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Deere & Co. (DE)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Deere & Company Second Quarter Earnings Conference Call. Your lines have been placed on listen-only until the question-and-answer session of today's conference.

I would now like to turn the call over to Mr. Josh Jepsen, Director of Investor Relations. Thank you. You may begin.

Joshua Jepsen

Director-Investor Relations, Deere & Co.

Thank you. Hello. Good morning. Also on the call today are John May, Chairman and CEO; Ryan Campbell, Chief Financial Officer; Cory Reed, Ag & Turf Division President; and Brent Norwood, Manager of Investor Communications.

Today, we'll take a closer look at Deere's second quarter earnings, then spend some time talking about our markets and our current outlook for fiscal 2020. After that, we'll respond to your questions.

Please note slides are available to complement the call this morning. They can be accessed on our website at johndeere.com/earnings.

First, a reminder, this call is being broadcast live on the Internet and recorded for future transmission and use by Deere & Company. Any other use, recording, transmission of any portion of this copyrighted broadcast without the expressed written consent of Deere is strictly prohibited. Participants in the call, including in the Q&A session, agree that their likeness and remarks in all media may be stored and used as part of the earnings call.

This call includes forward-looking comments concerning the company's plans and projections for the future that are subject to important risks and uncertainties. Additional information concerning factors that could cause actual results to differ materially is contained in the company's most recent Form 8-K and periodic reports filed with the Securities and Exchange Commission.

This call may also include financial measures that are not in conformance with the accounting principles generally accepted in the United States of America, or GAAP. Additional information concerning these measures, including reconciliations to comparable GAAP measures is included in the release and posted on our website at johndeere.com/earnings under Quarterly Earnings and Events. I'll now turn the call over to John May.

John C. May

Chairman & Chief Executive Officer, Deere & Co.

Thanks, Josh. Good morning and welcome to John Deere's second quarter earnings call. Before discussing the details of the quarter, I'd like to begin the call with an overview of our response to COVID-19 and the near-term implications of the pandemic for our business.

First off, I sincerely hope that you and your families are safe and healthy and well. These times are challenging for many people, and my thoughts are with those affected by COVID-19. Additionally, I'd like to express my sincere gratitude to those who are serving our communities so that we can all overcome this pandemic, from the

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courageous medical professionals to those tirelessly working in industries essential to stability and recovery, such as the extraordinary colleagues at John Deere and many of our customers, I want to say thank you.

As John Deere has responded to COVID-19, our first priority has been and will always be the health, safety, and overall welfare of our employees. It is only by protecting our workforce that we can ultimately deliver on our commitment to our customers and fulfill our role as an essential business, a designation we are both proud of and humbled by.

Over the last two months, we've proactively implemented additional health and safety measures at our operations around the world. Importantly, many of these measures were taken on very early and ahead of regulations or official guidelines; these measures, such as employee health screening, additional personal protective equipment, social distancing guidelines, enhanced cleaning and sanitation efforts and staggered production schedules.

By diligently pursuing health and safety measures, we not only help protect our workforce, but we also provide our employees with peace of mind so that they feel secure coming to work. And consistent with our dedication to health and safety in our workforce, we also provided a number of additional benefits to encourage employees to take care of themselves and their loved ones without fear of financial harm. These additional benefits help support symptomatic employees or those deemed high risk, while also supporting workers who are challenged by the lack of school or daycare options.

During this time, our strong partnership with the UAW and other labor organizations across the globe has played a key role in helping us implement these measures, allowing us to answer the call as an essential business. I'm proud to report that substantially all of our global manufacturing base is running with exception of a few facilities operating at limited capacity, such as those in India.

Our commitment to health, safety and well-being extends outside of our walls and into the communities our employees call home. For instance, John Deere is producing thousands of protective face shields to meet the immediate and ongoing needs of healthcare workers serving our communities. To this, we add our Foundation's support of our social safety net in our home communities around the world, highlighted by our recent investments in food banks and their capacity. At the same time, we're also modifying our work to ensure that our customers and dealers can keep their operations running.

Underlying Deere's designation by many governments as an essential business is the fundamental recognition of the role our customers play in securing our global food supply and vital infrastructure. One goal has been to maintain customer uptime. To do this, we kept new equipment shipments moving and parts depots operational around the world. This has been no small task, particularly in light of the economic complexities of the regulatory, economic and other barriers that have affected our supply chain.

As it relates to our dealer channel, the vast majority are operating today and were able to maintain business safely throughout the last two months. Importantly, they've leveraged our e-commerce tools and connected support capabilities throughout the pandemic, allowing them to remotely service customers, machines and maintain appropriate social distancing.

Ultimately, the measure that we've taken to ensure continuity of operations have enabled our customers to carry out the essential work of promoting food security and providing critical infrastructure. While customers' operations vary around the world, this is an especially critical time for those involved in agriculture.

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During the last two months, many of our customers have been planting or harvesting a crop and, therefore, have required continual support from John Deere and our dealers. Furthermore, John Deere Financial has continued providing financing to customers globally throughout this crisis and has provided flexible terms to customers experiencing disruptions due to COVID-19.

To best summarize our efforts over the last two months, we are protecting our employees, who in turn help ensure that the essential operations of our customers keep running. And where our customers need even further support and financial assistance, John Deere Financial allows us to serve customers in ways that others cannot.

In addition to the operational actions, we've also proactively managed our balance sheet and cost structure to ensure we are well capitalized through this period of uncertainty. Over the years, we built a business with a cost structure that can flex with movements up and down the cycle. So much of this is already in our DNA. In addition to that, we plan to make further structural improvements beyond the typical cost levers we pull throughout the cycle.

Lastly, I'd like to revisit the strategy we laid out during our analyst event at CES in January. Regardless of COVID-19, all of the key elements of our strategy continue to direct our efforts. We continue to work on executing our priorities, which have proved more important now than ever.

