profitable throughout that downturn and it speaks to our ability to manage costs even in a very dramatic downturn. We don't handicap the likelihood of an extremely dramatic downturn as we move into 2019. We've been I think good about being able to call where the markets will go. As we get through the end of 2018, we'll take a look at inventory level and all the leading indicators that we use to give you a more specific guide. But as we look to those indicators right now, we don't see a very strong contraction in China or in other parts of our overall market.

Operator

And the next question comes from Amit Daryanani with RBC Capital Markets.

Amit Jawaharlaz Daryanani - *RBC Capital Markets, LLC, Research Division - Analyst*

Two questions for me as well. What -- when I think of the $40 per vehicle you guys talked about in electric vehicles post the GIGAVAC acquisition, which I think Martha you mentioned was growing 30% plus -- GIGAVAC revenue rather, do you think your market share in EV is going to compare with what you have in combustion engines today? Or is it different? And how is it different, I guess? And then secondly, is there a potential for you to accelerate the GIGAVAC revenues, assuming you can open more doors for them that they might not be able to open as a standalone entity.

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes, I think to the second question, yes. There's definitely that opportunity. As you know, even in electric vehicles, we're talking about long cycles from a design end perspective. But I'm very confident in our ability to be successful with customers outside of the U.S. for example. In terms of

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market share, we do expect similar market shares. When you look at the nature of the product solutions we're bringing to market in electrification, they're really mission-critical, they're very difficult to do, we've developed incumbency positions. Those are the same themes that led to our high market shares that we've seen in our core sensing business. And then finally, just recognize, a portion of that $40 content today is actually on our traditional sensors that we're finding new ways to deploy into battery electric vehicles and plug-in hybrids, for example.

Amit Jawaharlaz Daryanani - *RBC Capital Markets, LLC, Research Division - Analyst*

Fair enough. And if I could just follow up. There's been a lot of concerning talk about auto slowdown not just in China, but I think across different geographies at this point. As you think about 2019 initially, what do you -- what's your assessment and what are you seeing on the ground in terms of auto production trends, at least initially for next year?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes. Look, again, it's important to understand, we're seeing the end market slowdown right now. So I think we're beyond the point of wondering if there's going to be a slowdown. China declined in the quarter; Europe, overall, down in the quarter. So we're managing that right now. And you can see the overall organic growth of the business. As we look ahead to 2019, we don't think the market's going to be helpful, but we've already seen some contraction in portions of the marketplace. We look at a number of leading indicators that would not suggest that we're going to see a major contraction as we move into 2019. Obviously, as we get to the end of the year and we look at where inventory levels sit and what those leading indicators look like, we're going to give you another perspective. But I just cannot emphasize enough that the secular growth dimension of our business is one that we have very high confidence in as we move though 2019. Just recall that we had secured a number of very strong design-ins and design wins. We gave you those figures when we came out of last year. We'll do it again at the end of this year. We talked about a 3-year guide where we have 90% confidence in the 2020 revenue point, and that's based on puts and takes in the end market. So continuing to grow against that overall guide. So I hope that gives you some confidence.

Operator

And the next question comes from Jon Dorsheimer with Canaccord Genuity.

Jonathan Edward Dorsheimer - *Canaccord Genuity Limited, Research Division - MD & Analyst*

Martha, I guess, just first question, and I think it's been kind of asked a few different ways. But as we look out, you had a high watermark in terms of growth this year. And -- or the first 3 quarters of this year. 50% of your content in auto is in sort of a high-value where your exposure to EVs and the secular growth trends, as you've talked about, are accelerating. And then with the GIGAVAC acquisition, that should -- the content is only increasing. So as we look out at '19, if you're not expecting some type of draconian scenario, then it would seem as if you would be flat to up from a -- based on your secular growth. Am I hearing all that correctly?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

You are. So the flat markets will be up, that's what our long-term guidance implies, that's what our secular growth implies. So very strong confidence around that point.

Jonathan Edward Dorsheimer - *Canaccord Genuity Limited, Research Division - MD & Analyst*

It's what I thought. I just wanted to ask it a different way. And then as a follow-up question regarding the GIGAVAC integration, do you have the same sales force that's now offering the GIGAVAC products? Or do you have GIGAVAC salespeople? Do you have some duplicity in terms of crossover of product portfolio? Or would you mind just providing a little bit more detail on the specifics of that integration?

