ArborGen Holdings

H120 commentary

Positive actions sustaining EBIT progress

Basic materials

ArborGen is set to deliver good year-on-year progress in FY20 despite constrained availability of advanced seedlings due to prior year weather effects. Net opex increases cause us to trim our current year earnings expectation. However, the addition of nursery capacity suggests that management remains confident in improving medium-term seedling volume and mix in the US to drive group profitability forward.

Year end	Revenue (US$m)	EBITDA** (US$m)	PBT* (US$m)	EPS* (c)	P/E (x)	EV/EBITDA** (x)
03/19	49.1	4.6	4.7	1.1	11.1	14.5
03/20e	58.2	7.7	7.1	1.5	7.8	11.0
03/21e	64.4	10.1	9.5	1.9	6.2	8.2
03/22e	71.7	12.5	12.2	2.4	4.8	6.3

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles and exceptional items. No tax charge is anticipated in our estimates. **US GAAP.

Good H1 progress, small FY20e EPS reduction

ArborGen's non-US markets contributed to a 46% group revenue increase with gross profit up almost 90% and a reduced group EBITDA loss in H120 trading. Preparations for the key US selling season in H2 appear to be progressing normally albeit with restricted mass controlled pollination (MCP)/advanced seedling availability after storm damage to a seed orchard in FY19. Small net increases in opex items cause us to reduce our FY20 PBT estimate by 8.5% (down 3.5% at the EPS level), with minor net adjustments in the following two years.

Investing in growth platform

Having added nursery capacity in the last couple of years (two in the US, one in Brazil taking the total group seedling capability to c 400m pa) and latterly acquiring the US head office premises, the company is clearly investing in the business for growth. We acknowledge the drag from prior year weather events on estimates but expected progress is significant nonetheless with the real value of advanced seedling development still to come. This underpins confidence in the company's future prospects we believe. Investors may need to see greater evidence of the associated mix/pricing/margin financial benefits coming through, but the company's strategy and positioning is clear.

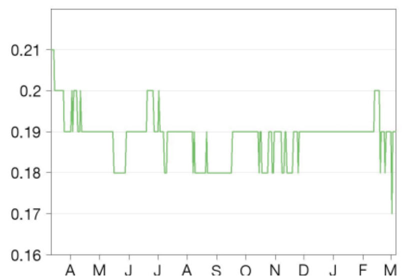
Valuation: Low multiples, significant discounts

ArborGen's share price sits towards the lower end of its NZ$0.18–0.22 trading range of the last 12 months and has effectively yet to regain any ground lost since pre-hurricane levels in mid-2018. The company's P/E multiples are in declining single digits over our estimate period and the EV/EBITDA (US GAAP) reduces from 11.0x this year to 6.3x by FY22 based on our model. We note that the share price remains at a significant discount to the H120 NAV (NZ$0.45) and our core gross equity DCF valuation (NZ$0.72), which is little changed from our last note.

9 March 2020

Price	**NZ$0.19**
Market cap	**NZ$95m**
	US$0.62 NZ$
Net debt (US$m) at 30 September 2019	31.6
Shares in issue	499.9m
Free float	53%
Code	ARB
Primary exchange	NZX
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(2.6)	(2.6)	(11.9)
Rel (local)	(1.0)	(3.7)	(24.9)
52-week high/low	NZ$0.21	NZ$0.17	

Business description

ArborGen is an NZX-listed investment company and is the world's largest integrated developer, commercial manufacturer and supplier of advanced forestry seedlings with operations in the US, Brazil and Australasia.

Next events

FY19 results	March 2020

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Edison profile page

ArborGen Holdings is a research client of Edison Investment Research Limited

H120 results overview

The company changed its name to ArborGen (from Rubicon) at the end of September 2019. H120 results showed good revenue progress and narrower US EBITDA losses in ArborGen's seasonally quieter US and group first half trading period. Management expects to deliver record revenues in FY20 despite prior year hurricane damage and US GAAP EBITDA (pre central costs) up 20% y-o-y. We have lowered our current-year PBT expectations – dampened at the EPS level by a tax credit – with minor net changes to headline estimates thereafter. The company's established business development strategy of increasing the volume and proportion of advance seedling sales is very much intact.

