The Effect of Intellectual Capital on Business Performance Among SMEs in Malaysia: The Mediating Role of Innovation Capability

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ABSTRACT

This study examined the effect of intellectual capital (IC) on business performance among manufacturing SMEs in Malaysia, with innovation capability serving as a mediating variable. This study employed a descriptive survey research design. The population included all manufacturing industries in Malaysia. From a target population of 57,187 manufacturing SMEs, a sample of 382 was selected for analysis. Questionnaire was used to collect data for the study. The proposed hypotheses were tested using Partial Least Squares Structural Equation Modelling (PLS-SEM) with Smart PLS 4. The measurement and structural models were evaluated, and the significance of the direct and mediating effects of innovation capability was assessed using the bootstrapping procedure. The results indicate that intellectual capital exerts a significant positive influence on business performance among manufacturing SMEs in Malaysia. Furthermore, innovation capability serves as a significant mediator in the relationship between intellectual capital and business performance. This suggests that increased intellectual capital strengthens innovation capability, thereby enhancing business performance. To strengthen innovation capabilities and improve business performance, manufacturing SMEs are advised to invest in personnel development, organizational knowledge systems, and strategic partnerships to reinforce their intellectual capital. In order to increase the competitiveness and sustainable growth of Malaysian manufacturing SMEs, policymakers and SME support organizations should also encourage activities that foster innovative capability.

Keywords: Effect, Intellectual Capital, Innovation Capability, Business Performance and Manufacturing Industries

INTRODUCTION

Intellectual capital (IC), which includes relational, structural, and human capital, has emerged as a crucial strategic asset in today's knowledge-based economy that helps businesses generate value, maintain a competitive edge, and perform better. IC enables businesses to increase operational efficiency, innovation, and overall business success by improving employees' knowledge and abilities, reinforcing organizational procedures, and cultivating strong partnerships with suppliers and consumers (Hina et al., 2024). However, prior research has suggested that unless organizations are able to convert knowledge into unique products, services, and procedures, intellectual capital alone might not directly result in better corporate success. Thus, by enabling the efficient use of organizational knowledge and resources, innovation capability has become an essential mediating factor that transforms intellectual capital into concrete economic outcomes (Aljuboori et al., 2022).

This relationship is particularly essential to Malaysian manufacturing SMEs, as the country's focus on digital tr ansformation under the New Industrial Master Plan 2030, rapid technological advancements, and growing glob al competition force businesses to constantly improve their intellectual capital and innovation capacity to incre ase productivity, competitiveness, and sustainable business performance (Ganesh & Haslinda, 2023). Therefore, analyzing the intermediary role of innovation capability might assist us in better understanding how intellectual capital affects company performance among Malaysian manufacturing SMEs.

A study was conducted by Aljuboori et al. (2022), a stratified sampling method was used wherein 262 participants' responses from the focused manufacturing firms were obtained and analyzed via the structural equation model (SEM) and resource-based view (RBV). The results showed that the relationship between intellectual capital and firm performance was strengthened due to the mediation of innovation capability, thereby gaining higher competitive advantages. However, human capital did not have a significant relationship with innovation capability, and innovation capability did not significantly mediate the relationship between human capital and firm performance. Similarly, structural and relational capital did not directly influence firm performance without innovation capability. According to a study by Muda et al. (2018), relational and human capital significantly increased the performance of SME businesses in Malaysia, proving that intellectual capital enhances organizational performance. These contradictory results suggest that more research is necessary to fully comprehend how innovation aptitude relates to intellectual capital and business performance, especially in Malaysian manufacturing SMEs.

LITERATURE REVIEW

Intellectual Capital and Business Performance

Intellectual capital (IC) has been widely recognized as one of the most valuable strategic resources that enables organizations to create, manage, and sustain competitive advantage in today's knowledge-based economy (Bonits, 1996). IC is commonly conceptualized into three key dimensions: human capital, structural capital, and relational capital. Human capital refers to the knowledge, skills, experience, expertise, and capabilities possessed by employees that contribute to organizational value creation and innovation (Subramaniam & Youndt, 2005). Structural capital represents the institutionalized knowledge embedded within an organization's processes, systems, databases, routines, and organizational culture, enabling knowledge to be retained and effectively utilized beyond individual employees (Teece, 1996). Relational capital, on the other hand, encompasses the value derived from an organization's relationships with external stakeholders, including customers, suppliers, business partners, and other networks, as well as intangible assets such as reputation, brand image, and customer loyalty (Bonits, 1996). Together, these three dimensions form the foundation of intellectual capital, enabling organizations to strengthen their innovation capability and achieve superior firm performance.