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Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes. And look, we have very strong channel to market on the Sensata side that we'll make good use of, particularly when you think about that globally. When you look at other elements, we actually see some reverse synergies. So there are places where we saw a bit of duplicative product investment. We think the starting point at GIGAVAC is, quite frankly, stronger. So we see some opportunity to streamline on that front as well. But overwhelmingly, what's important for us to get the return on the GIGAVAC investment is growth, and it's growth in battery electric vehicles, it's growth in the HVOR market and in the industrial market. GIGAVAC has been growing largely on the industrial side of the business. So our ability to extend that, I think, is quite good. But hopefully, that gives you a sense for how we're going to deliver shareholders a great return on the investment.

Operator

(Operator Instructions) And the next question comes from Shawn Harrison with Longbow Research.

Shawn Matthew Harrison - *Longbow Research LLC - Senior Research Analyst*

Paul, just the free cash flow decline in terms of the excess inventory, is there any market vertical that's associated with or product vertical for Sensata? And when would you expect to clear that out? Does that happen now in the first half of '19? Or is it going to take longer than that?

Paul S. Vasington - *Sensata Technologies Holding PLC - CFO, CAO & Executive VP*

To be clear, I mean, we expected to clear some of that out this year and the reason for the change in the guide. Mostly increase in inventory is around raw materials. The business is growing, we have the inventory to support the growth. We're going to clearly to continue to optimize our inventory levels as we go into 2019. So I would expect that to get better. And -- but we do see the opportunity to improve, but it just wasn't quite as good as we expected to see this year based on our original cash flow guidance.

Shawn Matthew Harrison - *Longbow Research LLC - Senior Research Analyst*

Okay. And then second, just as a follow-up on the specific China weakness in the industrial and I'm assuming kind of the HVAC compliance markets. Are you seeing an inventory correction as well? Or just weaker overall demand? If I think back to 20 -- probably '15, which when the industrial side of the business saw a little correction in China was a bit prolonged because you saw both demand as well as the inventory correction?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes, good memory. If you look at what I would describe as an inventory correction, we're not seeing a lot of that. Actually, one exception, and it's a small part of our business. But a dramatic impact on a small part of the business is where there've been exporters from China. So that's an area where pretty dramatic overall inventory correction as you might expect. That portion of our business is well below $50 million in overall revenue. What we are watching is what's happening with building inventories, and we're seeing some of that on the industrial side of the business in China. Keeping a close eye on it.

Operator

And the next question comes from Rich Kwas with Wells Fargo Securities.

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Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Just on that last point, Martha, is there any contingency with regards to the back half weighting of the revenues for the quarter here short-term given that auto and other industries can push out on deliveries once you get close to the holidays? What kind of contingency do you have in place?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

It's a normal part of our planning, Rich. So we look at past years, we look at it customer by customer, we look at where their inventory sits. We also look at some places quite frankly, where inventory is quite tight just given the increased demand that we're seeing for content growth. So there are both sides of that right now in the business. I think we have it called pretty well.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. So you're comfortable with that? Okay. So a follow-up. Just longer term and shorter-term I guess, is GIGAVAC -- is any of that in the guidance for the year? For the fourth quarter? And then second, it would seem like.

Paul S. Vasington - *Sensata Technologies Holding PLC - CFO, CAO & Executive VP*

No.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. So no. Okay...

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes, it hasn't closed yet, Rich.

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

I didn't think it did, but I just wanted to make sure.

Paul S. Vasington - *Sensata Technologies Holding PLC - CFO, CAO & Executive VP*

It's a relatively small business. So there is no... yes?

Richard Michael Kwas - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Right. Okay. And then in terms of winning business once it closes, it would seem that industrial is probably the area where you can expand or scale and grow in the shorter term, and then auto is going to take a few years, at least, to get in on new quotes, et cetera, and integrate that. Is that the right way to think about it? And if you were to frame up incremental revenues, not taking their base business but talking about incremental revenues, how should one think about that in terms of adding to the growth rate over the next few years?

