
THE ROLE OF PROFITABILITY IN MEDIATING THE EFFECT OF LEVERAGE ON COMPANY VALUE: EVIDENCE FROM INDONESIA'S BANKING INDUSTRY



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Abstract

This study seeks to analyze the correlation between leverage and company value with profitability serving as an intermediary mechanism in banking companies listed on the Indonesia Stock Exchange over the observation period of 2022–2024. This research employed a quantitative methodology, utilizing path analysis and mediation assessment using the Sobel test. The study sample included 26 conventional commercial banks selected based on specific criteria through purposive sampling. Empirical findings in this study indicate that company value is not directly influenced by leverage, while an increase in leverage is statistically proven to decrease a company's profitability. Furthermore, profitability levels were discovered to have a significant and beneficial relationship with company value, while also serving as an intermediary variable that facilitates the impact of leverage on company value. These results verify that the influence of leverage on company value is indirect, as it operates through profitability, which serves as a channeling mechanism in this relationship.

Keywords: Leverage, Profitability, Company Value, Banking

INTRODUCTION

The banking sector is a crucial indicator of a nation's economic vitality, performing strategic functions in channeling funds, raising financing, and maintaining economic stability (Dendawijaya, 2009). Therefore, the performance of the banking industry is often used as a key indicator in assessing the condition and resilience of the national economy (Kasmir, 2018). The performance and value of banking companies are key factors that attract the attention of investors, regulators, and other stakeholders in the Indonesian economy, as the banking sector plays an instrumental role in driving and supporting economic growth.

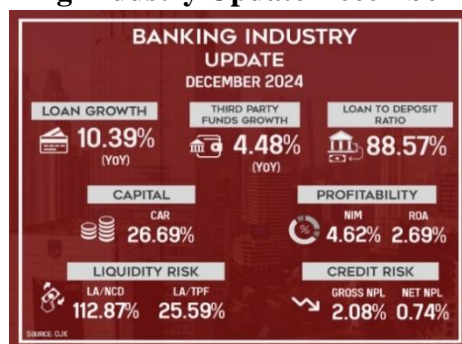
The period from 2021 to 2024 is crucial for the banking industry in Indonesia, as it reflects a transition from post-pandemic recovery to the normalization of economic activity, amid various economic challenges such as global uncertainty, commodity price volatility, and geopolitical dynamics that may disrupt sector stability. In addition, competition intensity is increasing, particularly with the development of digital banking, requiring banks to continuously innovate to maintain their competitiveness (Ubaidillah, 2025).

International Monetary Fund (2024) It has been confirmed that in 2024, global economic growth is expected to reach only around 3.1%, a figure below the average global growth rate in the decade before the pandemic, which was around 3.8%. This condition reflects a global economic slowdown triggered by monetary policy tightening in various countries and heightened geopolitical risks that are putting pressure on global economic activity. The slowdown has also affected the stability of domestic financial markets, including the banking sector, prompting investors to be more selective in evaluating the prospects and sustainability of companies.

This uncertainty underscores the importance of an in-depth analysis of profitability mechanisms to explain the relationship between leverage and company value. In addition to reflecting the financial health of banks, profitability also serves as a critical indicator for investors of a company's capabilities and the effectiveness of its capital structure management amid uncertain economic dynamics.

Macroeconomically, the performance of Indonesia's banking industry in 2024 showed relatively strong resilience, as reflected in credit growth, which remained steady at 10.39% (year-on-year) as of December 2024, despite liquidity pressures marked by an increase in the Loan-to-Deposit Ratio (LDR) to 88.57%. Nevertheless, the sector's Net Interest Margin (NIM) remained stable at 4.62%, indicating the ability of banks to optimize productive assets and maintain net interest income performance (OJK, 2025).

Figure 1.
Banking Industry Update December 2024



Source: OJK (2025)

Interestingly, this stable performance has not been fully reflected in the strengthening of the market value of banking companies. This condition is reflected in the dynamics of the Indonesian capital market, where pressure on bank stocks was also seen at the end of February 2025 when the JCI closed in the red zone by nearly 1.8%, with major banking stocks such as BBRI, BMRI, BRIS, and BBCA being the main contributors to the index's decline (Respati & Ika, 2025). These market conditions can be understood as a response or further reflection of banking performance in the previous period, including performance achievements up to December 2024.