Exhibit 1: ArborGen interim results

Year end 31 March (US$m)	H119	H219	FY19	H120
Group revenue	**9.7**	**39.4**	**49.1**	**14.2**
Gross profit - reported*	1.6	15.5	17.1	3.0
Group EBITDA – US GAAP	**(5.0)**	**9.6**	**4.6**	**(4.0)**
R&D – capitalised	2.3	2.4	4.7	1.9
IFRS 16 adjustments	N/A	N/A	N/A	0.5
Other	(0.3)	0.0	(0.3)	0.0
Change in fair value of biological assets**	6.7	(5.9)	0.8	6.5
Group EBITDA – NZ IFRS	**3.7**	**6.1**	**9.8**	**4.9**
Depreciation*	(1.0)	(1.9)	(2.9)	(1.0)
Depreciation IFRS 16				(0.4)
Group operating profit* **	**2.7**	**4.2**	**6.9**	**3.5**
EBITDA margin % – US GAAP	*(51.5%)*	*24.5%*	*9.5%*	*(28.2%)*
EBITDA margin % – NZ IFRS	*38.1%*	*15.6%*	*20.0%*	*34.5%*

Source: ArborGen, Edison Investment Research. Note: *Some depreciation relating to seedling production assets is included in cost of sales so reported gross profit is not directly comparable to the two EBITDA lines below. **Change in the fair value of biological assets – in H1 this represents the increase in the fair value of ArborGen's seedling stock as it grows less estimated costs to sell under IAS 41 – Agriculture; advanced recognition of expected future profit is offset against actual realised profit in H2. ***Edison operating profit adds back amortisation of acquired intangible assets.

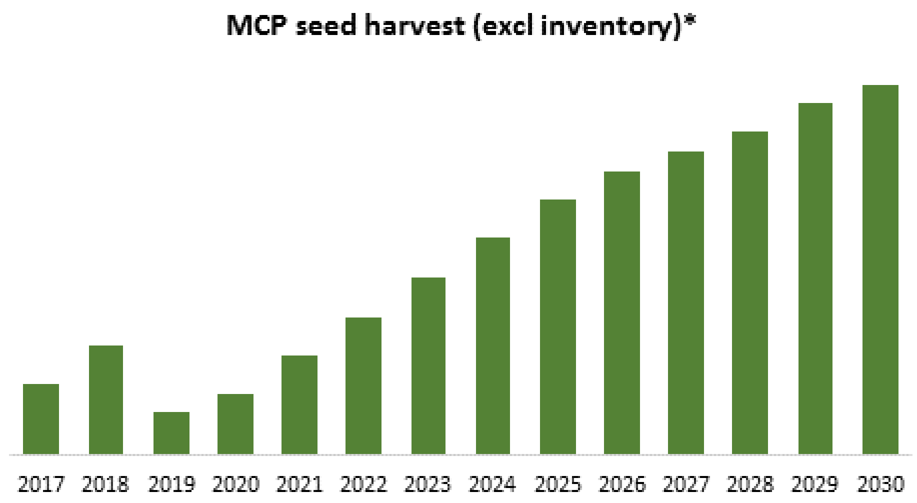
US: Being positioned for growth

While the US is ArborGen's largest sales territory, its seedling uplift and forestry customer planting season is very heavily skewed to second half trading (October to March). Consequently, the contribution to first half revenues is minimal, though of course local opex (including head office, lease and sales and marketing costs) continues to be incurred. Hence, a US GAAP group EBITDA loss in H1 is the normal trading pattern and the year-on-year reduction seen here in H120 primarily reflects increased revenue and profit contributions from ArborGen's other trading regions we believe (see later).

