

Equities

28 November 2011 | 15 pages

GDF Suez (GSZ.PA)

Overpriced Risks, Underappreciated Opportunities. Buy.

- Company Update
- Target Price Change
- Estimate Change

- **It's all about conversion rates** — Over the last 5 years GDFSuez has consistently – and we forecast will continue to do so – converted every €1 of EBITDA into €0.75 of Op. Cash Flow post interest. The bottom-line conversion rate however has declined from €0.4 of net income for every €1 of EBITDA in 2007 down to €0.2 in 2011.
- **We expect bottom-line conversion rates to trough** — in 2012 and start improving from 2014 as the capex program plateaus. This should allow the 8.1% EBITDA 2011-13 CAGR to drive 12% adjusted adj. earnings CAGR over the same period, from a now reduced €1.65 EPS in 2011 to €2.02 in 2013.
- **€14b of annual EBITDA already locked in** — through 2014 as it relates to contracted volumes, PPAs, or regulated businesses and assuming Suez Environnement profitability is back down to its 2008/09 recession levels. At the group level this corresponds to 60-80% of our annual forecast through the period.
- **Cash equity value depleted by 'just' 10-15% in the last 24 months** — but the share price is down double that. Part of this is explained by the market's increased focus on medium-term EPS which suffered – 2013 estimates down 20% – because of the high capex program. But this fails to take into account the future earnings contribution of these investments or indeed the intact cash flow generation.
- **Political and sovereign concerns (Belgium & France)** — should not be ignored but we believe are overstated in the share price. GDFSuez's dividend yield premium over its own 2015 bond yield is higher than that of Enel's yield over its corporate bonds. Given the geographic exposure of the two stocks, their respective dividend outlook and balance sheet strength we view this as unjustified for GDFSuez.
- **We reiterate our Buy rating on GDFSuez** — We set our price target at €26 cut from €29 to reflect our new estimates and removal of life extensions. We estimate that at the current stock price the group's earnings that are not locked-in, i.e. 25% of our 2013 EBITDA forecast, comes for 'free', which we consider an attractive value proposition.

Buy	1
Price (25 Nov 11)	€18.13
Target price	€26.00
	from €29.00
Expected share price return	43.4%
Expected dividend yield	8.3%
Expected total return	51.7%
Market Cap	€40,828M
	US\$54,505M

Price Performance (RIC: GSZ.PA, BB: GSZ FP)



GDF Suez (EUR)

Year to 31 Dec	2009A	2010A	2011E	2012E	2013E
Sales (€M)	79,907.0	84,484.0	97,030.6	100,603.9	106,157.8
Net Income (€M)	4,650.8	3,915.0	3,685.8	4,036.6	4,503.1
Diluted EPS (€)	2.12	1.79	1.65	1.81	2.02
Diluted EPS (Old) (€)	2.12	1.79	1.81	2.28	2.29
PE (x)	8.5	10.1	11.0	10.0	9.0
EV/EBITDA (x)	5.9	5.8	5.8	5.7	5.5
DPS (€)	2.27	1.50	1.50	1.50	1.58
Net Div Yield (%)	12.5	8.3	8.3	8.3	8.7