First, we are focusing on capital allocation, both investments in R&D and investments to the areas of greatest potential for differentiation and profitability, resulting in intensified precision ag investments, higher penetration in our aftermarket and retrofit business and an increased emphasis on high-performing product lines, while actively addressing any lower-performing product line.

Second, we are reorienting our organization design to create a business that is more customer-focused across the entire production system, in order to better capitalize on the immense opportunity in front of us. As it relates to intensifying our precision ag business, the current environment highlights the importance of Deere's technology stack as a key differentiator in the market.

We've been investing in machine connectivity and data platforms for nearly a decade. Having those foundational technologies in our installed base has enabled our connected machines metric to increase significantly year-over-year, which has provided, in some cases, triple-digit growth in adoption of the services like Remote Display Access, Service Advisory Remote and Expert Alerts.

In light of the current circumstances, we see it as an obligation to continue investing in precision technologies that support customers and keep them running. We remain convinced of the value of creating a more agile organization to more nimbly respond to ever-changing market conditions. These organizational shifts will ensure our managers are empowered to make decisions and take action as required.

At this time, I'd like to turn the call over to Brent Norwood, to cover some of the details on the quarter. Brent?

Brent Norwood

Investor Relations, John Deere

Thanks, John. Now, let's take a closer look at our second quarter results beginning on slide 5. Enterprise net sales and revenues were down 18% to $9.25 billion, while net sales for our equipment operations were down 20% to $8.22 billion. Net income attributable to Deere & Company was down 41% to $665.8 million, or $2.11 per diluted share.

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In the quarter, the company recorded impairments totaling $114 million pre-tax and approximately $105 million after-tax related to certain fixed assets, operating lease equipment and a minority investment in a construction equipment company headquartered in South Africa.

At this time, I'd like to welcome to the call Cory Reed, President of Ag & Turf for the Americas for a discussion of the division's results. Cory?

Cory J. Reed

President-Worldwide Agriculture & Turf Division: Americas and Australia; Global Harvesting, Crop Care, and Turf & Utility Platforms; & Ag Solutions, Deere & Co.

Thanks, Brent. Let's start with the Worldwide Ag & Turf second quarter results on slide 6. Net sales were down 18% compared to last year, primarily driven by lower shipment volumes and the impact of currency translation, partially offset by positive price realization. Price realization in the quarter was positive by 1.5%, while currency translation was negative by 2%.

Operating profit was $794 million, resulting in a 13.3% operating margin for the division. The year-over-year decrease is primarily due to lower shipment volumes, sales mix, along with the unfavorable effects of foreign currency exchange. These factors were partially offset by price realization, lower selling, administrative and general expenses, reduced production costs and lower research and development expenses.

Before reviewing our industry outlook, I'll first provide an update on the operational status of our facilities around the world, as well as some commentary on the regional dynamics impacting ag markets, starting on slide 7.

In North America, nearly all Ag & Turf facilities remained operational during the second quarter. A few factories have experienced temporary production stoppages due to the supply-based disruptions. Although risk and uncertainty remain, we currently forecast to recover any delayed shipments throughout the balance of the year.

For our large ag business, the remainder of our 2020 production schedule is largely backed by customer orders through either our early order programs or rolling order books. Specifically, order programs for combines and crop cares are completed, while large tractor order books extend into the fourth quarter, roughly 90% full.

Right now, our North American customers are focused on planning and crop protection. Planted acres for soybeans are expected to rebound this year, while corn acres are forecasted at the highest levels since 2012. Favorable spring weather has resulted in above average planting progress at this stage of the season and is running well ahead of last year's severely impacted progress.

Despite the recovery in planted acres, the current environment is weighing on farmer sentiment, as near-term demand for agricultural commodities remains uncertain. Recent shifts in the food supply chain combined with decreases in ethanol demand have contributed to the likelihood of elevated carry-out levels for grain, which has weighed on commodity prices. The impact of the Phase One agreement with China remains an unknown variable at this time, since most agricultural exports to China from North America tend to occur around the harvest season. As a result, farmers are taking a wait-and-see approach on any anticipation of an uptick in exports.

Despite the many unknowns and variables, large row-crop farmers, by and large, have continued operations as normal. And on a positive note, key input costs such as fuel and fertilizer have decreased, providing some offset to the decline in commodity prices.

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Dairy and livestock farmers, on the other hand, have seen greater degrees of short-term disruption due to lower milk and protein prices. Restaurant and school closures have shifted food consumption trends, creating an oversupply of some ag products in the near term. Government aid directed towards these producers will help offset some of the recent effects, though we expect this segment to remain challenged for the year.

Regarding our consumer-oriented businesses in the US, turf and utility sales have remained resilient, especially in the seasonally important month of April. With many US consumers quarantining and together with favorable spring weather in North America, home and lawn projects have buoyed demand for products such as riding lawn mowers and compact utility tractors. While we've been encouraged by demand through April, it's important to note that demand is typically driven in part by the overall economic situation; and as a result, we've taken a more cautious outlook for the rest of the year.

Shifting to South America, farming conditions in Brazil have been favorable, as the first crop is mostly harvested and expected to set a record for soybean production, despite some persistent dryness in the southern growing regions. Its second crop is also in overall good condition.

Crop exports have been particularly strong, while a sharp depreciation in the Brazilian real has posted and boosted margins for the industry. Despite the solid levels of profitability, farmers have remained cautious on further investment due to the uncertainty caused by COVID-19 as well as possible implications stemming from the Phase One US-China trade agreement.

Moving on to Europe, our ag facilities are largely operational after experiencing some short-term disruptions. This is due in large part to the amazing efforts of our team and what they've put in place to both keep employees safe and keep operations running. As an example, at one facility, we entirely restructured our processes over the course of two days, and were able to reopen immediately thereafter. We split production into two shifts, enhanced social distancing by workstation, and procured additional personal protective equipment. Furthermore, we designed and trained employees on entirely new work protocols. These actions gave our employees the confidence to return to work.