During the course of H1, in addition to regular seed orchard and nursery activities, ArborGen will also have continued the development and integration of two nurseries brought into the portfolio in the previous financial year.[1] Most obviously, with an annual cycle complete, the company's own developed seed can be used for new seedling growth for the coming selling season. With this c 45m initial incremental seedling capacity expected to rise to 60m over time as the Taylor nursery is developed, this suggests a level of confidence in the future prospects of the group in this region. The most obvious representation of this comes from the company's own projections of its expected supply/availability of its more advance MCP seedlings, as shown in Exhibit 2.

1 Taylor nursery, SC (April 2018, 10-year lease), Triple T nursery, TX (November, five-year initial lease term); this takes US operations to six seed orchards and eight seedling nurseries in total (the other six being owned) and current seedling capacity of c 400m per annum.

Exhibit 2: MCP supply availability



Source: ArborGen Holdings. Note: *Years are the year of seed harvest.

While the scale is not shown above, management has stated that it expects MCP seed supply (ie the following year's seedlings) to 'more than treble from 90m in 2018 to c 300m by 2025' as relatively new seed orchards mature and become more productive. Further growth in production is expected beyond 2025 also. The significance of this is that mass controlled pollination (MCP) seedling sales value is typically more than double the highest genetics open pollination (OP) equivalent and therefore a potentially significant driver of revenue growth and profitability.

In the near term, the dip in MCP production (in 2019, with a partial recovery in 2020) is understood to be largely a coastal region effect following hurricane-related disruption to the Bellamy, FL, seed orchard operation in mid-FY19. Naturally, this reduced seed production profile feeds into lower seedling sales in the following year (ie affecting FY20 and FY21). Other MCP seed orchard capacity exists in other states, which is able to serve local market requirements. Given the skew to US sales, the FY20 mix effects will become more apparent in H2; we expect that ArborGen will be able to sustain overall MCP levels seen in the prior year ie approaching 90m seedlings. Bearing this in mind, the company commented at the interim stage: 'orders are at record levels this year, and we are already sold out in many product categories. Subject to the normal weather caveats, we expect to report record total seedling volumes and revenue for the current fiscal year.'

We interpret this as growth being generated by higher volumes of OP seedling sales. For the record, we have assumed that seedling volumes are in the order of 310m in FY20, of which c 29% are MCP (versus 280m and 32%, respectively, in the prior year). This infers some modest dilution in average selling price in the short term. The strategy of converting OP customers to MCP over time and at the same time increasing overall sales volume is very much intact. Overall levels of demand appear to be healthy currently and delivering record revenues (we believe FY18's US$46m to be the previous peak) would be testament to this.

Other notable actions seen in H120 include:

- **US head office, Ridgeville, SC** (also comprising scientific laboratories, manufacturing, greenhouse and other growing facilities on a 13.5 acre site). This property, leased by ArborGen since 2012, was acquired for US$14.4m in August 2019 funded 80:20 by an existing primary lender and subordinated related party debt; the annual cost of servicing this incremental funding (4.22% average interest rate) is around half of the US$1.4m existing lease cost. Moreover, part of the site is sub-let, further improving cash flow and c US$6m of lease guarantees have been extinguished.

- **Exceptional costs**. ArborGen Inc recognised US$2.8m costs of an exceptional nature in H120. The majority of this related to rectifying weather-related damage in the prior year (including a US$1.6m abnormal seed cost provision and US$1.0m for customer seedling inventory replacement), with the remainder being the final ArborGen retention plan expense.

Australasia: Busy in New Zealand

Australasia was the dominant group revenue generator in H1 reflecting the annual selling bias and seedling planting cycle of the region. Acknowledging this, the H120 results announcement noted that, 'with the current year results for Australasia largely in hand, we are focusing on the production and sale of our next year's crop.' No further financial information was given.

