

# ENFORCED REFORM AND PAYOUT POLICY in EMERGING MARKETS

YoungKyung KO <sup>1,\*</sup>

<sup>1</sup>Center for Research and Consultancy, UNITAR International University, Malaysia

\*Corresponding author, Youngkyung.ko@unitar.my

## ABSTRACT

This study examines how the governance reform measures influence on corporate payout policy. The previous research shows that most of Korean firms controlled by family were less likely to pay cash dividends while the controlling shareholders tended to extract private benefits. From 1998, Korean government introduced restructuring and reform policy following IMF's conditionality in order to improve corporate governance. Regardless of performance, firms must meet criteria. The result shows that firms increase size of both payouts continuously while they increase the ratios of cash dividends to earnings and repurchase to earnings immediately after the corporate governance reform driven by the government is enforced. This implies enforced reform measure make temporary influence on corporate payout rather than corporate governance quality. In addition, whether firms pay cash dividends or repurchase shares depends on the ownership structure. Firms with higher foreign ownership and controlling shareholders' ownership increase dividends and firms with less control rights spend more on share repurchase. The firms with less volatility of profits, large size, lower debt ratios, more cash flows, and higher capital expenditures are more likely to increase ratios of payouts after controlling growth opportunity, stock options and other events.

**Keywords:** corporate governance, payout policy, controlling shareholder, ownership structure, cash dividends, share repurchase.

## INTRODUCTION

Asian countries experienced the financial crisis in 1997, which made impact on political, social areas as well as economic. There are many reasons to have brought the crisis such as high debt ratio, overinvestment and lower level of transparency. In Asia, many large corporations have been controlled by families. Family control with weak governance mechanism is more likely to make decision of excessive diversification and lack appropriate level of monitoring business behaviors.

After financial crisis, governments in many countries adopted corporate reform policy in order to improve governance system. However, reform driven by a government is not always led to successful results (Krugman, Wurgler, 2000; Himmelberg, 2002; Price, Roman, and Rountree, 2011).

South Korea is said to have overcome the economic crisis in the late 1990's and enhanced the competitiveness in 2000's. It is the most prominent sample among the countries which had been suffered from the financial turmoil. Korean economy is mainly dominated by Chaebol, which is owned and controlled by a family (Lee, 2000). Though adoption of various reform policies, Chaebol's influence has been increasing.<sup>1</sup>

In this study, I introduce Korean government's reform policy adopted since the economic crisis in 1997. This reform policy focused on corporate governance to protect minority shareholders and prohibit controlling shareholders' expropriation from other shareholders' wealth.

The remainder of the paper is organized as follows: Section 2 reviews the corporate governance reform policy. Section 3 explains ownership structure of Korean firms and governance issues related to family control and Section 4 presents hypothesis. Section 5 describes our data and sample. Section 6 present the main empirical findings. Section 6 provides a brief conclusion.

## CORPORATE GOVERNANCE REFORM POLICY

The Korean government needed the rescue loans to bail out the economy from IMF in 1997. IMF suggested the conditionality of structural reform, which included industry restructuring, corporate governance measures, and reducing regulation on foreign investors. This conditionality should be implemented for the urgent financial support. IMF demanded budgetary austerities and high levels of interest rates, and reduction of current account deficit. IMF also demanded financial and industrial restructuring, and elimination of unfairness in business and trade.

In addition, the Chaebol, a key economic player in Korea, was required to be reformed. Finally, the Korean government declared corporate governance reform and five restructuring principles in Feb, 1998: (a) business consolidation into core competence areas rather than diversifying (b) capital structure improvement with lowering debt to equity ratio (c) elimination of cross-debt guarantee (d) enhancement of management accountability and transparency (e) strengthening controlling shareholders' and top managers' legal responsibility.

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<sup>1</sup> Samsung Group alone accounts for roughly 20% of South Korea's GDP in 2014.