Within a week of establishing these new processes, our facility was operating near its original level of productivity. This is just one of many examples in the region, where we've taken extraordinary efforts to maintain operations in order to support our customers.

While our facilities remain up and running, market conditions in Europe are mixed. Arable farmers are contending with the uncertainty of lower yields due to adverse weather and softening commodity prices impacted by the pandemic. Despite the uncertainty, conditions for arable farmers remain mostly stable, with weaker currency providing some support to the incomes.

On the other hand, the dairy sector has experienced significant pressure, as dairy prices have been negatively impacted by the closure of schools and restaurants and the overall disruption to the food supply chain and near-term changes in consumption. Conversely, pork margins remain strong, as exports to China are at an all-time high.

Lastly, in Asian markets, our operations have varied significantly by country. In China, our facilities are all open after experiencing closures in January and February. Meanwhile, our Indian facilities shut down from late March through most of April and are operating at limited capacity today. Correspondingly, market conditions and sentiment vary country by country, with key markets in India, China and Southeast Asia moderating due to uncertainty.

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Before reviewing our industry outlook, I'd like to highlight a few themes observed throughout the quarter on slide 8 that reflect the value of our dealer channel and connected support capabilities. First, regarding our channel, it's important to note that substantially all of our dealers remained operational during the quarter and remained full ability to service our customers. We've long viewed their overall financial health as a formidable competitive advantage in our industry.

Financially, our North American ag channel came out of the last agricultural trough stronger than when they entered. Today, as they work through COVID-related challenges, our channel is starting from a position of strength and stands ready to serve an industry fleet advancing in age, while offering support on new technologies that deliver lower cost of operations and overall better outcomes.

Because of consistent investments made by both Deere and our dealers over the last 10 years, we're uniquely able to serve our customers in this challenging environment in a way that sets us apart from other industry players. The combination of dealer investments and service capabilities, coupled with Deere's investment in critical precision ag infrastructure, positioned us to meet customer needs throughout the pandemic.

Since 2011, Deere has equipped large ag vehicles with connectivity capabilities standard in each machine. This basic connectivity was the first critical step on this long journey to enable the many precision tools customers rely on today. Features like the John Deere Operations Center, Service Advisor Remote, Expert Alerts and Remote Display Access are all part of a comprehensive precision ag infrastructure we've been building out for a decade, and important tools that feed our data and analytics capabilities.

Just as importantly, our dealer channel already has the resources and infrastructure in place to actively utilize these tools and to serve our customers. Over the years, they've invested significantly in establishing their own technology departments and operation centers to better monitor and service customer machines.

For example, over the last two years, our Brazilian channel established over 30 customer data operation centers, dedicated to the full-time monitoring and support of customers' operations. The value of these collective investments became more evident than ever over the course of the last few months. We've seen a significant increase in the use of our connected support tools, with total connected machines up 30% year-over-year, totaling over 200,000 ag machines worldwide. For some features such as Remote Display Access, we've seen adoption rates increase well over 100% since last year. The increase has been particularly encouraging in regions like Europe and Brazil.

Not only have these tools allowed customers to practice social distancing guidelines, they've also decreased downtime and the cost of their operations. So, while the recent environment has been challenging on many fronts, it's also confirmed to us that our strategy to intensify our precision investments, while reshaping our organization to allow for greater degrees of agility and responsiveness, is positioning us to deliver our customers a truly differentiated experience.

With that context, let's turn to our 2020 Ag & Turf industry outlook on slide 9. We expect ag industry sales in the US and Canada to be down roughly 10% for 2020, reflecting increased uncertainty in the US and slightly more challenging conditions in Canada. Moving on to Europe, the industry outlook is forecast to be down 5% to 10% as a result of lower yields for arable farmers and a difficult market for dairy producers.

In South America, industry sales of tractors and combines are projected to be down 10% to 15% for the year. Despite relatively positive fundamentals in Brazil, farmers have adopted a cautious stance due to COVID-related

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uncertainty and any potential shifts in global trade between the US and China. Meanwhile, there remains an ongoing economic uncertainty in Argentina.

Shifting to Asia, industry sales are expected to be down moderately as key growth markets like India slow due to country-wide lockdowns. Lastly, industry retail sales of turf and utility equipment in the US and Canada are projected to be down 10% in 2020. Despite positive sales trends through the second quarter, we've taken a more cautious outlook on the rest of the year.

Moving on to our Ag & Turf forecast on slide 10, fiscal year 2020 sales of worldwide Ag & Turf equipment are forecast to be down between 10% and 15%, which includes expectations of 2 points of positive price realization, offset by currency headwind of about 2 points. For the division's operating margin, our full year forecast is ranging between 8.5% and 10%.

At this time, I'd like to turn the call back over to Brent Norwood to cover details on the quarter for Construction & Forestry division. Brent?

Brent Norwood

Investor Relations, John Deere

Now, let's focus on Construction & Forestry on slide 11. For the quarter, net sales of $2.26 billion were down 25%, primarily due to lower shipment volumes and the impact of currency translation, partially offset by positive price realization. Operating profit moved lower year-over-year to $96 million, primarily due to lower shipment volumes and sales mix, impairments of an asphalt plant in Germany and an unconsolidated equipment company headquartered in South Africa, and the unfavorable effects of foreign currency exchange, partially offset by lower production costs and price realization.

Let's turn to our 2020 Construction & Forestry industry outlook on slide 12. Construction equipment industry sales in the US and Canada are now forecast to be down between 20% and 30%, reflecting sharp declines in oil and gas activity, rental CapEx as well as overall moderation in general economic activity during the second quarter.