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Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes. The one thing I would point out, they -- this actually does come with design ins right now. So for example, they're -- they've got a great design-in position at Tesla. They're actually shipping revenue into Tesla right now. They've got some design-in positions over in Europe. So we'll be building on those positions, I think, quite quickly. And you're going to see the impact of automotive growth in the GIGAVAC product portfolio in the near term. So we don't expect this to be a hiatus. We expect this to be able to continue to extend the growth of GIGAVAC.

Operator

And our next question comes from the line of Joe Giordano with Cowen.

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

When you talk about the 90% confidence in 2020, obviously that depends on current production schedules. And like how do you handicap that with what you're seeing in the markets now? And how likely are those schedules to be changed downward over the next few years?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes. One of the things we provided when we gave that overall guide was our actual assumptions about the end market. So I think if you go back and look at auto, we were very, very small in production growth throughout the 3-year time horizon. When you look at HVOR, we expected that to mitigate to get to an overall 3-year CAGR of about 3% to 4%. So you can look at what those assumptions are. We'll share with you some of the assumptions as we provide the guidance for 2019. But we did look carefully and analytically at what we expected end markets to do and provided that with the overall 3-year guide.

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

And then, can you talk a little bit about inflation you're seeing across the supply chain? Whether it be from -- like indirect tariffs? I know a lot of people are talking about components are tight from alternative sources and logistics kind of getting a little bit crazy. Anything you're seeing there of note?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

No, not really. Just recall that we don't have much what you would describe as commodity exposure in overall spend. So less than $70 million in overall spend there. We actually reduced that slightly with the divestiture of our valves business. So I think continuing to make sure the business model is as robust as it can be. We had seen some period of tightness on some passives and electronics. That has improved over the course of the year. So not a lot there that I would describe as inflationary for Sensata.

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

And then last for me. Is there anything noticeably different on GIGAVAC's kind of -- if I compare their manufacturing to how Sensata is in terms of your flexibility, is there any noticeable differences there? Or anything that you'd kind of try to work them into how you run your business?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Well, the starting point is quite small. And so when we think about how to grow that, most of that growth, and if you think about mass customization and in volume, that's going to come via Sensata. That's what we're going to bring to the overall endeavor. We see some flexibility in the way that that's managed today, so not a lot of fixed asset base that needs to be undone. So I think, again, we talked about the things that we're leveraging

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inside Sensata. Our automotive position is clearly one of those. Our global channel is very important. And our overall manufacturing capability, important as this business grows.

Operator

And the next question comes from Ryan Johnson with Barclays.

Unidentified Analyst

This is Steven on for Ryan Johnson. Just had a couple of quick questions. Slide 9 here, pretty interesting with the future $175 of incremental CPV. I just wondered if you could provide a little color on wireless battery management. I know you guys present that at Investor Day almost a year ago here now at this point. I just wondered if you could provide any update on design wins and expectations for launches, where that stands overall? And then it looks like post GIGAVAC, CPV is around $40 and then BEV of the future is $175. Just wondering the motor position sensing and expansion of core sensors, whether or not -- when do we expect that shift to the next battery electric vehicle where you guys could start picking up that type of content on battery electric vehicles.

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes. A little bit of color here. The short answer would be, is outside of that 3-year time horizon that we guided to. And that's just the nature of those vehicles and the sophistication of those vehicles in particular. I will tell you that we are well beyond the point of simply developing technology well into proof of concept with customers, highly engaged with customers, with development agreements across that portfolio. So we're confident in our ability to bring that to market. I think the size and scale and timing is a bit TBD just given that these are third and fourth gen battery electric vehicles. But very, very promising when we look at the engagements and where with the product solutions have evolved to.

Operator

And our next question comes from Matt Sheerin with Stifel.

Matthew John Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Senior Equity Research Analyst*

Just wanted to ask another question regarding the EBIT margins. You talked about some headwinds, particularly investments in both businesses, particularly the Sensing Solutions business. And then of course you've had some positive benefits from the integrations of the 2 prior acquisitions. So -- and you're guiding margins up year-over-year in Q4. So how should we think about leverage here, particularly investments that you've made so far?