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Dec	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	8.5	10.1	11.0	10.0	9.0
EV/EBITDA adjusted (x)	5.9	5.8	5.8	5.7	5.5
P/BV (x)	0.7	0.7	0.6	0.6	0.6
Dividend yield (%)	12.5	8.3	8.3	8.3	8.7
Per Share Data (€)					
EPS adjusted	2.12	1.79	1.65	1.81	2.02
EPS reported	2.05	2.11	2.23	1.88	2.02
BVPS	26.66	27.64	28.63	29.01	29.45
DPS	2.27	1.50	1.50	1.50	1.58
Profit & Loss (€M)					
Net sales	79,907	84,484	97,031	100,604	106,158
Operating expenses	-71,560	-75,689	-87,921	-90,381	-94,769
EBIT	8,347	8,795	9,110	10,223	11,389
Net interest expense	-1,628	-2,221	-2,400	-2,311	-2,401
Non-operating/exceptionals	230	966	1,652	532	403
Pre-tax profit	6,950	7,540	8,362	8,444	9,391
Tax	-1,719	-1,913	-2,013	-2,690	-3,146
Extraord./Min.Int./Pref.div.	-753	-1,010	-1,363	-1,567	-1,742
Reported net income	4,478	4,617	4,986	4,187	4,503
Adjusted earnings	4,651	3,915	3,686	4,037	4,503
Adjusted EBITDA	14,012	15,087	16,573	17,879	19,360
Growth Rates (%)					
Sales	-3.8	5.7	14.9	3.7	5.5
EBIT adjusted	-2.5	5.4	3.6	12.2	11.4
EBITDA adjusted	0.9	7.7	9.9	7.9	8.3
EPS adjusted	-10.9	-15.8	-8.1	10.0	11.6
Cash Flow (€M)					
Operating cash flow	12,483	10,908	13,939	13,205	14,381
Depreciation/amortization	5,183	5,901	7,093	7,286	7,601
Net working capital	1,989	-258	1,797	315	534
Investing cash flow	-8,369	-7,784	-21,194	-11,594	-10,971
Capital expenditure	-9,646	-9,292	-21,194	-11,594	-10,971
Acquisitions/disposals	515	1,517	0	0	0
Financing cash flow	-3,098	-3,985	-3,252	-3,138	-4,619
Borrowings	1,990	1,285	2,508	2,518	1,293
Dividends paid	-4,028	-3,918	-3,360	-3,344	-3,511
Change in cash	1,016	-861	-10,507	-1,527	-1,209
Balance Sheet (€M)					
Total assets	171,425	184,658	204,721	210,680	216,632
Cash & cash equivalent	10,324	11,296	12,797	12,797	12,797
Accounts receivable	19,749	21,334	24,017	24,902	26,276
Net fixed assets	69,665	78,703	90,427	94,927	98,612
Total liabilities	105,899	113,940	124,390	128,681	132,775
Accounts payable	16,594	14,835	16,941	17,464	18,322
Total Debt	42,272	47,238	49,746	52,264	53,556
Shareholders' funds	65,527	70,718	80,331	81,999	83,857
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	17.5	17.9	17.1	17.8	18.2
ROE adjusted	7.9	6.4	5.8	6.3	6.9
ROIC adjusted	4.9	4.8	4.5	4.5	4.7
Net debt to equity	48.8	50.8	46.0	48.1	48.6
Total debt to capital	39.2	40.0	38.2	38.9	39.0

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Earnings outlook & momentum

What happened to earnings in the last 2 years and why?

Figure 1. GDFSuez – 18-24 months earnings changes

		2012	2013	2014
Pro Forma estimates (Citi + consensus) in 2010	EBITDA	19,752	20,739	22,563
	EPS	2.38	2.54	3.02
Now	EBITDA	17,879	19,360	22,147
	EPS	1.81	2.02	2.65

Source: Citi Investment Research and Analysis, Bloomberg. Note EPS is adjusted for non-recurring items.

As Figure 1 shows, since early 2010, EBITDA for GDFSuez has been downgraded by ~9% for 2012, ~7% for 2013 and ~2% for 2014. For our starting point we used pro forma earnings estimates for the combination of GDFSuez and International Power, a merger that was announced in August 2010 and completed in early 2011.

Figure 2. Reasons for EBITDA downgrade (in % terms of delta in EBITDA)

	2012	2013	2014
Belgian nuclear tax	-13.0%	-16.8%	-72.3%
French gas supply	-12.3%	0.0%	0.0%
International Power	-19.5%	-24.0%	-0.7%
Extra disposals	-20.5%	-52.7%	-227.2%
Oil-to-gas spread	-12.5%	-21.1%	0.0%
Suez Environnement	9.8%	15.3%	79.4%
Global Economy / LNG	-43.0%	-43.5%	-102.3%
extra capex contribution	10.9%	42.6%	223.0%
total	-100.0%	-100.0%	-100.0%