Moving on to global forestry, we now expect the industry to decline 15% to 20% this year with the US and Canada markets declining more than the rest of the world as lumber and pulp prices soften in North America.

Moving to the C&F division outlook on slide 13, Deere's Construction & Forestry 2020 net sales are forecast to be down between 30% and 40% compared to last year. The incremental decline relative to the industry guidance reflects plans to underproduce retail sales as we take further actions to reduce field inventory. The order book remains within our historical 30- to 60-day replenishment window, but at a much reduced production schedule.

Our net sales guidance for the year includes expectations of about 1 point of positive price realization and a currency headwind of about 2 points. For the division's operating margin, our full year forecast is ranging between 2% and 4%.

Let's move now to our Financial Services operations on slide 14. Worldwide Financial Services net income attributable to Deere & Company in the second quarter was $60 million, as a result of a higher provision for credit losses, unfavorable financing spreads and increased losses and impairments on lease residual values primarily for construction equipment, partially offset by income earned on a higher average portfolio.

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For fiscal year 2020, net income forecast is now $490 million, which contemplates a tax rate between 24% and 26%. The provision for credit losses in 2020 is forecast at 37 basis points, reflecting a higher degree of uncertainty relative to last year.

Slide 15 outlines our guidance for net income, our effective tax rate and operating cash flow. Our full year outlook for net income is now forecast to be in a range of $1.6 billion to $2 billion, with an effective tax rate projected to be between 22% and 24%. Cash flow from the equipment operations forecast is now in a range of $1.9 billion to $2.3 billion for 2020.

I will now turn the call over to Ryan Campbell for closing comments. Ryan?

Ryan D. Campbell

Chief Financial Officer & Senior Vice President, Deere & Co.

Before we respond to your questions, I'd first like to offer some thoughts on our liquidity position, cost management, financial forecast and the status of our strategy we discussed at CES.

First, I'd like to highlight some of the actions taken during March and April to enhance our liquidity and financial position. In mid-March, we stopped our share repurchases. In late March and early April, we successfully executed two medium-term note offerings. The first offering raised $2.25 billion through the issuance of 5-, 10- and 30-year notes. The second offering raised €2 billion through the issuance of 4-, 8- and 12-year notes.

Also in March, we successfully renewed our revolving credit facilities totaling $8 billion, an increase of $200 million from our prior-year renewal. These actions provide extra support for our overall liquidity profile in light of the continuing uncertainties arising from the ongoing COVID-19 pandemic. They are also squarely in line with our use of cash priorities, which continue to serve us well through these challenging times.

As a reminder, the priorities are to maintain our A rating, fully fund our operations, pay dividends to shareholders, and finally repurchase shares when conditions warrant.

As it relates to cost management, the year-to-date results reflect our strong heritage of managing performance throughout the business cycle. Given the speed of the recent downturn, we were able to maintain decremental margins below 25%, even including the costs associated with the voluntary separation program in our first and second quarters and the impairment charges taken in our second quarter.

The quick actions taken by employees at all levels, pulling cost and capital levers, allowed us to achieve these strong results in this very challenging environment.

Second, I want to provide some perspective on the $1.6 billion to $2 billion net income forecast that we are providing. It goes without saying, but I want to emphasize that we are still operating in a very uncertain environment, given the ongoing COVID-19 pandemic. However, we felt it was important to provide some perspective on our current estimate of fiscal 2020 financial performance.

Our forecast is driven by estimated industry performance as well as our expected inventory positioning. Although all parts of our business have some level of demand uncertainty, certain products, like those subject to our early order programs, operate on more of a sold-ahead basis and we have higher visibility to demand in those areas.

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Other products have lower levels of visibility as they do not operate off early order programs and tend to be driven, to a larger extent, by general economic trends such as housing starts, the price of oil, levels of GDP and other factors. Our ranges attempt to reflect these dynamics.

In addition, supply-related risks remain as our global supply base deals with the complexity caused by the COVID-19 pandemic. While we have confidence in our supplier capabilities, they contend with uncertainties caused by the pandemic such as workforce availability, effectiveness and availability of transport carriers and overall availability and pricing of materials.

Uncertainty also remains with respect to our ability to maintain the level of operation required to support the production schedules we are currently forecasting. Although we have had good success to-date, there are many different factors that could impact our production and other operations. First and foremost is the ability to provide a safe working environment for our employees.

Our forecast attempts to reflect these and other risks. It provides our best estimate based on the factors that drive our performance as we see them as of today.

The higher end of the range reflects our current expectation of demand and our ability to manage through the current environment with minimal disruption, while the lower end of the range would reflect lower order receipts coupled with higher levels of manufacturing suspensions and distribution challenges. Given the complexity and uncertainty of the COVID-19 pandemic, actual performance could deviate from our range.

Finally, I want to emphasize John's points on the strategic direction of the company. CES seems like a long time ago, given everything that has happened over the last few months. However, managing through these difficult times leaves us even more convinced in the priorities we articulated at that time.

We will continue to allocate capital to the areas that have the highest potential for differentiation like large and production system ag. Accordingly, as we have pulled levers to reduce costs in this environment, we have protected the investment in these areas as they will be a significant driver of our future performance.

We will aggressively drive growth in our aftermarket parts and retrofit business, and we'll drive more efficiency in our cost structure in order to move with enhanced speed and agility, unlocking the full potential of our talented employee base.

Joshua Jepsen

Director-Investor Relations, Deere & Co.

Now, we're ready to begin the Q&A portion of the call. The operator will instruct you on the polling procedure. In consideration of others, please limit yourself to one question. If you have additional questions, we ask that you rejoin the queue. Operator?

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Jamie Cook with Credit Suisse. Your line is open.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning, and glad to hear everyone's well. I guess, just my first question, can you just address – you talked in the quarter about taking additional – or looking at structural costs. Can you talk about sort of the items that you're contemplating and what that could potentially mean, if any, for savings in 2021?