As intellectual capital represents a critical organizational resource, understanding its contribution to business performance has become an important area of research in strategic management and innovation literature. Smriti and Das (2018) investigated the association between intellectual capital (IC) and firm performance in companies listed on India's Centre for Monitoring Indian Economy Overall Share Price Index (COSPI). The study employed secondary data obtained between 2001 and 2016 to evaluate intellectual capital using Pulic's (2000) Value Added Intellectual Coefficient (VAIC) model and analyze the data using the System Generalized Method of Moments (SGMM) estimator. The findings showed that intellectual capital has a considerable positive effect on firm performance, implying that companies that manage their intellectual resources more efficiently obtain better financial results. Human capital was found as the most influential factor in increasing business productivity, although structural capital efficiency and capital employed efficiency had a substantial impact on sales growth and market value. Overall, the study indicated that effective use of intellectual capital is critical to creating value and enhancing corporate performance, highlighting IC as a strategic resource for obtaining long-term competitive advantage.

Overall, the past research demonstrates that intellectual capital is an important strategic resource for improving business performance. Therefore, further empirical investigation is needed to examine the relationship between intellectual capital and business performance within the context of Malaysian manufacturing SMEs.

Intellectual Capital and Innovation Capability

In today's fast-paced corporate world, innovation has become vital to organizational survival and long-term competitiveness. Buenechea-Elberdin (2017) emphasizes the importance of understanding the relationship between intellectual capital (IC) and innovation, stating that innovation is critical to sustaining corporate growth and competitive advantage. Although there is no commonly acknowledged definition of innovation, most researchers believe that it entails the creation and execution of anything new within an organization (Lee & Tsai,

2005). The existing literature consistently shows a positive relationship between intellectual capital and innovation, implying that organizations with strong intellectual capital are better positioned to generate innovative ideas, improve processes, develop new products and services, and improve overall innovation performance (Buenechea-Elberdin, 2017; Hsu & Fang, 2009; Subramaniam & Youndt, 2005). Intellectual capital, which includes important intangible resources such as human capital, structural capital, and relational capital, facilitates knowledge creation, information exchange, and organizational learning, all of which contribute to improved innovative performance.

Fidanbas and Irdan (2019) mentioned that organizations must continuously innovate in today's highly competitive business climate to attain and maintain a competitive advantage. Intellectual capital is widely recognized as a fundamental engine of innovation because it allows businesses to successfully produce, acquire, and utilize knowledge. Human capital contributes through employees' knowledge, skills, creativity, and experience, whereas relational capital promotes innovation by building ties with consumers, suppliers, and other external stakeholders, resulting in useful ideas and feedback. Together with structural capital, these intangible resources facilitate knowledge sharing, organizational learning, and the effective creation and implementation of ideas, ultimately improving innovation performance.

KESKİN et al. (2018) studied the impact of intellectual capital on innovation quality and business performance through questionnaire data. The study found that there was no statistically significant association between human capital and innovation quality. However, organizational and social capital were discovered to have significant positive relationships with innovation quality, implying that organizational systems, knowledge-sharing practices, and strong stakeholder relationships are more important in improving innovation outcomes than human capital alone. These findings give empirical evidence that some elements of intellectual capital have varying effects on innovation performance. These contradictory findings suggest that the relationship between intellectual capital and innovation performance remains ambiguous and may differ among industries and organizational situations.

Therefore, this study seeks to examine the relationship between the dimensions of intellectual capital and innovation performance among manufacturing SMEs in Malaysia to provide further empirical evidence and address the inconsistencies identified in previous research.

Innovation Capability and Business Performance

Innovation capability is widely acknowledged as a critical organizational capability that allows businesses to establish and maintain a competitive advantage. It reflects an organization's ability to generate and implement new ideas, products, processes, and technologies while maximizing its resources and capabilities. As business environments become more dynamic, companies with strong innovation capabilities are better positioned to respond to market changes, increase organizational performance, and generate superior business results. As a result, Rajapathirana and Hui (2018) regard innovation capability to be a key driver of company performance.

Rajapathirana and Hui (2018) investigated the relationship between innovation capability, innovation type, and firm performance, including innovation, market, and financial performance, in the Sri Lankan insurance industry. Using data from 379 senior managers, the study discovered that innovation capability has a significant and positive relationship with firm performance. The findings indicate that efficient management of innovation capabilities improves innovation outcomes, which in turn improves market and financial performance.