Paul S. Vasington - *Sensata Technologies Holding PLC - CFO, CAO & Executive VP*

As Martha said, we're in an intense period of new product launches, which is impacting the Performance Sensing business and to a lesser extent the Sensing Solutions business. We continue to invest in the Sensing Solutions business for growth, improving the capability of the team, business, the processes. And if you look back, we've increased margins 180 basis points since 2016. So we continue to drive productivity and efficiency in the business and we expect that to continue. Q4 margin profile looks stronger than Q3. Q3 was certainly in line with what we've guided to. So feel good about the year and feel good about what we're doing in terms of we continue to drive to our 250 basis point margin target over the 3-year period.

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Matthew John Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Senior Equity Research Analyst*

Okay. And just as my follow-up, Martha, could you update us on the Quanergy investment and partnership there and what's the strategy on autonomous? Any changes there?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

I would say not a lot of change there. Lighter continues to be a really important building block for Class when we get to level 4, level 5 autonomy in auto. I think part of the work that we're doing has us looking at a variety of use cases, and some of those actually extend outside automotive. So looking at the technology in a more fulsome way. But I would say, not a lot of news on that front. It's a long slog in terms of getting the technology ready and other pieces of that solution that need to come together, not just in Quanergy, but at the customer base as well.

Operator

And the next question comes from Steven Fox with Cross Research.

Steven Bryant Fox - *Cross Research LLC - MD*

Just one question from me, please. Looking back on the North American markets, you mentioned the secular growth there was well above end markets. I was wondering if you could just provide a little bit more color on what specifically drove it in the quarter, and if there's any investments that you mentioned that are specifically tied to North America that we could see productized into next year.

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes. The organic growth in North America was very strong double digits, just to be quite clear about that, so more than just outpacing the end market. When we look at what's driving that familiar theme, so we're seeing the extension of gas direct injection for example. We're seeing the deployment of the 9 and 10 speed transmissions, which are really important to getting fuel economy in the larger platforms, the SUVs and the heavy-duty -- or light-duty trucks that are becoming really popular in the overall market. We've had some really interesting wins in tire pressure sensing that look at things like trailer tow packages and we're bringing a full solution to that. It's still some of the investments I would describe that are relevant to North America, some of them unique to North America, if you think about trailer tow, for example. So really happy with the performance that we're having in North America and the secular growth that we're delivering there.

Operator

And the next question comes from William Stein with SunTrust.

William Stein - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Two questions, please. First, I'm hoping you can comment on the effects of WLTP. Is that loosening up and therefore -- or I should say, is capacity loosening up and, therefore, benefiting either the Q3 results or the Q4 guide? And how you expect that to progress into 2019? And then I have a follow-up, please.

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes. I think the way we think about that is as sort of a bottleneck in getting to market as opposed to something that's impacting overall market demand. It was clearly a headwind for us in the third quarter. So not something that we benefited from, actually it was a headwind because it kept more of the products out of the overall market and delayed some of the actual launches. So not helpful in the third quarter, but again, something

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we anticipate, and we actually talked about it on the Second Quarter Earnings Call. We think that, that starts to correct as we get through the end of the year, and the industry will have calibrated to it by the time we get into 2019.

William Stein - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

That's helpful. And then the follow-up, Martha, I was hoping you could talk about 2 of the content growth drivers, specifically sort of updating us on the timing of uptake on those and if there's any legislation driving them? And those are TPMS in China and the gas particulate filters in Europe.

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes, both important content growth drivers, but 2 of many, quite frankly. But in terms of TPMS, that regulation is in place, installed and being enacted upon through our customers right now. So it's driving growth now ahead of the overall mandate, which comes into play as we get to the end of next year. So very high confidence that, that remains a catalyst for us and we're seeing that growth play out right now. And gas particulate filter is very much the same. That is driving our growth right now. We're seeing it in gas engines in Europe and in China. And we're also now having discussions with customers with regard to Euro 7, where there is an added -- there is a potential for an added content wave associated with exhaust sensing in the Euro 7 mandates that are developing and would have an impact in the '20, '22, '23 time frame as I recall. The two important areas to ask about, so I appreciate the question.

Operator

And the next question comes from Mark Delaney with Goldman Sachs.