And then just a follow-up on that, are there any costs associated with the structuring implied in your net income guide? Thank you.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Thanks, Jamie. I'll start. As we think about cost actions that we've taken, we had the voluntary separation program that we executed in the first quarter. We're seeing savings on that throughout the remainder of 2020. On top of that, as we've talked about, we pulled levers. We reduced SA&G. Full year, we expect it to be down about 11%. We've been more targeted or surgical with what we've done on R&D. And then we also see some things like incentive comp that's a bit of an automatic lever as we shift up and down the business. So, those are the things that would be contemplated in our guide. As it relates to further actions, we don't have anything in this forecast today.

Ryan D. Campbell
Chief Financial Officer & Senior Vice President, Deere & Co.

A

Jamie, it's Ryan. I'd point you back to CES and our talking points there. We're still executing against that strategy, and we said about 1 point of structural cost improvement. Our structural improvement in our margins will come from cost. So, we've got the voluntary separation programs we did in 2019 and 2020. The full year run rate on those is about $120 million. We talked about the Wirtgen synergies of about €125 million. That would leave us about $100 million-plus remaining of actions related to cost efficiencies, looking at footprint, looking at organizational design. We'll make those decisions over the next several months, and we'll update as those decisions get made.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Thank you. We'll go ahead and jump to our next question.

Operator: Our next question comes from Jerry Revich with Goldman Sachs. Your line is open

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Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Hi. Good morning, everyone.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Hi, Jerry.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

I'm wondering if you can talk about precision ag. So, we're hearing from the field that adoption rates have actually been ahead of our expectations for a lot of folks on RTK and Precision Planting. Can you talk about what your take rates for those products are looking like for this season? And if you could update us on the aftermarket ExactEmerge Kits.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Yeah. I'll start, Jerry. I think when we look at precision ag, I think we're continuing to see strong adoption. Cory made reference to our connected machines, over 201,000 connected machines, engaged acres, now over 190 million engaged acres. And those are the – you think about – those are the things that are driving the underlying tools that are executing on that. We've continued to see strong adoption of things like ExactEmerge in planting and planting progress. This year, obviously, weather's been conducive, but you're seeing significant improvements in what we've done there.

And things like Combine Advisor, some of the things that we've talked about in the past all continue to be strong. I think today what we're seeing, and Cory can add some context here, just what we're seeing on the aftermarket side and the ability to deliver a customer experience to customers that is somewhat unmatched, particularly in an environment like this.

Cory J. Reed
President-Worldwide Agriculture & Turf Division: Americas and Australia; Global Harvesting, Crop Care, and Turf & Utility Platforms; & Ag Solutions, Deere & Co.

A

Yeah, Jerry, I would start with, we made a couple of comments about the core infrastructure. The ability to connect out to each of these machines, both at the individual vehicle level and at the system level, has allowed us to keep customers up and running. I'll give you an example of planting.

We had a customer who had hooked his planter up wrong, had individual hydraulic downforce on his planter. We're now getting digital connections between those planters back to our dealers who are able to diagnose those machines down to the individual row unit without having to be in the field looking at the problem. We're able to proactively see that alert come through, alert the customer when they were starting planting that it wasn't planting appropriately and be able to turn that into a fix that allows that customer's crop to be planted correctly and preserve their revenue. That's one of a thousand of these examples.

On the aftermarket side, it's been incredible to see how the digital infrastructure has allowed us to see machine failures, be able to connect with customers through digital portals, be able to seamlessly continue aftermarket connections back to the dealership in a way that allows us to deliver parts without ever having a face-to-face transaction.

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So, that's just a decade of putting the infrastructure in place that's allowed our customers and dealers to now take that infrastructure and turn it into tremendous experience for them in a difficult time.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Thanks, Jerry. We'll go ahead and go to our next question. Appreciate it.

Operator: Our next question comes from Ashish Gupta with Stephens. Your line is open.

Ashish Gupta
Analyst, Stephens, Inc.

Q

Hi. Good morning. Thanks for taking the question. Just following up on aftermarket, have you guys sort of seen a pick-up in aftermarket sales in the quarter beyond what you would have expected, just being driven by the connected machines? And based on what you're seeing so far, relative to the goals you have for the long-term guidance increasing aftermarket, are you kind of getting a – seems like you're getting an increased level of confidence in your ability to sort of achieve that aftermarket target.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Yeah, I think, we're certainly, we're early days on some of these initiatives. But I think we've seen good progress. I mean, the digital tools and being able to diagnose these things and do it proactively has definitely helped. This year, we're planting earlier than we did last year, so that plays some role into it. But we have seen an uptick, particularly in North American ag parts in the early part of the year, so that's been positive. But we've also – dealers have also done a lot of work in addition to our parts organization to support that.

Cory J. Reed
President-Worldwide Agriculture & Turf Division: Americas and Australia; Global Harvesting, Crop Care, and Turf & Utility Platforms; & Ag Solutions, Deere & Co.

A

Yeah. I think you have a couple of things. This is Cory. You have a couple of things going on. Number one, we have an aging fleet. We've been down in new volumes over a number of years, so as the fleet ages, the opportunity for that aftermarket potential. If you look back four, five, six years ago, at some of the highest machine populations we've put in, that aftermarket opportunity is huge. We put an infrastructure in place to be able to connect to those machines to keep our customers up and running. And we put systems in place at our dealers that allow them to transact in an e-commerce way that differentiates them in the market.

So, a couple of points there: obviously, there's an opportunity for us to both upgrade their equipment through performance upgrades, things that we can take back across their fleet, and also the opportunity to trade them into new equipment over time. That aging fleet gives benefits in a number of ways. The connections that our dealers have been able to make using e-commerce, using their dealer customer portals is a differentiator for them today and they've continued to grow their aftermarket business as a result of it.