Naala et al. (2017) also researched the relationship between innovation competence and business performance among Nigeria's small and medium-sized firms (SMEs). A quantitative approach was employed, with data collected from 280 SMEs using self-administered questionnaires and analyzed using Partial Least Squares Structural Equation Modeling (PLS-SEM). The findings showed that innovation capability has a significant positive effect on business performance, implying that organizations with higher innovation capability are more likely to perform well. The study revealed that innovation competence is an important success element for SMEs since successful adoption and implementation of innovative strategies improves overall organizational performance.

Firms with a strong innovation capability can create new products, enhance processes, respond to market changes, and achieve greater organizational performance. Nonetheless, the intensity of this relationship may vary by industry, country, and organizational situation. Further empirical research is required to validate the association between innovation capabilities and business performance in Malaysian manufacturing SMEs. Therefore, this study intends to evaluate the relationship between innovation capability and business performance among manufacturing SMEs in Malaysia.

Intellectual Capital, Innovation Capability, and Business Performance

Recent empirical evidence highlights the importance of intellectual capital in enhancing organizational performance through innovation-related capabilities. A study by Ha (2026) investigated the role of green intellectual capital, comprising green human capital, green structural capital, and green relational capital, in improving the social performance of Vietnamese SMEs. Using a quantitative approach and Partial Least Squares Structural Equation Modeling (PLS-SEM) with data collected from 508 SMEs, the study found that green knowledge sharing and green innovation sequentially mediated the relationship between green intellectual capital and social performance. Specifically, organizations with stronger intellectual capital were more likely to develop effective knowledge-sharing practices, which subsequently enhanced their innovation capabilities and contributed to improved organizational performance. These findings suggest that intellectual capital alone may not directly generate superior performance; instead, its value is realized through the development of innovation capabilities that transform organizational knowledge into valuable outcomes. This evidence supports the view that innovation capability serves as a critical mechanism linking intellectual capital to enhanced organizational performance.

Osman Zainal Abidin (2024) empirically examined the relationships among intellectual capital, strategic orientations, innovation capability, and firm performance in Malaysian Information and Communications Technology (ICT) SMEs. The study proposed that intellectual capital, as a valuable knowledge-based resource, enhances a firm's innovation capability, which subsequently improves firm performance. Consistent with previous studies(Subramaniam & Youndt, 2005; Wu et al., 2007), the findings demonstrated that intellectual capital is positively associated with innovation capability by enabling firms to integrate and leverage knowledge resources for innovation. Furthermore, the empirical results revealed that innovation capability plays a crucial mediating role in strengthening the positive effect of intellectual capital on firm performance. Specifically, firms with higher levels of innovation capability were able to derive greater performance benefits from their intellectual capital, suggesting that merely possessing intellectual capital is insufficient unless it is effectively transformed into innovative products, services, or processes. These findings highlight the importance of innovation capability as the mechanism through which intellectual capital contributes to superior firm performance, particularly among Malaysian SMEs.