The NZ Crown Forestry's One Billion Trees (OBT) Programme[2] was announced in November 2018; through grant funding and project partnerships the objective is for non-commercial forestry landowners to plant up to 40% of this quantity of tree seedlings in aggregate over the 10-year period to 2028. (The other volume is consistent with and to come from normal commercial forestry activities.) The initiative began operation in early 2019; the latest data (to end June) indicated that directly funded tree plantings had accounted for just over 15% of the total arising from approvals up to that point. Acknowledging that both approvals and seedling nursery owners require a ramp-up period, ArborGen Australasia – as an operator of seven NZ nurseries (four in the North Island, three in the South Island) – will be benefiting from these increased activity levels. Consequently, annualised revenues have risen as a result of this programme. That said, we understand that the funding mechanism is in the process of changing and the impacts of this, if any, remain to be seen. In addition to seedling sales, ArborGen continues to develop its high-value horticultural services (such as quarantine and tissue culture development) in NZ, with species currently including blueberries, hops, apples, strawberries and raspberries.

In more recent news, the coronavirus emanating from China is having some impact currently on NZ logging and shipment rates. The rate at which economic activity in China returns to more normal levels after taking an extended New Year break into account is indeterminate at this stage. However, given timber rotation periods, we feel that this is unlikely to have a material impact on nursery and planting activity in the near term. In Australia, nursery capacity expanded in 2019, with plans to extend this further in 2020 supported by favourable market conditions and demand projections.

Brazil: Market development continues

This market typically has a more even planting and selling season with a potentially significant addressable segment of independent forestry owners. ArborGen's commercial seedling activities are founded upon exclusive licensing and development of the eucalyptus clones of International Paper (since 2013) and more latterly Gerdau (from November 2018) as well as some of its self-cultivated pine varietals (from 2014). The trees of both species are harvested for use in the pulp/paper and packaging industries, with eucalyptus also grown to produce charcoal feedstock used in steel production, while solid pine wood is typically used as a building material also.

This region generates revenues with an annualised run rate of c US$8m pa but is still considered to be very much in a developmental phase for ArborGen, approaching break even this year. In Brazil, ArborGen is largely reliant on contract nursery providers[3] for growing its eucalyptus varieties and pine seedlings. In November 2019 it entered a five-year arrangement to lease and operate a

[2] www.beehive.govt.nz/release/one-billion-trees-fund-offers-new-opportunities

[3] ArborGen has arrangements with around 17 nurseries; its eucalyptus seedlings are grown mainly in south-eastern states (Mato Groso do Sul, Minas Gerais and São Paulo) and its pine seedlings come chiefly from two of the southern states (Santa Catarina and Paraná).

nursery at Inimutaba (c 175km north of Belo Horizonte, the state capital of Minas Gerais). This adds c 15m eucalyptus seedling capacity, compared to FY19 sales of c 40m (around 80% of the company's total seedling sales in Brazil in that year). As in other regions, this now allows ArborGen to have greater control with an integrated supply chain process from genetic development to seedling delivery. The benefits of this arrangement should start to become more apparent in the next financial year, subject of course to increasing penetration of the independent forestry sector. The OECD predicts an improving GDP outlook (with real growth approaching 2% in each of the next two years, from below 1% in 2019) with monetary policy and below target inflation supporting investment and consumption in the country.

Seasonality contributes to underlying increase in H1 net debt

At the end of September, ArborGen's net debt position stood at US$31.6m while IFRS 16 leases on the balance sheet were US$5.6m. The purchase of the previously leased ArborGen Inc US headquarters property towards the end of H1 moved it from a 'right of use' to an owned asset at the end of the period and was a material line item in the H120 cash flow statement.