The decline in market value occurred in the context of complex macroeconomic dynamics, such as inflationary pressures, the implementation of tight interest rate policies by Bank Indonesia, and increasing global uncertainty. These factors have impacted the narrowing of banking margins and further complicated the leverage structure. This indicates that market valuation is not solely based on profit performance, but also on the composition of funding, the level of leverage risk, and the prospects for long-term profitability.

This phenomenon indicates that the correlation between leverage, profitability, and the value of banking companies is not always linear. Under certain conditions, an increase in leverage aimed at driving expansion and profitability can actually be perceived by the market as an increase in risk, thereby the company's value is adversely affected. Conversely, high profitability does not necessarily result in an enhancement of a company's market value if investors believe that the profits were obtained through a less than optimal or risky funding structure. Thus, this dynamic reinforces the assumption that there is an indirect mechanism that explains how leverage affects company value through profitability.

The inconsistency of findings in previous studies further emphasizes the importance of this research. Firmansah & Sari (2024) conducted a research of four state-owned firms in the banking sub-sector from 2013 to 2022, revealing that an increase in the Debt to Equity Ratio (DER), indicative of capital structure, led to a substantial decline in Price to Book Value (PBV). These data substantiate the notion that an increase in leverage correlates with a decline in company value. Conversely, other studies examining firms within the food and beverage industry indicate that the level of leverage does not contribute significantly to determining company value (Novaliza & Nursiam, 2025). The variation in these research results reflects the complexity of the the link between capital structure and company value, which is likely to be influenced by specific company characteristics, differences in the observation period, and prevailing macroeconomic conditions.

On the other hand, profitability tends to show a higher level of consistency in influencing company value. A study by Suryana & Chrisnanti (2022) on industrial sector enterprises revealed that profitability significantly contributes to enhancing company value. These findings align with research conducted in the energy sector, demonstrating that profitability considerably enhances firm value (Alifian & Susilo, 2024). The consistent findings regarding the beneficial impact of profitability on company value corroborate signaling theory, which posits that a company's profit-generating capacity serves as a vital indicator for investors assessing management quality, financial stability, and growth potential.

A notable discovery that has not been extensively examined in prior research pertains to the function of profitability as a variable that mediates the impact of leverage on the valuation of financial institutions, especially in the post-pandemic era characterized by

volatile economic conditions. This is relevant to examine in the banking sector, given that banks' operational activities are highly dependent on debt-based funding structures, so that leverage management has the potential to affect profitability performance and company value. If leverage affects profitability, either positively or negatively, and profitability is demonstrated to impact company value, then profitability can be seen as a mechanism that indirectly bridges the relationship between leverage and company value. This study seeks to empirically examine the impact of leverage on company value, with profitability serving as a mediating variable, across banking firms listed on the Indonesia Stock Exchange.

This study aims to enhance the theoretical understanding of Signaling Theory by positioning profitability as a mediating factor that explains the impact of leverage policy on corporate value. The findings of this study are expected to assist bank management in formulating more effective capital structure policies to improve profitability, thereby signaling favorable performance to investors and enhancing firm value. Furthermore, these findings can also serve as a reference for investors and regulators in assessing the performance, risk level, and stability of banking companies in Indonesia.

REVIEW OF LITERATURE

Signaling Theory

The concept of signaling theory introduced by Spence (1973) emphasizes the strategic role of information conveyed by companies in influencing investment decisions by external parties. Through the conveyance of such information, companies seek to signal their condition and performance to external parties so that they can assess the company's condition and prospects (Panjaitan & Supriyati, 2023). In the context of capital markets, investors and analysts rely heavily on the quality of available information to make assessments and investment decisions. The clarity, consistency, and credibility of the information provided by companies will shape market perceptions of their performance, with strong and transparent signals tending to reflect better company performance (Nurjanah et al., 2025).