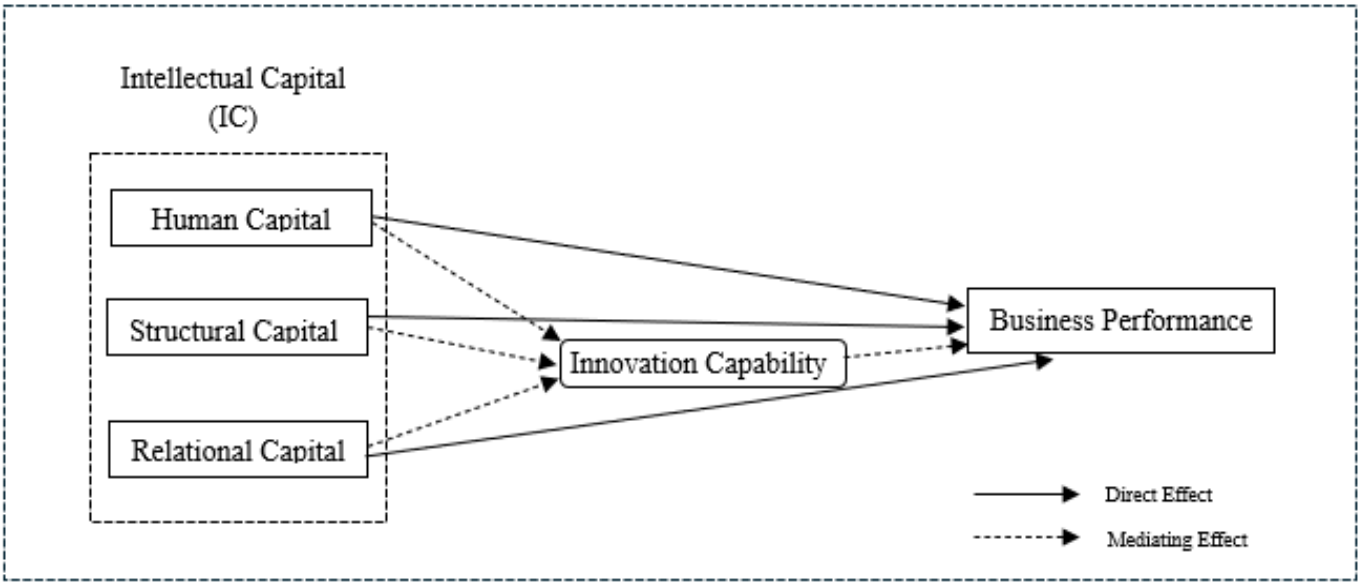

Figure 2.1: Conceptual Framework

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Research Objectives

1. To examine the effect of intellectual capital on business performance among manufacturing SMEs in Malaysia.
2. To examine the effect of intellectual capital on innovation capability among manufacturing SMEs in Malaysia.
3. To examine the effect of innovation capability on business performance among manufacturing SMEs in Malaysia.
4. To examine the mediating role of innovation capability in the relationship between intellectual capital and business performance among manufacturing SMEs in Malaysia.

Research Questions

1. What is the effect of intellectual capital on business performance among manufacturing SMEs in Malaysia?
2. What is the effect of intellectual capital on innovation capability among manufacturing SMEs in Malaysia?
3. What is the effect of innovation capability on business performance among manufacturing SMEs in Malaysia?
4. Does innovation capability mediate the relationship between intellectual capital and business performance among manufacturing SMEs in Malaysia?

METHODOLOGY

The study used a cross-sectional survey method with a quantitative research design. Three sections of a structured questionnaire were used to gather data. A five-point Likert scale, ranging from 1 (strongly disagree) to 5 (strongly agree), was used in the questionnaire's design to examine the study variables. The structured questionnaire allowed for the systematic collecting of standardized responses from participants, which aided statistical analysis of the study variables. The study population consisted of Malaysian small and medium-sized manufacturing firms (SMEs). The target respondents were owners, managers, or senior executives of these firms, as they are directly involved in strategic decision-making and have the relevant knowledge regarding the firm's intellectual capital, innovation capability, and business performance. A total of 382 questionnaires were issued to the respondents, and all questionnaires were collected from them. The questionnaire was created to collect managers' perspectives on the impact of intellectual capital on business performance, as well as to investigate the function of innovation capability as a mediator in the relationship between intellectual capital and business performance.

Furthermore, the sampling technique was chosen based on the research objectives, the availability of a sampling frame, and access to the target population. The desired sample size was determined using an appropriate sample size determination method. In this study, all questionnaires distributed to targeted respondents were successfully collected, yielding a 100% response rate. The returned surveys were then checked to ensure that they were complete and appropriate for further study. Following the screening process, 382 valid questionnaires were kept and used in the final data analysis with SmartPLS 4.

The acquired data was analyzed using descriptive and inferential statistical methods. The demographic data of the respondents and the study variables were summarized using descriptive statistics such as frequencies, percentages, means, and standard deviations. SmartPLS 4 was used to conduct inferential analysis on both the measurement and structural models. The measurement model was evaluated using indicator loadings, Cronbach's alpha, Composite Reliability (CR), Average Variance Extracted (AVE), and discriminant validity. The bootstrapping approach was used to assess the provided hypotheses of the structural model, including route coefficients, coefficient of determination (R^2), effect size (f^2), predictive relevance (Q^2), and the mediating effect of innovation capability. Statistical significance was evaluated at a threshold of 0.05.

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RESULTS

Table 1: Assessment of Internal Consistency Reliability and Convergent Validity

Construct	Cronbach's alpha	Composite reliability (rho_a)	Composite reliability (rho_c)	Average variance extracted (AVE)	Interpretation
BP	0.703	0.701	0.804	0.745	Acceptable reliability
HC	0.825	0.722	0.788	0.732	Acceptable reliability
INC	0.846	0.871	0.750	0.724	Acceptable reliability
RC	0.771	0.770	0.794	0.715	Acceptable reliability
SC	0.732	0.736	0.769	0.711	Acceptable reliability

The findings of the convergent validity and internal consistency reliability tests for business performance (BP), human capital (HC), innovation capability (INC), relational capital (RC), and structural capital (SC) are shown in Table 1. All constructs demonstrated good internal consistency reliability, as indicated by the Cronbach's alpha values, which varied from 0.703 to 0.846. The reported composite reliability (rho_C) values varied from 0.750 to 0.804, but the rho_A values varied from 0.701 to 0.871. Based on the widely accepted criteria of 0.70, these results often show excellent internal consistency reliability.