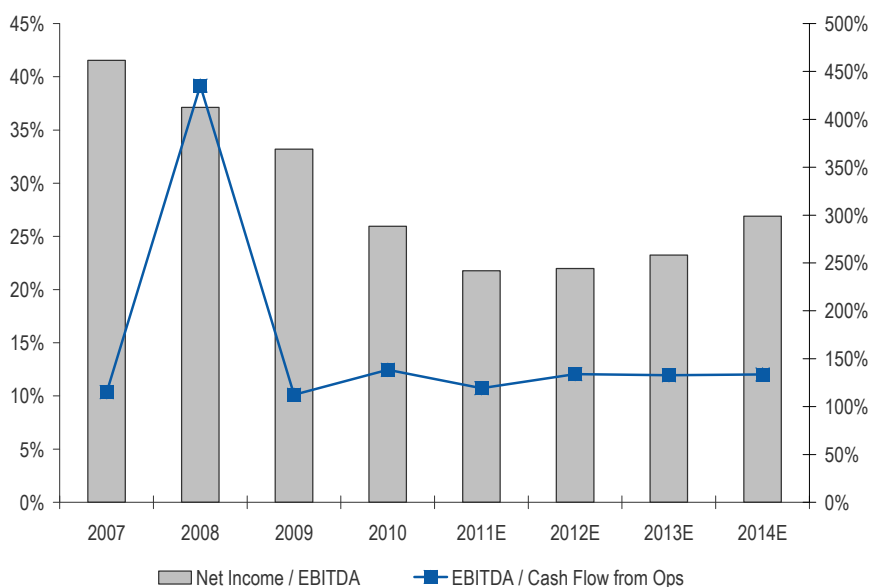
Source: Citi Investment Research and Analysis

Figure 2 shows the drivers for these earnings downgrades. Political intervention (Belgian nuclear tax increase and French gas tariff freeze) are big contributors as was the larger (€10b) disposal program. Downgrades on International Power estimates were also a contributor, particularly in 2013. Organically for GDFSuez's operations the single biggest negative driver has been the reduction in estimates for the group's Global Gas & LNG business as a result of reduced LNG activity and lower European prices. Suez Environnement and new projects / tuck-in M&A have moderated some of the effects.

It is all about EBITDA conversion ratios

More important to GDFSuez's earnings story, however, has not been the decline in EBITDA forecasts, which has been modest in relation to other utilities and largely related to exogenous factors, but the conversion of EBITDA into earnings.

Figure 3. Stable cash conversion but net income decline as % of EBITDA



Source: Company Reports and CIRA Estimates

Figure 3 shows that GDFSuez's cash conversion (EBITDA conversion into cash flow from operations after tax, interest and WC) has been pretty consistent – with the exception of 2008 which saw an exceptional working capital outflow – and this should stay so at ~120%. i.e. every €1 of EBITDA converts to €0.75 of cash. However, the net income conversion (EBITDA conversion into recurring net income) has been declining rapidly from >40% in 2007 to 26% in 2010. On our estimates this will deteriorate further this year to 22% and will not start recovering until 2014 (back to 2010 levels). This is due to an 80% increase in D&A, 165% increase in net financial expenses, 50% increase in effective tax rate and a ~40% decline in equity income. Although the market often likes to discuss the rising minorities line in GDFSuez's income statement, as a portion of the group's EBIT this has remained roughly flat through 2007-11 and therefore has not contributed to the deterioration of the net income conversion ratio.

Looking at these issues, we believe that the contribution of rising tax rate and falling equity income should have now plateaued, as the P&L taxes are now closely aligned with corporate tax rates and the group's disposal program has been largely completed (or at least factored in).

The increase in depreciation and financial expenses has been a direct result of the group's growing capex. The €11b p.a. investment level though now seems the ceiling – both logistically and in terms of balance sheet headroom – and therefore we wouldn't expect a further hike once it is completed in 2013.

For these reasons we are confident that net income conversion rates should trough in 2011-13 at our forecast levels.

The drawback on this situation is that GDFSuez's EPS going forward will be much more sensitive to operational changes due to the higher capital intensity (higher depreciation) and higher financial gearing (higher financial expenses). So in the past a 10% rise in EBITDA due to e.g. better pricing would yield a ~15% increase in EPS, whereas going forward it will yield a ~30% increase in EPS and vice-versa.

Lower starting base, but still attractive growth profile

Our new earnings estimates call for 8.1% EBITDA CAGR 2011-13 (9.5% 2011-15) and 12% adj. EPS CAGR 2011-13 from €1.65 this year to €2.02 in 2013. This is far superior than the mid-single digit EPS growth the sector offers. Our core set of assumptions for our 2012-13 forecasts are:

- 1) \$85-100/bbl Brent oil price.
- 2) €5-6/MWh negative oil-to-gas spread, with no new gas contract renegotiations.
- 3) No French gas tariff increase in 2012. We remind that there is a freeze in place until the July 2012 tariff adjustment.
- 4) Return to normal weather conditions (temperature, hydro) in 2012.
- 5) Belgian regulation as per latest government announcements (€550m industry nuclear tax, no nuclear life extensions).
- 6) Eurozone recession in 2012 priced in our Suez Environnement estimates.