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Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Yeah. Maybe one last thing to add on top of that, just from a digital tool perspective, a lot of our dealers have done a lot of work with online showrooms, virtual machine walk-arounds and we've seen significant opportunities there of our dealers differentiating their offering. And maybe in particular in Brazil, where we've seen just a lot of great activity relative to how do we support and sell in a different environment.

With that, we'll go ahead and go to our next question. Thanks, Ashish.

Ashish Gupta
Analyst, Stephens, Inc.

Q

Thanks.

Operator: Our next question comes from Courtney Yakavonis with Morgan Stanley. Your line is open.

Courtney Yakavonis
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Thanks for the question. I appreciate the color you guys gave on some of the structural costs that you're addressing. But I think last quarter, you talked about some costs, whether it was elevated freight or maybe some costs associated with social distancing that might be weighing on your margins going forward. Can you just kind of break out for us if there's anything that we should be expecting kind of as you guys are returning back to normal volumes that will weigh on margins?

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Yeah. I mean, when you think about particularly what we've got included in our forecast, last quarter we talked about premium freight being one of the biggest items. So, we continue to expect that. Full year, on the ag side, for example, we expect about $50 million of premium freight as supply bases come back online and we're working to get those parts and components into our facilities. So, that would be one of the bigger ones.

On top of that, it's harder to quantify some of the disruption or, to your point, social distancing, additional PP&E to keep folks safe. So, there are other costs relative to operating in this environment as well as just some of the inefficiencies relative to disruption. So, we have some of those really in both divisions. But if you think about from an Ag & Turf perspective, even with those costs, we're talking about for the full year decrementals in the upper teens to low 20s. So, feel really good about the ability to execute there in the uncertain environment.

Courtney Yakavonis
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Great. And then you also had mentioned the replacement schedule and that some of the sales this year were locked in from your early order program. So, when we're thinking about next year, can you just comment on the willingness of farmers to replace their equipment, given where commodity prices are today and any impact that some of the government aid programs that we're seeing come through could impact those decisions?

Cory J. Reed
President-Worldwide Agriculture & Turf Division: Americas and Australia; Global Harvesting, Crop Care, and Turf & Utility Platforms; & Ag Solutions, Deere & Co.

A

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Sure. This is Cory. I think, no doubt, that there's uncertainty created by what's happened with the pandemic. I think the big factors are thinking about what the demand will look like from US-China trade deal. It's certainly the case that our fleet is aging. So, if you look at the availability to take technology and upgrade both the performance of the machine and the profitability of a farmer's operation, we really have two ways of doing that. We can take those technologies back across the existing fleet through performance upgrades, or we can trade those farmers going forward into new technology.

I think the demand side of that is yet to be determined going into 2021 because there's a lot of interruptions. Certainly, the government programs, if you look at what they've done, they've been a leveling effect that's helped customers both maintain their profitability throughout this year. Their insurance programs have given them a level of certainty as to where their incomes will be. As we look to 2021, we'll look to the general economy and look to how trade continues through the remainder of the year.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

All right. Thanks, Courtney. We'll go ahead and go to our next caller.

Operator: Thank you. Our next question comes from Rob Wertheimer with Melius Research. Your line is open.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Hey. Good morning, everyone. So, my question is on construction, and there's a pretty substantial dealer destock implied in the gap between your market and your own revenues. And my question is did dealer inventory kind of trend the way you wanted over the cycle? Or did rental fleets or something else get out of hand as an output of that? Is it going to bounce back when the market comes back, or would you rather have a more streamlined dealer inventory? And then just a small one, how come we didn't – or you didn't, rather, cut construction a little bit more in 2Q versus 3Q, 4Q implied? Thanks.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Yeah. Thanks, Rob. I mean, I think as you think about construction inventories, and really in particular, we're talking about North American construction equipment, we entered the year, at 1Q, we talked about under-producing, we will underproduce and we'll underproduce more than we expected to coming into this quarter. I think the – how much did it come down in 2Q versus expectations, I mean, the speed at which the deceleration occurred was candidly just faster than we would have expected, and we've taken actions there to pull back there. And as I mentioned, we'll underproduce and try to manage those accordingly.

Maybe to the other part of your question, a little bit of the phenomenon how we saw those inventories evolve, I mean, I think it's a combination of managing new, fresh inventory in the dealer channel as well as dealer-owned rental fleets. So, there's a combination. When we think about total dealer inventory, it's really two pieces in trying to manage the combination of those two.

Now – and certainly, on the production side as we underproduce, we can pull back the new faster, and then the dealers will work through those – converting those rental machines into sales. So, it's really a balance of managing both components of those inventories.

All right. Thanks, Rob. We'll go ahead and jump to our next question.

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Operator: Our next question comes from Steve Fisher with UBS. Your line is open.

Steven Fisher
Analyst, UBS Securities LLC
Q

Thanks. Good morning, guys. I just wanted to follow up on the margins and, specifically, in construction. Could you just talk about what you have assumed for the second half of the year? I think it implies around 1% margin. So, are you assuming that you're profitable in both quarters or more profitable in one quarter and losing money in the next?

And then as you think beyond sort of 2020, how quickly could the margins come back there and what does it really require? Is it sort of the neutralizing of oil and gas? Is it something more on the Wirtgen side, the synergies? Those are the questions. Thanks.

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

Yeah, thanks, Steve. I mean, I think when we think about the back half of the year for C&F, I mean, as mentioned, the biggest driver is volume and the underproduction that we're doing in the back half of the year. So, that has a pretty significant impact.

And I think when you think about road building, road building for the full year we expect to be down about 25%. So, that's a pretty significant reduction as well on a business that drives pretty strong margin performance as well.

I think as we look at overall, though, maybe to your point and to your question, we'd expect that we're positive in the back half of the year, so no major shifts.