<http://www.theglobeandmail.com/report-on-business/international-business/asian-pacific-business/south-koreas-chaebol-problem/article24116084/>

To implement these principles, accounting rules were modified and the minimum ownership required to exercise anti-director rights and monitor management was lowered. At least one outside director was mandated for all listed companies. The government opened corporate control market allowing hostile takeovers and mitigating the rule for acquirers. Furthermore, the limit of foreign ownership was deleted in 1998 and foreign investors might enter the M&A market.

In August 1998, the government announced additional rules on Chaebols. There three rules are (a) reduction of indirect cross ownership (2) prevention of anti-competitive intragroup transactions and unlawful insider trading (3) prevention of the evasion of inheritance and gifts taxes. So-called "five plus three rules" were established for Chaebol reform and restructuring. Furthermore, the government prohibited debt payment guarantee between firms in unrelated industries in Dec 1998 and then all debt-payment guarantees in Mar 2000.

Specifically, in cross investment, the government had regulated this investment in affiliated firms in 2001, however the restriction was eased in Jan 2002 because large firms resisted. As the corporate control market was open, Korean firms was more likely to be exposed to M&A threat by foreigner. They needed tool to protect their control.

Publicly listed Korean firms were required to appoint at least one or more outside directors based on firm size, almost all firms have barely complied only to meet the minimum quota (Regulation of Security listing).

## CHAEBOLS IN KOREAN ECONOMY

Big firms in Korea played the role of engine for fast economic growth in 1970's and 1980's. They grew up to be Chaebols under exclusive government support and protection (Lee, 2000). Chaebol refers big business group composed of firms controlled by a family. It is characterized diversification, political relations, cross shareholdings among affiliated firms, and pyramidal structure of ownership. During export driven industrialization, chaebols expanded business lines and dominated Korean economy. Table 1 shows the influence of Chaebols on Korean economy.

Table 1. Chaebol Influence in Korean Economy

	Total	Top 5 Groups (%)	Top 30 Groups (%)
<b>Asset (Bil. KRW)</b>	910,044	29.22	46.25
<b>Liability</b>	736,584	29.79	47.94
<b>Revenue</b>	875,156	32.29	45.94
<b>Employees</b>	21,048	2.70	45.86

Source: Korea Center for Free Enterprise- An Affiliate of Federation of Korean Industries, 1998. (Lee, 2000)

A majority of Korean companies including chaebols' affiliated firms are family –controlled. Founding family members used to be the largest individual shareholders and succeed their control right within family. Family firms show highly concentrated ownership of controlling families through direct family ownership and complicated interlocking ownership among affiliated firms.

Pyramidal structure enable family with small cash flow right to control all firms within the business group (La Porta, Lopez-de-Silanes, and Shleifer, 1999). In contrast, stand-alone firms' shareholders have much less control rights because of small interlocking ownership (Joh and Ko, 2009).

Why families try to hold and maintain their control over the business group is related with the level of private benefits which they may extract. Nenova(2003) and Dyck and Zengales(2004) show that Korean firms traditionally have some of the highest private control benefits in their cross country analyses. As Korean government substantially prohibited M&As before the crisis incumbent controlling families were protected from corporate control takeover threat (Joh, 2004). Consequently, many firms including large business groups could avoid competition for corporate control, which led to engage self-dealing activities.

When a chaebol-affiliated firm makes an acquisition, its stock price on average falls while the controlling shareholder of that firm on average benefits. The acquisitions within a business group lowered corporate performance both before (Bae, Kang, and Kim, 2002; Joh, 2003) and during (Baek, Kang, and Park, 2004) the 1997 Asian economic crisis.

The Korea Fair Trade Commission (KFTC) declares largest business groups including all chaebols and large corporations every year. They are prohibited to engage cross investment among affiliated firms. The KFTC is monitoring these firms in order to prohibit excessive market dominance, illegal cross debt guarantee, and unfair transaction within as well as outside business group.