Leverage

Leverage is a financial ratio that indicates the extent of a company's reliance on debt financing as an alternative source of capital, aimed at augmenting its assets and enhancing profit income (Safitri et al., 2024). The findings of Rehan et al. (2023) findings lead to the conclusion that companies in various sectors tend to adjust their capital structure towards an optimal level of leverage. Firms with elevated leverage are viewed as having a heightened incentive to optimize their financial performance and exhibit managerial initiatives aimed at enhancing earnings or returns (Wijaya & Rahayu, 2025). Increased leverage employed by a corporation elevates business risk, which ultimately implies a weakening of the company's value (Widyantara et al., 2024).

Profitability

Profitability is a metric that signifies a company's ability to make profits from its operational activities (Melina & Endri, 2024). According to Indriaty et al. (2024) assert that a rise in a company's profitability indicates positive business prospects, which demonstrates the effectiveness of management in optimizing the utilization of company resources. An optimal level of profitability can enhance company value, reflecting its ability to generate wealth for investors (Yuliandri et al., 2025). Conversely, low profitability tends to imply a

decline in company value, signifying the company's inadequate ability to produce economic returns for capital stakeholders.

Company Value

The value of a company reflects investors' perceptions of its current achievements and performance quality, and its prospects for future growth. This value, typically correlated with stock price fluctuations, reflects the market's evaluation of the company's overall standing and future potential (Saputra et al., 2025). In the banking sector, company value has strategic significance because it reflects the level of investor confidence in financial resilience, management quality, and the bank's growth potential in the coming period. Thus, the value of a banking company can be understood as the market's evaluation of its performance and future potential, where a high value indicates operational efficiency, financial resilience, the capacity to generate sustainable profits, and the market's confidence in the of resource management and effective risk management by the leadership (Hidayati & Hwihanus, 2024).

The Effect of Leverage on Company Value

Leverage is seen as a measure of a company's capital structure that may affect market evaluations of the company's value (Aryadita et al., 2024). Optimal leverage conditions are generally perceived as a favorable signal, hence enhancing investor confidence and resulting in an increase in the company's value (Aushaf et al., 2025). Conversely, excessive leverage may be perceived as a negative indicator, which has the potential to reduce investor confidence (Dery Melson et al., 2025). Thus, leverage can be assumed to be a determinant of company value. This premise is substantiated by empirical evidence from Oktaviani et al. (2024), which proves that leverage significantly influences company value.

H₁: Leverage has a significant impact on company value.

The Effect of Leverage on Profitability

Leverage is associated with a company's profitability (Ilham et al., 2021). Sartono (2014) states that debt-based financing is employed to stimulate profit growth that surpasses the costs of assets and funding sources, including through tax savings. Financial leverage is applied with the aim of generating profits that exceed the costs of assets and funding sources used, thereby ultimately increasing the level of returns received by shareholders (Trisnayanti & Wiagustini, 2022). The findings of Ardhefani et al. (2021) substantiate the assertion that finance practices, as indicated by the Debt to Equity Ratio (DER), significantly influence a company's profit-generating capacity. The use of external funding sources is employed to improve operational performance and expand the scale of the business, which in turn drives increased profitability. The use of external funding sources is employed to improve operational performance and expand the scale of the business, which in turn drives increased profitability.

H₂: Leverage has a significant impact on profitability.

The Effect of Profitability on Company Value

Profitability refers to a company's capacity to make profits through sales, optimal asset utilization, efficient use of capital, and various other operational factors, including the number of employees and number of branch offices (Harahap, 2006) Profitability is also used as an indicator to assess overall managerial performance, evident in the profit level a company attains relative to its sales and investment activities (Hidayat & Khotimah, 2022). A favorable profitability level is viewed as a positive indicator by the market because it