Steven Fisher
Analyst, UBS Securities LLC
Q

But it's positive in both quarters, profitable in both quarters?

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

That's right.

Steven Fisher
Analyst, UBS Securities LLC
Q

Okay. Thanks very much.

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

Thanks, Steve. We'll go to the next question.

Operator: Our next question comes from Joe O'Dea with Vertical Research. Your line is open.

Joseph John O'Dea
Analyst, Vertical Research Partners LLC
Q

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Hi. Good morning, everyone. A question on the Ag & Turf margin guidance, with the midpoint calling for back half of the year revenue declines similar to what we saw in the first half of the year, but implying decremental margins in the mid-20% range versus low-teens in the first half of the year. And so, what you're seeing to drive some of that difference in the decremental margin performance on similar revenue trends?

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

Yeah, I think when you think about back half, I mean, there's a few things, a couple that I mentioned I think in Courtney's question. So, we do have some of these incremental COVID-related costs, so premium freight, some of the inefficiencies just relative to disruption in the operations and other COVID-related costs. And then FX has turned pretty negatively as you saw significant deterioration versus the dollar on a number of currencies, but in particular, the Brazilian real. Obviously, that was occurring in March. So, you see more of that impact in the back half of the year. And then from a volume perspective, we do expect the back half to be down a little bit more than what we experienced in the first half of the year.

Joseph John O'Dea
Analyst, Vertical Research Partners LLC
Q

And specifically on mix, it looks like mix was a headwind in the quarter. But as we think about large ag that could be more stable relative to small ag, think about the aftermarket trends that you've been discussing, do you think about mix as being a tailwind in the back half of the year?

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

Yeah, full year, we expect mix is favorable, and it's been relatively neutral kind of through the first half of the year. So, that's correct.

Joseph John O'Dea
Analyst, Vertical Research Partners LLC
Q

Okay. Thank you.

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

Thanks, Joe. We'll go ahead and go to our next question.

Operator: Our next question comes from Stephen Volkmann with Jefferies. Your line is open.

Stephen Edward Volkmann
Analyst, Jefferies LLC
Q

Hi. Good morning, guys. Maybe just sort of a bigger picture or a longer-term question, I think some people I was speaking with were sort of surprised because, Cory, you laid out a bunch of headwinds in the ag space relative to very large plantings and lower crop prices and demand questions and so forth. So, I think it's a little surprising that your forecast isn't down a little bit more for the industry. So, I guess I'm curious are we just low enough that we're at an area where we'll continue to see some replacement, almost no matter what.

Traditionally, we haven't really viewed government funding as something that farmers will spend on equipment but maybe we're at a low enough area where that does happen now. I guess, I'm just trying to figure out how you're

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thinking about this from a little bit longer term perspective as we get into next year, perhaps. Sorry for the long question.

Cory J. Reed A
President-Worldwide Agriculture & Turf Division: Americas and Australia; Global Harvesting, Crop Care, and Turf & Utility Platforms; & Ag Solutions, Deere & Co.

No. I think you covered – I think you answered part of it that we're at some pretty low levels overall and we have a fleet that's sitting as old as it's been in probably a decade or a decade-and-a-half, which means one of the things that you see is the technologies available today give an opportunity for customers to lower their cost structure. In an environment, where overall demand is the question, the thing that customers can do is invest to make sure they have the lowest cost of production of anyone in the market. So, we see technology being driven across those acres.

So, old machine fleet, the ability to take products and technologies that we've delivered like ExactEmerge that's still relatively young in the market if you looked at total acres planted but will continue to grow, like our ExactApply and later our See & Spray technologies. We have the ability to change the cost structure on each acre. And if you take an aging fleet and you can change the cost structure, you have the ability to generate the sales.

I think our customers on the customer side, their incomes have been buffered by the programs. The remain to be seen is overall demand for commodities and ultimately how trade works between the regions going forward.

Ryan D. Campbell A
Chief Financial Officer & Senior Vice President, Deere & Co.

One other phenomenon that we talked about is our units with replacement kind of getting pushed out with trade and then COVID, our units have been flattish at a lower level, but we continue to grow the per unit sales in the business as customers continue to buy higher spec, more productive machines. And so, that's a phenomenon that gives us a little more confidence that even if industry is maybe a little bit challenged, we're going to be able to outperform given our value proposition and given our customers' propensity to continue to upgrade and purchase our latest and most productive equipment.

Stephen Edward Volkmann Q
Analyst, Jefferies LLC

Great. Thank you, guys.

Joshua Jepsen A
Director-Investor Relations, Deere & Co.

Thank you. We'll go to our next question.

Operator: Yes. Our next question comes from Tim Thein with Citigroup. Your line is open.

Tim W. Thein Q
Analyst, Citigroup Global Markets, Inc.

Thank you. Good morning. Maybe just to circle back, Cory, for you on your comments on the order board at Waterloo, I think you said into the fourth quarter, I think you're doing some movement or transitioning with the 8R, with that line. So, I'm just curious, you're taking that into account, obviously, that – those slots can be impacted by production rates. So, I'm just trying to, I guess, get a better understanding for what that actually means in terms of

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where were you at this point last year and is there any impact there in terms of potentially the actual build rates. Have they come down at all or been changed? So, that's the question.

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

Yeah. Thanks, Tim. Hey, this is Josh. I'll start. I mean, I think the – when you look at Waterloo, as Cory mentioned, 90% of the year ordered out. We've got – so 8R's availability is into September, into the kind of mid to late September. So, we continue to move forward there. So, I think that's a positive. Obviously, now we're building the new machines as we go forward.

We did see some disruption on the supply side. So, we spent a few weeks down as we were going through some supply challenges. And as a result, that's impacted a little bit what we've been able to do in May. But as Cory mentioned, we're confident in the ability to catch up there and are back up running building tractors today.