## **HYPOTHESIS**

Considering Chaebol's excessive influence on Korean economy, the governance reform focused on large corporations and these reform measures are associated with corporate payout policy. Before financial crisis in 1997, most of Korean firms controlled by family were less likely to pay cash dividends while the controlling shareholders tended to extract private benefits (Faccio, Lang, 2001). After crisis, Korean government adopted various reform measures to improve governance, which make influence on corporate policy but do not necessarily result in improvement in corporate governance quality.

The first hypothesis is that firm will be more likely to pay cash dividends and buyback shares in open market when a firm should adopt enhanced corporate governance guideline to protect minority shareholders' wealth and prohibit controlling shareholders' expropriation.

The future growth opportunity, stock options and events such as M&A affect corporate payout (Fenn and Liang, 2001; Weisbenner, 2000; Miller et al.; 1961). Furthermore, whether firms pay cash dividends or repurchase shares depends on the ownership structure (Joh and Ko, 2009). In conjecture, Firms with higher foreign ownership and controlling shareholders' ownership will increase dividends ratio and firms with less control rights spend more on share repurchase controlling investment opportunity, stock options and M&A.

## **DATA AND METHODOLOGY**

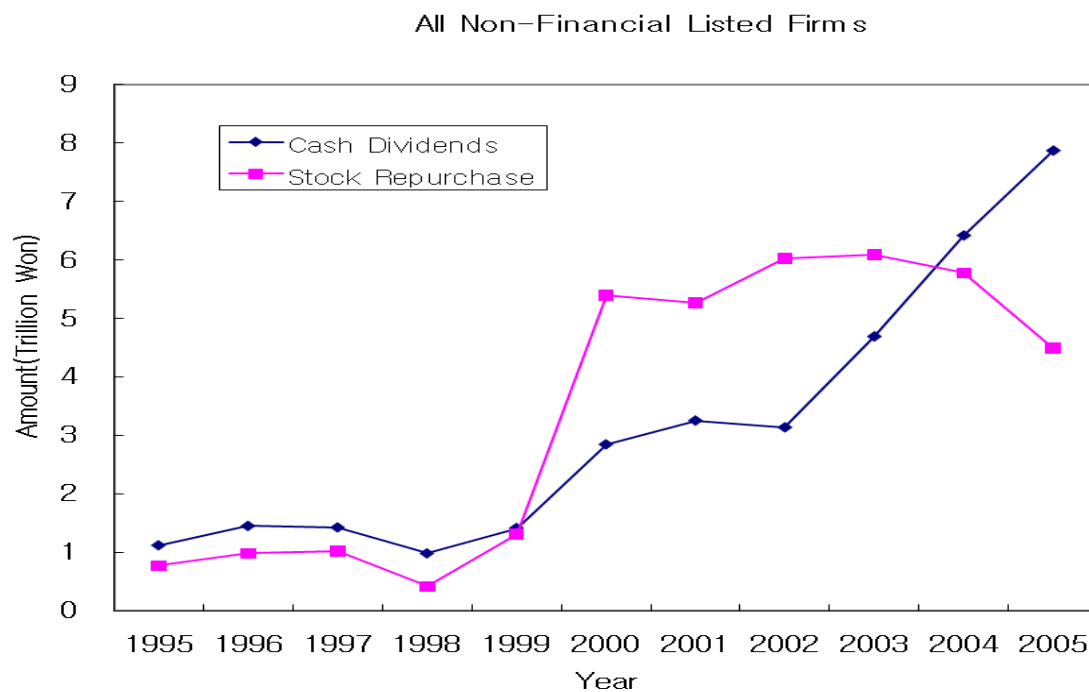
### DATA

I collect cash dividends and ownership information for all non-financial, publicly traded firms in the Korean Stock Exchange from January 1994 until December 2005. I use KIS-line data for financial information including cash dividends, TS-2000 data for controlling family ownership and interlocking ownership of affiliated firms, and FN-Guides for foreign ownership. For stock prices, I use data provided by the Korea Security Research Institute. We hand-collect information on share repurchases including announcement dates, amount of share repurchases, and number of shares to be repurchased from the Korea Investor's Network for Disclosure System (KINDS), operated by the Korea Stock Exchange. For large business groups, I use the classification by the Korea Fair Trade Commission (KFTC).