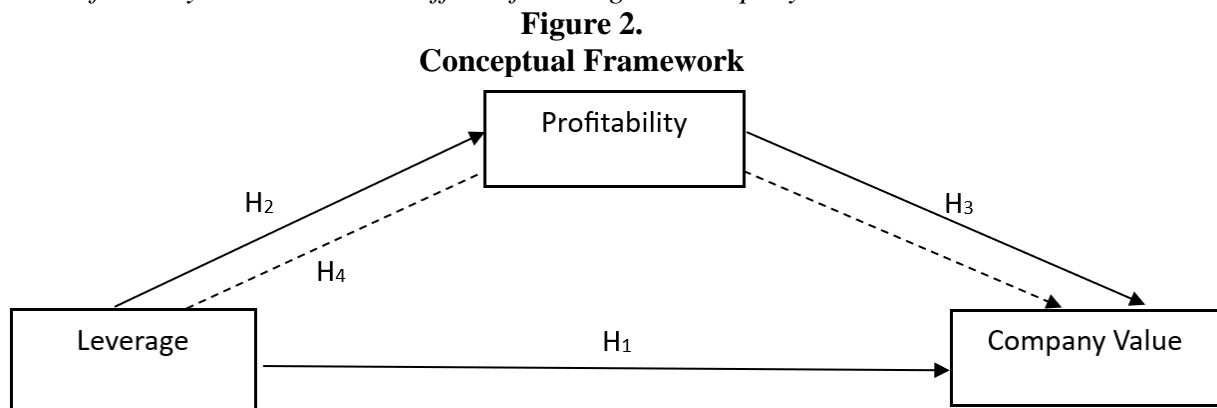
indicates management's ability to manage assets and cost structures efficiently, thereby enhancing expectations of cash flow and diminishing perceived risk, ultimately augmenting the company's value (Oktavia & Rimawan, 2025). This aligns with the conclusions of Shenurti et al. (2022), who concluded that an increase in earnings power reflects the efficient utilization of assets and the higher profit margin achievable by the company. This condition has implications for strengthening the company's value, which is reflected in an increase in stock returns in the following year.

H₃: Profitability has a significant impact on Company Value.

The Effect of Leverage on Company Value with Profitability as an Intervening Variable

Leverage influences profitability as the utilization of debt incurs fixed interest obligations, so if operating income cannot cover these costs, profitability will decline (Jenesia, 2022). Profitability affects company value through signaling mechanisms and investor return expectations. Increased profitability is generally followed by stock price appreciation and improved market valuation ratios, which ultimately elevate company value in accordance with a perceived reduction in risk and more appealing prospective returns (Jihadi et al., 2021). The intervening mechanism of profitability illustrates the causal path from leverage to profitability and then to company value. The decision to increase leverage will first affect the cost structure and financial risk, which in turn will affect net income and profitability ratios. Then, it is this established profitability that forms the basis of investor assessment in determining company value, so that the relationship between leverage and company value is mostly channeled through its role in influencing profitability. The findings are corroborated by Mubaraq et al. (2025) which concludes that a significant decrease in leverage has the potential to reduce companies' incentives to earn profits, which in turn can weaken the market's valuation of company value.

H₄: Profitability can mediate the effect of leverage on company value.



RESEARCH METHOD

This study employs a quantitative methodology, utilizing a causal-associative research design. According to Sugiyono (2023), quantitative research methods are grounded in the positivist paradigm and are utilized to investigate a particular population or sample through a data collection procedure employing research tools. The acquired data is further evaluated employing quantitative or statistical methods to evaluate the previously defined hypotheses. Furthermore, Sugiyono (2023) explains that causal associative research seeks to

find and analyze the cause and effect relationships among two or more variables. The metrics employed for each research variable are displayed in the subsequent table.

Table 1.
Variable Indicator

Variable	Indicator	Source
Leverage	$Debt\ to\ Equity\ Ratio\ (DER) = \frac{Total\ Debt}{Total\ Equity}$	(Herbowo et al., 2024)
Company Value	$Tobin's\ Q = \frac{(Market\ Value\ of\ Equity + Total\ Debt)}{Total\ Assets}$	(Suryana & Chrisnanti, 2022)
Profitability	$Return\ on\ Asset\ (ROA) = \frac{Net\ Profit}{Total\ Assets}$	(Siahaan & Alvia, 2024)

The research population comprises all conventional banking firms listed on the Indonesia Stock Exchange (IDX) from 2022 to 2024. The sample was selected using the purposive sampling method. The sample selection adhered to specified criteria outlined in the sample selection table, yielding companies that fulfilled the requirements.