Significant portion of 2012-14 earnings already locked in

We estimate that GDFSuez has already locked c.€14b p.a. on average EBITDA, i.e. 65-80% of our 2012-14 FY group EBITDA forecasts.

Figure 4. GDFSuez – locked in profitability (€ million)

	2012	2013	2014
Energy France	736	776	828
Supply	59	62	65
Generation	677	714	763
Energy Europe & International	6,199	6,029	6,097
BeNeDeLux	1,792	1,434	910
Rest of Europe	846	607	613
IPR	3,561	3,989	4,575
Global Gas & LNG	1,703	808	836
E&P	1,752	1,053	1,081
LNG	455	455	455
Midstream	(504)	(700)	(700)
Infrastructures	3,233	3,270	3,363
Energy Services	904	904	904
Environnement	2,260	2,260	2,260
total locked-in EBITDA	14,735	13,797	14,188
<i>as % of Citi(e) for the year</i>	<i>81.4%</i>	<i>70.9%</i>	<i>63.7%</i>

Source: Citi Investment Research and Analysis

Our estimates of what is locked in (Figure 4) are based on the following assumptions:

- 1) PPA / forward contracted volumes @ disclosed / historically estimated prices.
- 2) Merchant generation volumes that are not contracted at the 2008/09 trough power prices (low €40s/MWh).

- 3) Supply @ zero unless margins locked in.
- 4) LNG @ only the volume/prices already locked in under long-term contracts.
- 5) E&P @ 2008/09 trough oil price of \$45/bbl unless already locked in.
- 6) T&D @ current regulation assuming no volume growth.
- 7) Suez Environnement and Energy Services @ 2008/09 trough profitability adjusted for scope changes.

These estimates do not include:

- 1) Synergies / cost-cutting delivered post the end of 2011.
- 2) Upstream gas contract renegotiations.
- 3) Contribution from projects that are not already under construction.

Looking then at the group's capex program we estimate that ~€11b is already committed for 2012, ~€10b for 2013 and just under €8b for 2014. Taking into consideration depreciation on that committed capex, the debt progression and current yield curves, we estimate that GDFSuez has already locked ~€2b p.a. of net income and on average €1.3b of annual FCF before dividends.

Figure 5. GDFSuez – locked in earnings and cash flow

	2012	2013	2014
Locked-in FCF	304	622	2,985
Locked-in net income	2,395	1,689	1,857
Locked-in EPS	1.07	0.76	0.83

Source: Citi Investment Research and Analysis

Valuation

Share price decline much more severe than cash flow effects

As we've shown in Figure 3, GDFSuez's cash conversion ratio has remained quite stable if not improved and at the same time the EBITDA forecasts have only modestly been downgraded. Hence the group's Enterprise Value over the past 18-24 months should be largely unchanged to 5% lower. The economic net debt has increased by about 10%. Therefore, in terms of cash equity value, GDFSuez today should be worth ~15% less than 18-24 months ago.

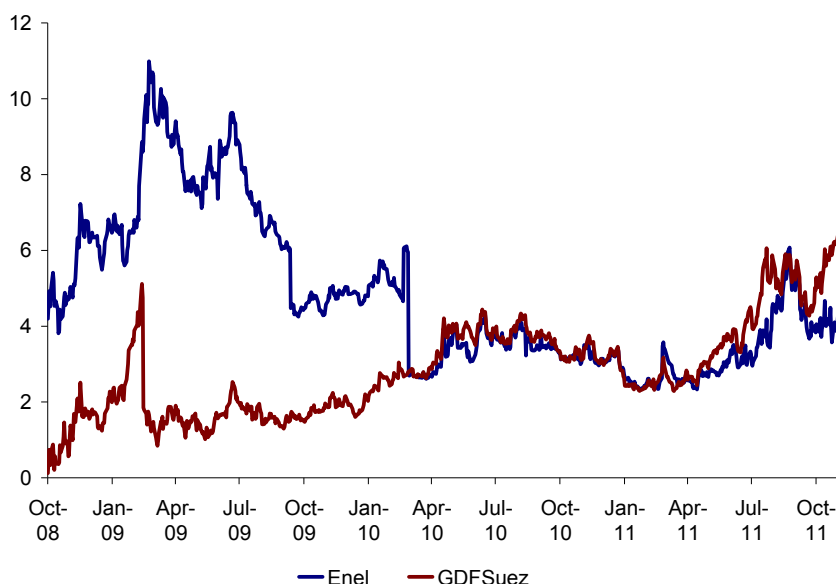
However, the average GDFSuez share price in 2010 was €27 and today it stands at €18, i.e. the stock market has priced in more than double the actual value destruction. While we think this is largely justified by the market's increased focus on medium-term earnings over long-term cash flow generation but even then the share price decline is bigger than the 20% EPS cut on benchmark 2013 forecasts.