In the data, there were 1,237 public announcements of share repurchases, after excluding firms with missing information on ownership structure or accounting information. The data include common stock repurchases only and exclude preferred stock repurchases. Due to the low frequency and low volume of preferred stock repurchases, such exclusion does not seem to make a significant difference in our analyses. We also exclude share repurchases when a firm buys back its shares in the process of corporate restructuring (such as post-M&As and during split-offs).

Below Figure 1 shows total amounts of cash dividends distributed and total amounts of money spent on share repurchases without retirement by publicly traded firms excluding financial firms between 1995 and 2005. Both magnitudes of cash dividends and share repurchase increase dramatically after 1999. This supports the first hypothesis that firm will be more likely to pay cash dividends and buyback shares in open market as the government reform policy is adopted.

Figure 1. Time trend of cash dividends and stock repurchases (without retirement) between 1995 and 2005.



While the total amount of payout increase and maintain without large drop since 1998, the proportions of payout to earnings show different path. Table 2 present annual trend of payouts via cash dividends and share repurchase. Payout ratio are the highest in 1999 while dividend yield in 1997. Divides to market value may be overestimated because of market crash in late 1997. In additional, share repurchase to market value and to outstanding shares are higher in 1999 and 2000. During 1997 and 1998, the corporate reform policy was enforced by government and the cap on foreign ownership was raised up.

Table 2. Annual trend of cash dividends and share repurchase

Year	Number of listed, non-financial firms	Number of listed, non-financial firms with information	cash dividends to earnings		cash dividends to market value		share repurchase to earnings		share repurchase to market value	
			mean	std	mean	std	mean	std	mean	std
			(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
1995	590	489	34.87	50.46	21.62	88.77	0.57	1.48	1.16	1.11
1996	654	490	34.95	65.21	24.57	102.02	0.92	2.34	1.59	1.71
1997	669	491	23.32	66.40	29.85	147.72	1.12	3.73	0.89	1.30
1998	656	459	25.24	67.45	15.44	107.15	0.74	2.76	1.77	2.99
1999	637	434	43.24	135.86	15.26	95.91	0.93	3.21	2.78	3.60
2000	628	494	21.35	50.06	21.95	75.57	1.92	3.97	2.24	2.64
2001	624	471	24.36	94.43	8.73	29.81	1.37	4.65	3.07	3.72
2002	620	461	25.70	52.44	11.73	44.99	1.26	4.24	3.05	3.63
2003	623	508	23.48	59.19	10.97	44.92	1.34	3.99	3.74	9.95
2004	627	522	28.66	80.40	6.82	27.21	0.88	3.37	3.38	4.55
2005	649	507	24.52	42.12	4.46	25.59	0.54	2.75	3.28	3.55

Table 3 shows the summary statistics on financial and ownership information along with earnings distribution. On average, controlling shareholders (CS) family ownership is 19.4% and affiliated firms' interlocking ownership is 11.0% for all firms. About 19% of firms in our data are affiliated with large business groups, chaebol.

Table 3. Summary Statistics

OP\_STD is 5-year standard deviation of operating profit to net sales, Firm\_Size is log value of assets, and Debt\_Asset is debt over assets. MTB is market value over book value. CASH is cash and marketable securities over total assets minus cash and marketable securities. Cash flow is cash flow from operating activity, and CAPEX is the change in fixed assets scaled by total assets. Chaebol, M&A, and Stock Option are a dummy variable that takes 1 when a firm belongs to a large business group, it faces a takeover threat, or it adopts managerial stock option in a given year, respectively. CS\_own is ownership by controlling families, and AFF\_own is ownership by subsidiaries. CS\_control is the sum of CS\_own and AFF\_own. Foreign\_own is the sum of all foreign shareholders' ownership. \*, \*\*, \*\*\* represent a significance level at 10%, 5% and 1%, respectively.