Table 2.
Sample Selection

Selection Criteria	Total Companies
Banking companies listed on the Indonesia Stock Exchange during the research period that consistently publish annual financial reports and have complete data for measuring research variables	47
Not a sharia bank or digital bank	30
The company recorded a profit during the research period.	26
Sample Size (Total Companies x Year of Research)	78

Data analysis in this study was conducted using path analysis, given that the research model involved direct and indirect relationships between variables and involved one variable that functioned as a mediator. The path analysis method was utilized to quantify the extent of the direct impact of independent variables on dependent variables, while also assessing the indirect influence channeled through the mediating variable. Furthermore, the significance of the mediating role was tested using the Sobel test, which statistically determines whether the mediating variable effectively serves as an intermediary in transmitting the effect of the independent variable on the dependent variable.

Data processing and analysis were carried out using LISREL software to estimate the structural relationships among variables in the research model. Meanwhile, the Sobel test calculation with the help of quantpsy.org was performed using the path coefficient and standard error values obtained from the LISREL estimation results.

RESULTS AND DISCUSSION

Path Analysis

The research data was analyzed using LISREL software, with path analysis as the main method for examining the structural relationships between observable variables without involving latent constructs. The structural model was developed based on the conceptual framework and study hypotheses that had been formulated previously. Using LISREL, path coefficients representing the direct effects of variables were estimated. The significance of the correlations among variables was evaluated using the t-value, with a link being significant if the t-value exceeded 1.96 at a 5% significance threshold. Presented below is a path diagram illustrating the pertinent path coefficients and t-values.

Figure 3.
Path Coefficient

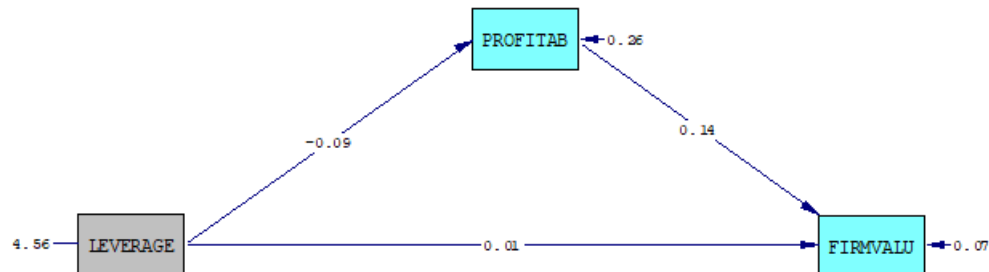
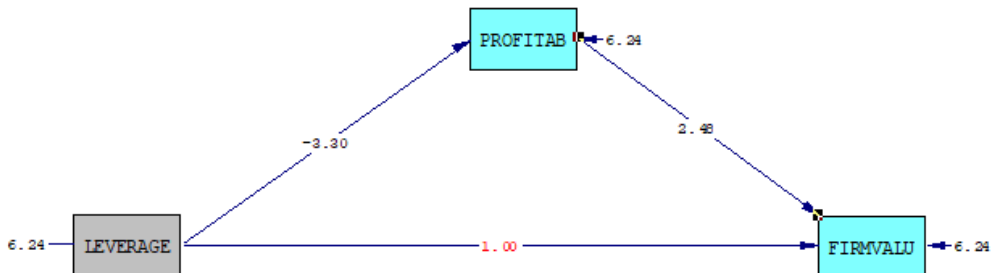


Figure 4.
T-Count



The path analysis results suggest that leverage has a considerable negative impact on profitability, evidenced by a route coefficient of -0.09 and a t-value of -3.30 . The t-value, which is above the critical limit of 1.96, confirms that an increase in leverage statistically reduces a company's profitability.

Furthermore, the estimation in the structural model confirms the positive and significant effect of profitability on company value, evidenced by path coefficient of 0.14 and a t-value of 2.48. The findings imply that better profit performance enhances the market appreciation of company value.

The direct impact of leverage on firm value lacks statistical significance, evidenced by a path coefficient of 0.01 and a t-value of 1.00. The analytical results demonstrate that the company's leverage level does not significantly affect its worth.

Based on the data processing output using LISREL, a structural equation consisting of two sub-structures was obtained. The path coefficient testing for each sub-structure is described as follows.