Political and Sovereign Risks overstated in the stock vs. peers

Uncertainty over the political and financial outlook of two of GDFSuez's core markets – France and Belgium – could be cited as a reason for this aggressive derating but in our opinion this fails to take into account GDFSuez's strong balance sheet and geographic diversification.

This mismatch is particularly evident in the group's dividend yield, which at 8.4% ranks near the top of the European Utilities sector and the broader European market, despite the fact it is one of the most defensive and protected dividend streams.

Figure 6. Yield spread (Dividend yield less bond yield) for Enel and GDFSuez in %



Source: Bloomberg and Citi Estimates

We demonstrate in Figure 6 that GDFSuez's dividend yield premium over its own 2015 bonds is now higher than Enel's dividend yield premium over its equivalent bonds. This is despite:

- 1) Enel's dividend being unsustainable (Citi estimates an 11% cut in 2012 and then another 8% cut in 2013 for Enel against GDFSuez's commitment to maintain DPS at least flat through 2013).
- 2) The Italian and Spanish economies are in worse shape than either France or Belgium (Citi economists estimate a 2.6% cumulative real GDP growth for Belgium 2012-13 and 1.4% growth for France vs. a 1% real GDP decline for Italy and 0.8% decline for Spain), and
- 3) GDFSuez earns a smaller portion of its income in France / Belgium vs. Enel does in Italy / Spain.

We therefore argue that GDFSuez's cash flow generation characteristics are underappreciated and overshadowed by medium-term earnings pressure due to the group's large investment program, whereas the earnings contribution of that investment program is ignored. At the same time, we think the sovereign / political risks are overpriced in GDFSuez's stock vs. its peers.

Everything that's not hedged, is for free

GDFSuez's traded Enterprise Value stands at €100b at today's share price. As we show in Figure 4, GDFSuez has already locked in €14b of EBITDA of 2013-14. So the stock is trading at 7x locked-in EV/EBITDA. The Pan European Utilities sector is also trading at 7x expected 2013 EV/EBITDA. That means that at the current GDFSuez share price, investors get for free all the non-regulated, non-PPA, non-contracted assets which account for about 25% of GDFSuez's operating profit.

Reiterate Buy rating, new price target €26 per share

Figure 7. GDFSuez SOP

Division	Enterprise Value	Method	2012 EV/EBITDA
Energy France	3,642	DCF	3.2
New International Power	36,325	At CITI price target	7.7
Europe generation	20,512	DCF @ 7.0% WACC	7.8
Global Gas & LNG	13,443		5.6
E&P	6,429	On \$6/bbl 2015 reserves	
Supply	1,447	6x normalised EV/EBIT	
LNG	5,567	5x 2012 EV/EBIT	
Infrastructures	25,983		7.3
Transmission	7,066	10% premium to 2011-end RAB	
Distribution	15,363	10% premium to 2011-end RAB	
Storage	2,200	€200/cm 2011-end	
LNG terminals	1,354	7x 2011 EV/EBITDA	
Energy Services	6,895	at 6.5x 2012 EV/EBITDA	6.5
Environnement	20,483	At CITI price target	7.6
Core Enterprise Value	126,168		7.2
Financial assets / Equity Assets	10,247	Book value & market value estimates	
Group Enterprise Value	137,528		7.7
Net debt	36,949	2011 year-end	
Provisions	15,916	2011 year-end	
Minorities	26,680	at fair value	
Total EV adjustments	79,544		
GDFSuez target equity value	57,984		
per share	26.0		

Source: Citi Investment Research and Analysis

To reflect our latest earnings and cash flow estimates we update our price target for GDFSuez to €26 per share (previously €29), the reduction relating partly to the removal of Belgian nuclear life extensions from our model. Our price target offers >40% total return vs. current levels.