Variables	All Firms			non-chaebol		chaebol		t-value
	Mean	Median	STD	Mean	STD	Mean	STD	
OP_STD	0.057	0.027	0.308	0.063	0.344	0.032	0.036	2.96 ***
Firm_Size	5.366	5.166	1.417	4.980	1.153	6.914	1.319	-47.51 ***
Debt_Asset	0.582	0.599	0.201	0.564	0.202	0.655	0.177	-13.46 ***
MTB	0.968	0.607	1.734	0.983	1.741	0.908	1.704	1.25
CASH	0.088	0.050	0.117	0.095	0.124	0.060	0.074	8.94 ***
Cash flow	0.040	0.043	0.110	0.037	0.115	0.052	0.089	-4.05 ***
CAPEX	0.026	0.020	0.170	0.021	0.166	0.045	0.187	-4.06 ***
Dividend to Earning	0.280	0.128	0.732	0.271	0.699	0.318	0.848	-1.91 *
repurchase to earnings	0.155	0.000	0.812	0.149	0.805	0.179	0.839	-1.08
Chaebol	0.200	0.000	0.400					
M&A	0.004	0.000	0.060	0.004	0.061	0.003	0.053	0.46
Stock-Option	0.112	0.000	0.316	0.088	0.284	0.210	0.407	-11.34 ***
CS_own	0.189	0.186	0.157	0.214	0.154	0.090	0.124	24.37 ***
AFF_own	0.095	0.000	0.153	0.069	0.132	0.199	0.184	-26.31 ***
CS_control	0.285	0.273	0.169	0.283	0.166	0.289	0.180	-0.91
Foreign_own	6.290	1.105	11.456	5.223	10.616	10.561	13.522	-13.84 ***
<b>N observation</b>	5326			4262		1024		

## METHODOLOGY

Our empirical analysis consists of two parts. One, I use Tobit models what factors affect magnitude of payout before and after the reform. For firms with corporate payout policy, we assign their actual payout ratio. However, when firms have negative net payout (i.e. firms engage in external financing) or no payout activity, we assign zero to these observations. Conventional least squares would not account for the qualitative difference in observations with a zero value and observations with a continuous non-zero positive value; it is therefore not appropriate to use OLS. For more discussion on Tobit analysis.<sup>2</sup> As many reform measures were introduced in the first half of 1998 and came in effects in late 1998 or in early 1999, we divided the panel data into two subgroups, in pre-reform period samples before the 1997 crisis (1994 and 1996) and post-reform period starting from 1999.

For an explanatory variable to measure incentive alignment of insiders with those of minority shareholders, we separately include four types of ownership and control rights information: CS' ownership rights (CS\_own), subsidiaries' interlocking ownership (Aff\_own), CS' control rights (CS\_control. CS\_control measured through the sum of CS\_own and Aff\_own represents total ownership controlled both directly and indirectly. In addition, the total ownership by foreign shareholders (Foreign\_own) is included as it can pose a threat to existing CS. With information on whether a firm faces an immediate outside takeover threat (M&A) or adopts a managerial stock option plan (Stock Option), the governance effects on payout decisions are examined.

Other explanatory variables include firm size, free cash flows, capital structure, market value to book value, financial volatility following the previous literature such as Dittmar (2000). A log value of total assets is a proxy for firm size (Firm\_size), and debt ratio over total assets for capital structure (Debt\_Asset). Cash flow is earnings before depreciation minus the interest expenses, the dividends, and income taxes, all scaled by total assets at t-1. Cash is cash holdings and securities divided by total assets at t-1. Market value to book value of equity (MTB) measures the value of future growth option. Capital expenditure (CAPEX) which is the change in fixed assets scaled by total assets also measures future growth opportunity. Financial volatility (OP\_STD) is measured through the standard deviation of operating profit to net sales in the previous 5 years with at least 3 years of observations. It represents corporate need for financial flexibility.