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PROFITAB = - 0.0889*LEVERAGE, Errorvar.= 0.257 , R2 = 0.123
Standerr      (0.0271)                (0.0415)
Z-values      -3.283                  6.205
P-values      0.001                    0.000
```

The coefficient of determination (R^2) value of 0.123 indicates that leverage accounts for 12.3% of the variability in profitability, whereas the remaining 87.7% is attributable to other factors not included in the research model.

The preliminary test findings indicate that leverage exerts a negative and statistically significant impact on profitability, evidenced by z value of -3.283 and p value of $0.001 (< 0.05)$. The data suggest that an increase in leverage is typically succeeded by a decrease in corporate profitability.

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FIRMVALU = 0.141*PROFITAB + 0.0145*LEVERAGE, Errorvar.= 0.0653 , R2 = 0.0733
Standerr  (0.0574)          (0.0146)                (0.0105)
Z-values  2.464              0.998                  6.205
P-values  0.014              0.318                  0.000
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The coefficient of determination (R^2) of 0.0733 signifies that profitability and leverage account for 7.33% of the variance in company value, with the remaining 92.67% attributed to external factors not included in the research model. The preliminary test findings reveal that profitability exerts a positive and significant influence on company value, evidenced by z value of 2.464 and p value of $0.014 (< 0.05)$. Simultaneously, leverage exhibits no substantial impact on company value, as indicated by z value of 0.998 and p value of $0.318 (> 0.05)$.

The study's findings indicate that leverage does not directly affect company value, but rather effects it indirectly via profitability. Consequently, profitability is demonstrated to function as a mediating variable in the correlation between leverage and company value.

Sobel Test

A mediation test was performed to assess the importance of indirect effects using the Sobel Test via Calculation for the Sobel Test on quantpsy.org. The outcomes of the mediation analysis utilising the Sobel Test method are delineated as follows.

Figure 5.
Sobel Test

Input:		Test statistic:	Std. Error:	p-value:
a	-0.09	Sobel test: -1.96582475	0.00640952	0.04931886
b	0.14	Aroian test: -1.91036981	0.00659558	0.05608562
s _a	0.0271	Goodman test: -2.02640745	0.0062179	0.04272305
s _b	0.0574	Reset all	Calculate	

The Sobel test calculation conducted by quantpsy.org yielded a Sobel statistic of -1.97 and p-value of 0.049 . P-value less than the 5% significance threshold signifies that the indirect effect of leverage on firm value via profitability is statistically significant.

Table 3.
Hypothesis Result

Hypothesis	Path Relationship	Coefficient (β)	t-value / z-value	Result
H1	Leverage \rightarrow Company Value	0.01	1.00	Rejected
H2	Leverage \rightarrow Profitability	-0.09	-3.30	Accepted
H3	Profitability \rightarrow Company Value	0.14	2.48	Accepted
H4	Leverage \rightarrow Profitability \rightarrow Company Value	0.013	-1.97	Accepted

The Effect of Leverage on Company Value

These findings indicate that leverage levels do not significantly impact company value. This indicates that the amount of debt-based financing does not directly affect the market's perception in valuing a company. Consequently, the degree of leverage is not a significant factor in assessing company value from the perspective of investors. Investors tend to respond more to other indicators that are considered more informative, such as profitability, rather than financing structure alone.

The empirical research findings align with the studies conducted by Silvia & Dewi (2022) and Kurniawan & Munawaroh (2022), which assert that leverage does not significantly impact company value. However, these results contradict the findings of Faisal & Gumala Sari (2024) and Dewi & Suaryana (2025), which prove that that leverage influences company value.

In certain sectors, the use of debt may be regarded as a signal of expansion and growth, while in other sectors it is seen as an increase in financial risk. In addition, macroeconomic conditions and market sentiment during the research period also have the potential to influence how investors interpret leverage as a signal, so that in an unstable economic situation, an increase in leverage tends not to elicit a positive response and has no implications for company value.

The Effect of Leverage on Profitability

The results demonstrate that leverage adversely and significantly impacts profitability. This condition indicates a rise in the amount of debt within a company's capital structure will result in an escalation of financial expenses, which tends to reduce the company's profitability.

This conclusion is corroborated by prior research that show the negative effect of leverage on profitability. Susilawati & Purnomo (2023) found that an increase in debt suppressed corporate profits in the telecoms sub-sector on the IDX, while Sati et al. (2024) found a similar effect in the food & beverage sector. However, research by Hasibuan & Ramadhan (2025) shows that leverage positively influences the profitability of certain companies, indicating that debt can increase profitability when managed optimally.