On our estimates the stock is trading on <9x 2013 PE and 8.8% 2013 yield, multiples that are in-line to a discount to its peers, when in our opinion the stock deserves a premium due to its better growth outlook, more defensive characteristics and strong balance sheet.

GDF Suez

Company description

GDF Suez is a utility with global presence in: electricity generation and supply, gas supply, oil and gas E&P, LNG, transmission and distribution, energy services and environment. It was created in July 2008 from the merger of Suez and GDF.

Investment strategy

We rate GDF Suez Buy as we find the balanced mix of defensiveness and growth attractive. We estimate that it is trading in line with its peers, whereas we believe its strong balance sheet offers options that deserve a premium. Strong focus on shareholder returns shown by the high sustainable dividend yield is an added positive that should provide support.

Valuation

We value GDF Suez at €26 per share using estimates at the bottom end of company guidance. We use a combination of DCF and multiples (premium to RAB, ROCE-WACC, EV/EBITDA, capacity) for our SOP.

Risks

We identify these risks to our thesis and achievement of our target price: 1) government intervention - the French government owns a 35% stake in the company and has influence over key regulatory decisions, most notably the gas supply tariffs, 2) balance sheet utilisation - although the company has a visible project pipeline, its strong balance sheet, relative to its peers, might tempt management to larger scale transactions, 3) commodities - although the company guidance is based on low commodity assumptions, if the oil and electricity prices carry on declining, we could see further derating of utilities like GDF Suez, 4) Integration - the integration of the portfolio of assets and managements of the two companies will be a lengthy process and given the scale, could be faced with delays or higher implementation costs.

ENEL SpA

(ENEI.MI; €2.85; 3)

Valuation

In our sum-of-the-parts calculation, we value ENEL at €26.2bn or €2.8 per share using an average WACC of 7.9% that reflects the higher-than-sector average cost of debt. In Generation, we use a WACC of 8% and assume long-term growth of 2%, in line with inflation. Our long-term commodity price scenario assumes Italian electricity prices reach €66/MWh in 2013, oil prices remain in the region of US\$100/bbl and Italian spark spreads reach €8/MWh. Our valuation of the regulated assets (electricity distribution network) is based on a DCF, in which we use a WACC of 6.7% up to 2020 and RAB as a terminal value. To value the group's other international assets, we use current share prices for Endesa, Enel Green Power and OGK-5.

Risks

Following risk factors may prevent the share from achieving our target price. On top of the commodity risk for an electricity generator, we would highlight substantial tariff risk in Spain given the persistent tariff deficit. In our model, we assume the group's tariff deficit is securitised completely in the next three years. The tariff deficit may also trigger further reform in Spain, which could curb integrated utility profitability (i.e. a hydro or nuclear tax). Italian distribution regulatory review also poses some uncertainties over the group's EBITDA outlook. We also see some project feasibility risk: we assume ENEL will build an additional 3.5GW of renewable capacity over five years (2011-15) and develop a nuclear power station in Slovakia by 2015. We also assume that Endesa will develop 2GW of capacity in Latin America. These projects carry some execution risk. Last but not least, ENEL's solid financial structure and strong cash flow generation might support acquisitions. If the impact on the company from any of these factors proves to be less/more negative than we anticipate, the stock could materially outperform/underperform our target price.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

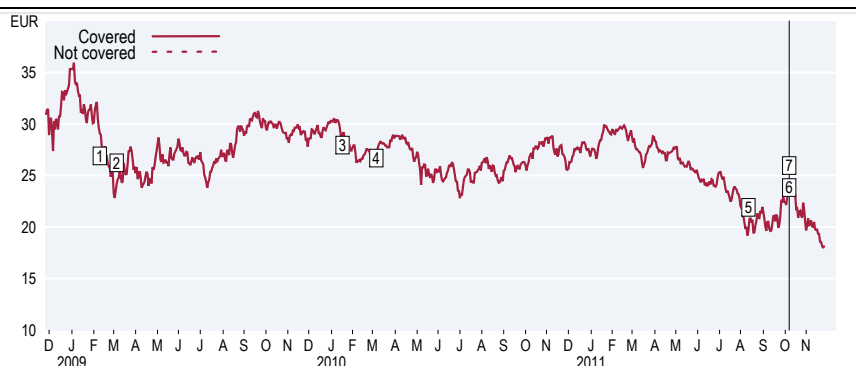
IMPORTANT DISCLOSURES

GDF Suez (GSZ.PA)