ArborGen's financial year is heavily skewed towards its second half driven by the selling season in the US, its largest market. This is reflected at the gross profit and US EBITDA levels but smoothed by changes in the fair value of biological assets[4] (ie H1 credit, H2 reverse/offset) at the reported NZ EBIT level. Excluding this non-cash EBIT benefit, ArborGen saw a **US$2.4m operating cash outflow** in H1, similar to but slightly less than that seen in H119. The main ongoing components of this were:

- a core EBITDA loss of US$1.6m (excluding R&D costs, treated as capex); and
- a working capital inflow of US$2.4m.

Hence, the overall net outflow was chiefly attributable to non-recurring items including c US$2.6m arising from storm damage remedial costs (including additional seed cultivation and customer compensation payments) and c US$1m deferred retention payments from FY19 exceptionals.

Net **bank interest costs of US$1.1m** were similar to H119 and, as then, no cash tax payment was required. ArborGen capitalises R&D, categorised as intangible capex spend in our model, amounting to US$1.9m in H120. Lastly, the aforementioned US property purchase represented a US$14.4m cash outlay and a further c US$1m in total was spent on other normal capital items, making **total capex of US$17.3m** for the period.

After the above items, in the first six months of the year **free cash outflow was c US$21m**. Excluding the one-off US property purchase the 'underlying' movement was c US$7m. This was effectively derived from the seasonal US GAAP EBITDA loss and exceptional P&L cash items (with positive working capital offsetting cash interest and capex).

IFRS 16: Noting that this accounting standard was adopted for the first time in reporting the H120 results, for the record the cash flow impact is relatively minor and largely presentational. Ongoing IFRS 16 lease costs are now split between right of use asset depreciation (although we understand that ArborGen previously treated its US head office lease costs this way, prior to acquisition) and associated interest costs. Capital repayments are now recorded under the financing section and amounted to US$0.6m in H1. Hence, in actual cash terms, IFRS 16 lease outflows – including US$0.1m interest - totalled US$0.7m in the period.

Cash flow outlook: Our revised earnings estimates (see below) feed into a small expected reduction in net debt by the end of FY20 to c US$28m. An H2 increase in revenue and profitability is the normal seasonal pattern, along with an uplift in debtors ahead of collection early in the next

[4] US$6.5m in H120 similar to last year's US$6.7m. We assume this reverses in H220, effectively factoring in the sale of all seedlings concerned.

financial year. However, we have also assumed that there is an abnormal working capital build in H2 to reflect a recovery in seed inventory as orchard output rises after damage incurred in the prior year. For the same reason, we currently incorporate inventory investment in the following two years, which has the impact of constraining net cash inflows to c US$2m in FY21 and then c US$4m in FY22 with a rising profit profile. We model end FY22 net bank debt to be c US$22m and on this basis, we expect pre IFRS 16 net debt:EBITDA to decline to 1.2x by the end of FY22, from 2.3x in FY20.

ArborGen has long-term US dollar borrowing facilities in place:

- **US$10.5m promissory note** (Agsouth Farm Credit: 4.95% coupon, 2036 maturity) secured on certain US properties.
- **US$11.5m mortgage** (Synovus Financial Corp: 3.52% fixed borrowing cost via term swap, 2026 expiry) secured on the US headquarters land and buildings.
- **US$2.88m ArborGen Inc notes** (related parties: 7% coupon, subordinated to all bank debt, August 2022 maturity).
- **US$17m revolving letter of credit** facility (Synovus: Libor +2.75%, subject to a minimum 4.75%, 31/08/21 expiry) secured on other US assets than those above, largely drawn at the end of H120.

Among other things, the third-party facilities above have net worth covenants (variously US$27m and US$24m) and US$2m of the US$7.4m cash on hand at the end of September is restricted and on deposit with Synovus. ArborGen NZ also has a NZ$2m credit facility subject to annual renewal.

Similar market conditions likely, net reduction to FY20 estimate

Normal US seasonal activity levels, absent further material weather events, supplemented by additional nursery facilities (both annualised effects and operational improvements) are expected to be seen in H2. Elsewhere, an improving Brazilian GDP growth outlook feeding into its primary steel and pulp and paper industries should continue to support progress there, while experiences from the initial phase of the NZ OBT planting programme will inform how it progresses during 2020 and beyond.