Companies with efficient financial management or higher profit margins may be able to utilize leverage optimally so that the impact of debt costs can be offset by increased revenue. Overall, this study's results substantiate empirical evidence that leverage typically

imposes adverse effects on profitability when an increase in debt is not offset by revenue growth or operational efficiency, so management needs to carefully consider debt ratios to avoid cost pressures that erode profitability.

The Effect of Profitability on Company Value

The analysis results demonstrate a positive and significant impact of profitability on company value, suggesting that a firm's capacity to create profits through asset utilisation enhances its market valuation. Increased profitability reflects better financial performance prospects, thereby boosting investor confidence in future profit potential and implying an increase in the company's market valuation.

Empirically, these findings align with the studies conducted by Astuti & Lestari (2024) and Handoyo & Herawati (2023), which show a positive and significant influence between profitability and company value, because profit performance is a critical determinant in evaluating company value. Research by Handoyo & Herawati (2023) on companies in the technology sector also reported a favourable and strong correlation between profitability and company valuation. However, several studies, such as Inrawan et al. (2025) found an insignificant effect on companies in the heavy construction and civil engineering subsectors, likely attributable to the industry's capital-intensive, high-risk, and highly dependent on long-term projects and macroeconomic conditions, so that short-term profits do not necessarily increase market value directly.

Thus, the differences in findings between studies confirm that the correlation between profitability and company value is significantly affected by the industry context, company operational characteristics, and surrounding economic conditions. This study's findings reinforce empirical evidence that in the banking sector, profitability plays an important role as a performance signal that can increase investor confidence and drive an increase in company value.

The Effect of Leverage on Company Value with Profitability as an Intervening Variable

The analytical results demonstrate that leverage does not directly influence corporate value; rather, its impact is mediated by profitability. This indicates that leverage is not a signal that automatically increases company value, but rather its effect depends on the internal financial performance generated. For investors, leverage is ambiguous as it may signify both management's confidence in handling finance and an escalation in financial risk. Conversely, profitability is more easily captured as a more tangible performance signal. Thus, leverage only contributes to company value if its management is able to drive increased profitability, so that its influence occurs through the mediation of profitability.

Empirically, the findings of this study align with prior research showing that the influence of financial variables on company value does not occur directly, but rather through the existence of certain mediating variables. Yulimtinan & Atiningsih (2021) found that leverage affects company value only through profitability, while Zoraya et al. (2023) reinforced this finding by proving the complete mediating effect of profitability in the link between leverage and company value. These findings confirm that the market assesses funding policies based on performance, making profitability the main transmission mechanism that bridges leverage and company value.

These findings affirm that profitability serves as a crucial intervening element in elucidating the link between leverage and corporate value. The results of this study have important theoretical implications for the development of signaling theory, particularly in the

context of corporate finance, namely that not all managerial policies function as directly effective signals. The existence of mediating variables is crucial to understanding how financial signals are interpreted by the market.

CONCLUSION

The discussion's conclusions indicate that the degree of leverage does not determine the company's value. Investors typically do not prioritise debt-based funding models when evaluating companies, instead concentrating on financial performance as indicated by profitability levels. Leverage has demonstrated a detrimental and substantial impact on profitability, signifying that elevated debt levels escalate financial expenses, thus diminishing the company's capacity to make profits. Moreover, profitability has been demonstrated to positively and significantly enhance company value, affirming that a firm's capacity to make profits is a crucial performance metric and possesses considerable attractiveness for investors. This study's primary finding indicates that leverage does not directly influence firm value; rather, it exerts an indirect effect through profitability as an intermediary variable. Consequently, profitability serves as the primary conduit that connects the influence of leverage on corporate value. This conclusion underscores the necessity of aligning the funding structure with enhanced profit performance, allowing the market to perceive the leverage policy as a favourable indicator that can elevate firm value.

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