Cory J. Reed
President-Worldwide Agriculture & Turf Division: Americas and Australia; Global Harvesting, Crop Care, and Turf & Utility Platforms; & Ag Solutions, Deere & Co.
A

Yeah. The only other thing I would add is what – that transition was taking place the end of the second quarter. We're now building a product that's outstanding. From a customer perspective as it's hitting the market, our customers have responded very favorably to it. So, while we obviously have our current order book largely filled, we're very pleased with the performance of the new machine as it's hitting the market. And it contains a lot of game-changing technology as we move forward into 2021 and beyond.

Tim W. Thein
Analyst, Citigroup Global Markets, Inc.
Q

Got it. And, Cory, just reminder, how much output typically gets exported from Waterloo these days?

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

It varies year to year. So, if you think about exports from Waterloo, though, it predominantly would be Europe and some other parts of the world; think like Oceania, Australia, New Zealand, but those would be some of the biggest ones, with Brazil now producing for themselves, so.

Thanks, Tim. We'll go ahead and go to our next question.

Operator: Our next question comes from David Raso with Evercore. Your line is open.

David Raso
Analyst, Evercore Group LLC
Q

Hi. Good morning. The revenue growth for the second half of the year in Ag & Turf, that decline being the same as the first half; I'm just trying to put that in better context. Can you help us with second half of last year, your high horsepower, if I remember correctly, was underproducing retail. What will the production be in the back half of this year versus retail for Ag & Turf, just so we get some sense of that swing from underproduction to, I'm assuming from these numbers, less underproduction.

And then second, if you can help just quantify the order book today, where is it versus a year ago? Because when you say it's out through September, that simply depends – it can be out certain amount of months based off of

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whatever the line rate is. We're just trying to get a sense of that down 12.5%, how much is the swing from underproduction to less underproduction, or maybe even producing in line? And also some sense of the backlog, including maybe color on the new product maybe helping that backlog more than the industry. Thank you.

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

Yeah. I mean, I think as it relates to Waterloo, maybe starting in Ag in total, the back half – we expect back half volumes to be down a little bit more than the first half. So, not equally matched, so down a little bit in the back half. As it relates to Waterloo, when you think about large or high-horsepower row-crop tractors, we're going to be in line effectively for the year in terms of production relative to retail, so, not huge shifts.

David Raso
Analyst, Evercore Group LLC
Q

Just on the second half? Just to be clear, just – I'm speaking just on the second half. Will production be in line with retail for high horsepower in the second half of the year versus, just to remind us, the comp it's going against a year ago? Production versus retail, second half versus second half.

Ryan D. Campbell
Chief Financial Officer & Senior Vice President, Deere & Co.
A

David, it's Ryan. I think what you're getting to, basically what's the year-over-year.

David Raso
Analyst, Evercore Group LLC
Q

Correct.

Ryan D. Campbell
Chief Financial Officer & Senior Vice President, Deere & Co.
A

And so a couple of different factors that you have to think about. One is the industry we're projecting to be down, but you point out correctly that we underproduced last year. So, we underproduced last year, industry's down, so we'll produce for the full year this year roughly in line. So, production at some of our larger facilities is a little bit higher.

As Josh talked about, our mix gets a little bit better this year. But one thing you need to think about is that's offset by a really weak currency environment. So, most of our currencies that we sell in outside the US dollar weakened significantly. So, that offset some of that.

David Raso
Analyst, Evercore Group LLC
Q

Okay. And the new product helped to the backlog. And again, if you can just help us some way to quantify where is your backlog today versus a year ago?

Joshua Jepsen
Director-Investor Relations, Deere & Co.
A

Yeah. I mean, I think probably hasn't changed significantly from where we've been a quarter ago, just because the -

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David Raso
Analyst, Evercore Group LLC

Q

From a year ago at the same time? I'm asking year-over-year. I apologize, I'm not being clear. The backlog today versus this time last year. I'm sorry. Year-over-year.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Yeah. Our orders in Waterloo are up about 10% year-over-year.

David Raso
Analyst, Evercore Group LLC

Q

Okay. That's a lot easier on the guide then. Thank you so much. I really appreciate the time.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

All right. We'll go ahead and do one more question.

Operator: Thank you. Our last question comes from Andy Casey, Wells Fargo Securities. Your line is open.

Andrew Casey
Analyst, Wells Fargo Securities LLC

Q

Thanks a lot, and good morning, everybody. Just a question on how you would like us to look at the upcoming early order programs in Ag & Turf? I mean outside of last year, order placement had been weighted to the early part of those programs. But with all the uncertainty you outlined in the market, should we expect farmers are going to continue to wait and see and therefore, should we expect looking at channel checks and whatever that the orders are probably going to be skewed towards the tail end when, presumably, visibility improves?

Joshua Jepsen
Director-Investor Relations, Deere & Co.

A

Yeah. It's a great question, Andy. And we'll kick off crop care EOPs here in early June. So, I think, as you rightly note, lots of questions and plenty of uncertainty from a customer perspective. So, I think we'll have to see how they play out.

Cory J. Reed
President-Worldwide Agriculture & Turf Division: Americas and Australia; Global Harvesting, Crop Care, and Turf & Utility Platforms; & Ag Solutions, Deere & Co.

A

Yeah. I think early order programs would be a good indicator. Generally, we get majority of the orders by phase in the later parts of the phase anyway. So, it's – our expectation is we won't know at the beginning of those early order programs. We usually have pretty good gates that we go through relative to the phases, as the last week of those phases generally give us a good indicator of what demand is going to look like.

Joshua Jepsen
Director-Investor Relations, Deere & Co.

Thanks, Andy. Well, thanks, everyone. With that, we'll wrap up the call. We appreciate the interest and we'll talk to you all soon. Thank you.

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Operator: Thank you for your participation. This does conclude today's conference call. You may disconnect at this time.

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