Our group revenue projections remain the same though there are a number of moving parts further down the P&L behind some relatively small value movements in our headline profit projections (being larger in percentage change terms in the current year, immaterial thereafter). The key elements of this are as follows:

- On an **underlying** basis (ie excluding the US property purchase and IFRS16 changes below) we have put through **PBT reductions** of c US$1.1m in FY20 (marginally less in each of the following two years) comprising:
  - Higher central/corporate costs and SG&A than assumed previously of c US$0.7m in FY20 (around half of this in next two years) and a minor underlying depreciation uplift
  - Underlying increase in interest costs US$0.2m in FY20 (and around US$0.5 pa in next two years)

(Note that lower R&D costs are a benefit to our US GAAP EBITDA estimates but have no impact on reported PBT as they are capitalised.) In addition to the above, our previously published estimates now also include adjustments for:

- **The US property purchase** which took place at the end of August; cash outflow occurred in H120 (see above) but there was little P&L impact in the period. The company expects the transaction (ie own lease costs saved plus sub-lease income gained less new borrowing costs) to benefit PBT by c US$1m in a full year.

- **Adoption of IFRS 16 leases** (which now discloses right of use asset depreciation as an operating cost, boosting NZ IFRS EBITDA) moves an associated US$0.3m imputed finance charge out from operating costs to net interest, modestly improving the operating margin but the overall effect washes out at the PBT level.

The overall changes to our estimates are summarised in Exhibit 3. The main impact is seen in the current year and chiefly reflects the underlying central/SG&A changes referred to above, while the EPS movement is slightly dampened by the tax credit seen in H1. Beyond the current year, the net adjustments to the headline reported PBT and EPS lines are not material.

Exhibit 3: Rubicon estimate revisions

	EPS FD norm (c)			PBT norm (US$m)			EBITDA* (US$m)		
	Old	New	% chg.	Old	New	% chg.	Old	New	% chg.
FY20e	1.6	1.5	-3.5%	7.7	7.1	-8.5%	7.7	7.7	---
FY21e	1.9	1.9	-1.3%	9.6	9.5	-1.1%	9.5	10.1	+5.8%
FY22e	2.4	2.4	0.4%	12.1	12.2	+0.7%	11.9	12.5	+5.4%

Source: Edison Investment Research. Note: *US GAAP basis.

Further out, the seed orchard recovery profile outlined by the company should drive increased advanced seed and seedling availability and sales volumes. We will publish FY23 estimates for the first time following the publication of FY20 results.

In valuation terms the above adjustments have little impact on the operating cash flows of the business and, hence, our previously outlined DCF approach has not changed materially.