The magnitude of cash dividends is scaled by earnings (i.e. dividend payout ratio) and the magnitude of share repurchase is also divided by earnings rather than by market value in order to avoid excessive decrease of market value in 1997.

## RESULTS OF EMPIRICAL ANALYSES

Table 4 reports Tobit regression results of Tobit analysis on firms' cash dividend over earnings and share repurchase over earnings. The coefficients of CS\_own, and Aff\_own show a significant positive effect on cash-dividend payout ratio. Firm size and cash flow also affect firms' cash dividends positively and significantly. Chaebol-affiliation dummy, the adoption of managerial

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<sup>2</sup> see Greene (1993)



stock options, and experience of M&A do not show a significant coefficient. On the other hand, firms with high variance of earnings, high debt, and high market to book ratios have lower DIV/E. In short, firms with high ownership concentration or high control rights pay more cash dividends when other factors are controlled for.

The coefficients for Aff\_own and for CS\_control are significant and negative while the coefficient for CS\_own is not significant. In addition, firms with high foreign ownership show a negative effect on the magnitude. Chaebol-affiliation dummy does not lower the magnitude. However, the adoption of managerial stock options increases the magnitude. These results remain robust when controlling for other control variables. Firm size and capital expenditure affect firms' share purchase positively and significantly. On the other hand, firms with high variance of earnings, more free cash flow, and high debt have lower share repurchases. In short, in both measures for the magnitude of share repurchases, firms with lower control rights buy more shares, and spend more money on share repurchases. These results are consistent with our hypothesis that weak firms are likely to engage in share repurchases in order to secure the control.

In Panel A, model 3 and 4 presents that Reform\_dummy does not influence payout ratio significantly while Share repurchase over earnings are positively related to Reform\_dummy. This results imply that a firm prefer increase of share repurchase rather than payout ratio because a firm is expected to maintain dividends level once increase it. Overall Korean firms raise up payout amount but the effect on payout proportions to earnings is more outstanding immediately after the reform policy is imposed. This policy does not affect consistently on improvement of corporate governance quality.

Table 4. Tobit Regression on Cash dividends and Stock Repurchase

Variables are defined in <Table 3>. Reform\_dummy is one if year is 1999 or 2000, otherwise is zero. Year dummy and industry dummy are all included model (1) and (2). Numbers in parentheses are t-statistics and \*, \*\*, \*\*\* represent a significance level at 10%, 5% and 1%, respectively.

Panel A. Cash dividends to earnings

	(1)	(2)	(3)	(4)
Intercept	0.2290 *** (4.86)	0.2416 *** (5.18)	0.2665 *** (5.96)	0.2855 *** (6.47)
<b>OP_STD</b>	-1.5424 *** (-11.65)	-1.5617 *** (-11.83)	-1.8709 *** (-14.04)	-1.9033 *** (-14.34)
<b>Firm_Size</b>	0.0291 *** (4.88)	0.0289 *** (4.85)	0.0189 *** (3.15)	0.0185 *** (3.09)
<b>CASH</b>	-0.1095 ** (-2.03)	-0.1129 ** (-2.1)	0.0691 (1.31)	0.0664 (1.26)
<b>Cash flow</b>	0.6081 *** (8.09)	0.6083 *** (8.1)	0.5220 *** (6.93)	0.5215 *** (6.93)
<b>CAPEX</b>	0.0689 (1.51)	0.0702 (1.54)	0.1808 *** (3.95)	0.1843 *** (4.02)
<b>Debt_Asset</b>	-0.6546 *** (-15.71)	-0.6592 *** (-15.85)	-0.4768 *** (-12.7)	-0.4817 *** (-12.84)
<b>MTB</b>	-0.0297 *** (-3.9)	-0.0300 *** (-3.93)	-0.0081 (-1.53)	-0.0084 (-1.59)
<b>Chaebol</b>	0.0054 (0.29)	-0.0052 (-0.29)	0.0352 * (1.85)	0.0197 (1.09)