Mark Trevor Delaney - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

I have 2. My first is actually a follow-up on the China TPMS adoption. I certainly appreciate it's a good opportunity. Do you have any more specifics in terms of where adoption may be today? Any estimates for what you think adoption could go to in 2019? And just remind us what Sensata's market share is?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes, I don't have a current run rate. I know as we came into the year, we were running at about $40 million in revenue. And we expect this to be about $100 million in revenue overall opportunity for Sensata as it plays out. Our market shares, we think, will be similar to what we see in Europe, where we sit in the mid-30s market shares. So we expect to have the same level of market position in China.

Mark Trevor Delaney - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. That's helpful. And for my follow-up question, Paul, you mentioned a more back-end weighted sales view for the fourth quarter. Can you just give more clarity as to what markets may be more back-end weighted and what's the reason for that?

Paul S. Vasington - *Sensata Technologies Holding PLC - CFO, CAO & Executive VP*

Just as you know, we're 85% billed, so we have a pretty good -- we have a very good view of what's been shipped so far and what's been ordered to come. And just based on that shipment and order time, we feel that the revenue will be a little bit more back-end-loaded than what we anticipated when we built our cash flow guidance originally. It's a minor shift, but it does -- given the size of the business, the amount we ship every day, it is meaningful to the cash flow guide.

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Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

It's also somewhat part of our seasonality and that can get amplified in any given year. So if you look at auto seasonality, we tend to be a little stronger in the fourth than the third, for example. We see some of that in areas like our HVAC business as well.

Operator

And the next question comes from Jim Suva with Citi.

Jim Suva - *Citigroup Inc, Research Division - Director*

I have one quick question. On the WLTP regulatory change in Europe, is that impacting inventories a bit normal than expected? And what I'm getting at is like, is there a drawdown of inventories ahead of the full rollout of that or buildup of inventories? And any potential impact there? Or is it not impacting inventories at all?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

I would say there's a perturbation around vehicle inventories. This is not the case where you have consumers pulling ahead to try to get ahead of more stringent regulation. It's really a protocol for testing that sort of extends the process for our customers to bring their vehicles to market. So you can think about it adding probably somewhat permanently a fixed amount of vehicle just as you extend that cycle into the marketplace. So a little bit of dislocation from the third to the fourth quarter, but not a major pull ahead of demand, if you will, Jim. It's not a more stringent tailpipe emissions. It's more prolonged testing to be able to bring the product to market.

Operator

And the next question comes from Craig Hettenbach with Morgan Stanley.

Craig Matthew Hettenbach - *Morgan Stanley, Research Division - VP*

Martha, just in the context of some of the recent slowdown in China relative to 2015 period, any differences in kind of demand signals? Or how you're seeing that play out this year versus 2015?

Martha N. Sullivan - *Sensata Technologies Holding PLC - CEO, President & Executive Director*

Yes, I would say it's quite different from 2015. So we saw -- well, if you talk about it from an auto perspective, while we've seen a production decline and we see some parts of the demand decline in China auto, the secular growth that we're delivering is so well above that, that the conversations we're having with customers is how fast can we get them product. So that element way different for Sensata than what we saw in 2015. I'd say on the industrial side, there are small pockets, like the export market in the industrial that are a bit like 2015. That's a very small exposure for Sensata at this point.

Craig Matthew Hettenbach - *Morgan Stanley, Research Division - VP*

Got it. And then just a follow-up question for Paul. Any thoughts in terms of intermediate term net leverage targets? If I think about you guys doing tuck-in acquisitions in the context of the next buyback?

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Paul S. Vasington - *Sensata Technologies Holding PLC - CFO, CAO & Executive VP*

We're trending to about 2.7x by the end of the year which was included -- assumed the GIGAVAC acquisition close in the fourth quarter. In general, we're thinking of that leverage of 2.5 to 3x is the range we'll probably be operating in normal time.

Operator

And that's all the time we currently have for questions. I would like to turn the floor to Joshua Young for any closing comments.

Joshua S. Young - *Sensata Technologies Holding PLC - VP of IR*

I'd like to thank everybody for joining us this morning. Sensata will be presenting at the RBC Technology Conference on November 13 in New York, and we'd welcome the opportunity for you to visit us at our headquarters in Attleboro, Massachusetts. We appreciate your interest in Sensata. Thank you, and good day.

Operator

Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines.

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