Ratings and Target Price History

Fundamental Research

Analyst: Sofia Savvantidou



	Date	Rating	Target Price	Closing Price
1	10-Feb-09	1M	*40.00	29.08
2	5-Mar-09	1M	*38.00	24.20
3	18-Jan-10	1M	*37.00	28.98

	Date	Rating	Target Price	Closing Price
4	5-Mar-10	1M	*33.00	27.34
5	11-Aug-11	1M	*29.00	19.63
6	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
7	7-Oct-11	*1	29.00	23.81

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

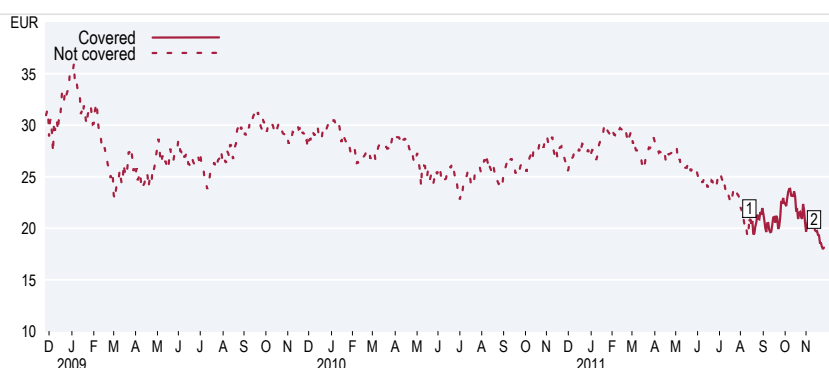
GDF Suez (GSZ.PA)

Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Sofia Savvantidou



	Date	Rating	Target Price	Closing Price
1	12-Aug-11	*ADD MP	-	20.76

* Indicates change

	Date	Rating	Target Price	Closing Price
2	11-Nov-11	*REM MP	-	20.50

Rating/target price changes above reflect Eastern Standard Time

ENEL SpA (ENEL.MI)

Ratings and Target Price History

Fundamental Research

Analyst: Antonella Bianchessi

Covered since June 6 2011



	Date	Rating	Target Price	Closing Price
1	23-Feb-09	*1H	*4.41	3.81
2	5-Aug-09	*1M	*4.30	3.80
3	6-Nov-09	*2M	4.30	4.10
4	11-May-10	*2H	*4.20	3.80

* Indicates change

	Date	Rating	Target Price	Closing Price
5	6-Jun-11	*2M	*4.50	4.62
6	4-Aug-11	2M	*3.90	3.73
7	31-Aug-11	2M	*3.50	3.40
8	7-Oct-11	Stock rating system changed		

	Date	Rating	Target Price	Closing Price
9	7-Oct-11	*2	3.50	3.51
10	20-Oct-11	*3	*2.80	3.39

Rating/target price changes above reflect Eastern Standard Time

ENEL SpA (ENEL.MI)

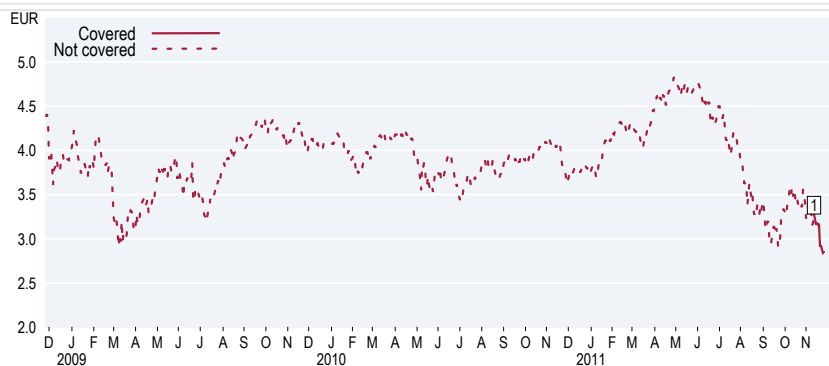
Ratings and Target Price History

Best Ideas Research

Relative Call (3 Month)

Analyst: Antonella Bianchessi

Covered since June 6 2011



	Date	Rating	Target Price	Closing Price
1	11-Nov-11	*ADD LP	-	3.28

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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