<b>M&amp;A</b>	0.0205 (0.21)		0.0142 (0.14)		-0.0002 (0)		-0.0083 (-0.08)
<b>Stock-Option</b>	-0.0012 (-0.06)		-0.0019 (-0.09)		-0.0672 (-3.26)	***	-0.0691 (-3.35)
<b>Foreign_own</b>	0.0022 (3.72)	***	0.0021 (3.55)	***	0.0023 (3.81)	***	0.0021 (3.56)
<b>CS_own</b>	0.2595 (5.55)	***			0.1900 (4.04)	***	
<b>AFF_own</b>	0.1663 (3.61)	***			0.0514 (1.12)		
<b>CS_control</b>			0.2116 (5.42)	***			0.1179 (3.04)
<b>Reform_dummy</b>					-0.0080 (-0.5)		-0.0088 (-0.56)
Industry Dummy	yes		yes				
Year Dummy	yes		yes				

## Panel B. Share Repurchase to Earnings

	(1)		(2)		(3)		(4)
Intercept	-1.5618 (-8.71)	***	-1.4753 (-8.36)	***	-1.1147 (-7)	***	-1.0169 (-6.51)
<b>OP_STD</b>	-1.2267 (-3.18)	***	-1.3255 (-3.43)	***	-1.8202 (-4.58)	***	-1.9519 (-4.91)
<b>Firm_Size</b>	0.1540 (7.23)	***	0.1511 (7.12)	***	0.1399 (6.57)	***	0.1360 (6.42)
<b>CASH</b>	0.3452 (1.86)	*	0.3164 (1.71)	*	0.5808 (3.25)	***	0.5597 (3.13)
<b>Cash flow</b>	0.6275 (2.4)	**	0.6410 (2.45)	**	0.4906 (1.89)	*	0.5031 (1.94)
<b>CAPEX</b>	0.4706 (2.58)	***	0.4855 (2.65)	***	0.8502 (4.63)	***	0.8802 (4.79)
<b>Debt_Asset</b>	-1.2813 (-8.49)	***	-1.3127 (-8.69)	***	-0.8827 (-6.65)	***	-0.9052 (-6.81)
<b>MTB</b>	-0.0039 (-0.2)		-0.0059 (-0.3)		0.0197 (1.26)		0.0182 (1.17)
<b>Chaebol</b>	-0.0690 (-1.05)		-0.1426 (-2.27)	**	-0.0265 (-0.4)		-0.1083 (-1.71)
<b>M&amp;A</b>	0.6608 (2.26)	**	0.6224 (2.14)	**	0.7117 (2.42)	*	0.6649 (2.27)
<b>Stock-Option</b>	0.2067 (2.93)	***	0.2042 (2.9)	***	0.0715 (1.05)		0.0639 (0.94)
<b>Foreign_own</b>	-0.0019 (-0.88)		-0.0025 (-1.17)		-0.0035 (-1.62)		-0.0041 (-1.93)
<b>CS_own</b>	-0.0022 (-0.01)				-0.2349 (-1.44)		
<b>AFF_own</b>	-0.6880 (-3.94)	***			-1.0114 (-5.79)	***	

<b>CS_control</b>		-0.3235 **		-0.6038 ***
		(-2.33)		(-4.38)
<b>Reform_dummy</b>			0.1599 ***	0.1568 ***
			(3.05)	(2.98)
Industry Dummy	yes	yes		
Year Dummy	yes	yes		

## CONCLUSION

Although the corporate governance reform driven by Korean government is not successful enough to improve values and satisfy all participants in the market, the reform measures affect the payout policy of listed companies, at least. Many firms in Korea have increased their cash dividends and buyback more shares after the reform was adopted. An alternative of payouts for shareholders depends on the ownership structure.

Our results imply that external governance reform and monitoring mechanisms does not necessarily lead to improvement in corporation's governance and value. KFTC is still struggling for monitoring unfair transaction, interlocking ownership and succession of control within Chaebols. However, this recent experience of government-initiated governance reform may provide lessons to other government to plan reform policy in emerging markets.

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