Exhibit 4: Financial summary

	US$m	2017R	2018	2019	2020e	2021e	2022e
Year end March (from 2018 onwards)		15m to Sep	6m to March		IFRS 16	IFRS 16	IFRS 16
PROFIT & LOSS							
Revenue		6	35.4	49.1	58.2	64.4	71.7
Cost of Sales		(4)	(19.4)	(30.3)	(36.2)	(40.1)	(44.5)
Gross Profit		2	16.0	18.8	22.0	24.3	27.2
EBITDA - US GAAP		(6)	6.0	4.6	7.7	10.1	12.5
EBITDA - NZ IFRS		(1)	6.2	9.8	12.2	14.8	17.3
Operating Profit (before GW and except.)		(2)	5.0	6.9	9.2	11.8	14.3
Intangible Amortisation - acquired		(1)	(2.6)	(5.8)	(5.8)	(5.8)	(5.8)
Exceptionals		0	(1.4)	(3.6)	(2.8)	0.0	0.0
Associate		3	0	0	0	0	0
Operating Profit		0	1.0	(2.5)	0.6	6.0	8.5
Net Interest		(2)	(1.4)	(2.2)	(2.2)	(2.3)	(2.2)
Profit Before Tax (norm)		(1)	3.6	4.7	7.1	9.5	12.2
Profit Before Tax (statutory)		(2)	(0.4)	(4.7)	(1.5)	3.7	6.4
Tax		0	2.6	0.5	0.4	0.0	0.0
Minorities		0	0	0	(0)	0	0
Discontinued		(4)	0	(0.1)	0.0	0.0	0.0
Profit After Tax (norm)		(1)	6	5.2	7.5	9.5	12.2
Profit After Tax (statutory)		(6)	2	(4.2)	(1.1)	3.7	6.4
Average Number of Shares Outstanding (m)		425.0	487.9	496.9	499.3	499.9	499.9
EPS - normalised (US c)		(0.2)	1.3	1.1	1.5	1.9	2.4
EPS - statutory (US c)		(1.4)	0.5	(0.8)	(0.2)	0.7	1.3
Dividend per share (US c)		0.0	0.0	0.0	0.0	0.0	0.0
Gross Margin (%)		33.3	45.2	38.4	37.8	37.8	37.9
EBITDA Margin (%)		-16.7	17.5	20.0	21.0	23.0	24.2
Operating Margin (before GW and except.) (%)		-33.3	14.1	14.1	15.9	18.3	20.0
BALANCE SHEET							
Fixed Assets		187	156.0	152.3	154.2	150.0	145.9
Intangible Assets		125	106.7	105.6	104.0	102.6	101.3
Tangible Assets		62	43.3	42.7	48.2	45.4	42.6
Investments		0	6.0	4.0	2.0	2.0	2.0
Current Assets		81	57.8	41.7	49.1	54.6	61.0
Stocks		41	24.8	29.4	33.2	37.7	42.9
Debtors		9	10.0	9.1	10.5	11.5	12.6
Cash		31	23.0	3.2	5.4	5.4	5.4
Current Liabilities		(57)	(36.2)	(15.8)	(27.6)	(26.3)	(23.3)
Creditors		(38)	(20.4)	(15.0)	(16.3)	(17.2)	(18.2)
Short term borrowings		(19)	(15.8)	(0.8)	(11.3)	(9.1)	(5.1)
Long Term Liabilities		(51)	(26.2)	(30.6)	(30.3)	(29.2)	(28.1)
Long term borrowings		(45)	(22.8)	(16.5)	(23.9)	(23.9)	(23.9)
Other long term liabilities		(6)	(3.4)	(14.1)	(6.4)	(5.3)	(4.2)
Net Assets		160	151.4	147.6	145.4	149.1	155.5
CASH FLOW							
Operating Cash Flow		(3)	3.5	4.1	6.1	10.9	12.8
Net Interest		(4)	(1.4)	(2.1)	(2.2)	(2.3)	(2.2)
Tax		0	0	0	0	0	0
Capex		(5)	(3.0)	(6.6)	(20.4)	(5.4)	(5.5)
Acquisitions/disposals		66	0.9	(7.6)	0	0	0
Financing		12	0	0	0	0	0
Dividends		0	0	0	0	0	0
Net Cash Flow		66	0	(12.2)	(16.4)	3.3	5.1
Opening net debt/(cash)		65	33.0	9.6	9.8	27.8	25.6
HP finance leases initiated		0	0	0	(1.1)	(1.1)	(1.1)
Other		(34)	23.4	0	(0.4)	0	0
Closing net debt/(cash)		33	9.6	21.8	27.8	25.6	21.6
IFRS 16 leases					5.0	3.9	2.8

Source: ArborGen, Edison Investment Research. Note: 2017R was restated to show discontinued operations separately. Significant other items in 2017R and 2018 cash flow relate to M&A activity associated with the disposed Tenon operations. **FY20 opening net debt has been restated to exclude IFRS 16 leases (which are now shown at projected year ends); the group's purchase of its US head office property in August 2019 moved this from a leased asset to an owned one.

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