The AVE values above the suggested minimum threshold of 0.50, ranging from 0.711 to 0.745. Consequently, the findings show that business performance, human capital, innovation capability, relational capital, and structural capital have satisfactory convergent validity.

Table 2: Discriminant Validity : Fornell-Larcker Criterion

Construct	AVE (Diagonal)	Highest correlation with another construct	Result
BP	0.745	0.655	✓ Acceptable
HC	0.732	0.655	✓ Acceptable
INC	0.724	0.655	✓ Acceptable
RC	0.715	0.659	✓ Acceptable
SC	0.711	0.659	✓ Acceptable

The Fornell-Larcker criterion was used to evaluate the constructs' discriminant validity. Table 2 demonstrates that the square root of AVE for RC, HC, and BP was greater than their corresponding correlations with the other variables, demonstrating adequate discriminant validity. Cronbach's alpha and composite reliability ratings for all constructs above 0.70, indicating acceptable internal consistency. The AVE values ranged from 0.711 to 0.745, which are above the acceptable threshold of 0.50. Therefore, the constructs satisfy the requirement for convergent validity.

Table 3: Structural Model Path Coefficient Results

	Original sample (O)	Sample mean (M)	Standard deviation (STDEV)	T statistics	P values
HC -> BP	0.228	0.226	0.052	4.357	0.000
HC -> INC	0.375	0.376	0.057	6.577	0.000
INC -> BP	0.233	0.233	0.052	4.515	0.000
RC -> BP	0.235	0.236	0.059	3.956	0.000
RC -> INC	0.203	0.206	0.060	3.389	0.001
SC -> BP	0.204	0.205	0.057	3.578	0.000
SC -> INC	0.232	0.233	0.059	3.906	0.000

The bootstrapping results demonstrate that all proposed direct relationships between variables are positive and statistically significant. Human capital positively correlates with business performance ($\beta = 0.228$, $p < 0.001$) and innovation capability ($\beta = 0.375$, $p < 0.001$). Innovation capability also correlates positively with business

performance (β = 0.233, p < 0.001). Additionally, relational capital influences business performance (β = 0.235, p < 0.001) and innovation capability (β = 0.203, p = 0.001), while structural capital shows similar positive correlations with both business performance (β = 0.204, p < 0.001) and innovation capability (β = 0.232, p < 0.001). All seven proposed direct-effect hypotheses are supported by the findings.

Table 4: Specific Indirect Effects

	Original sample (O)	Sample mean (M)	Standard deviation (STDEV)	T statistics	P values
RC -> INC -> BP	0.047	0.048	0.018	2.684	0.007
SC -> INC -> BP	0.054	0.055	0.020	2.765	0.006
HC -> INC -> BP	0.087	0.088	0.024	3.691	0.000

The bootstrapping results show that innovation capability mediates the relationships between the three dimensions of intellectual capital and business performance. Human capital has a significant positive indirect effect on business performance through innovation capability (β = 0.087, t = 3.691, p < 0.001). Structural Capital has a strong indirect effect on business performance through innovation capability (β = 0.054, t = 2.765, p = 0.006). Relational Capital has a positive and significant indirect effect on business performance through Innovation Capability (β = 0.047, t = 2.684, p = 0.007). As a result, the data validate the proposed mediation hypotheses, implying that innovation capability mediates the links between human capital, structural capital, relational capital, and business performance.

Table 5: Effect Size Analysis of Structural Model Relationships (f^2)

	f-square
HC -> BP	0.056
HC -> INC	0.145
INC -> BP	0.064
RC -> BP	0.065
RC -> INC	0.042
SC -> BP	0.043
SC -> INC	0.050

The effect size analysis shows that all associations have small effects, with (f2) values ranging from 0.042 to 0.145, according to Cohen (2013) criteria. human capital has the highest effect on innovation capability (f2 = 0.145), followed by relational capital on business performance (f2 = 0.065), and innovation capability on business performance (f2 = 0.064). The remaining associations similarly have minimal effects. Overall, the data indicate that human capital, relational capital, structural capital, and innovation capability all contribute modestly to explaining the variation in innovation capability and business performance among Malaysian SMEs.

Table 3: Result of R-square

	R-square	**R-square adjusted**
BP	0.414	0.413
INC	0.509	0.505

The explanatory power of the structural model was evaluated using the coefficient of determination (R^2). According to the findings, the predictor variables accounted for 41.4% of the variation in business performance across Malaysian SMEs, with an R2 value of 0.414. After accounting for the number of predictors, the explanatory power was comparatively stable, as indicated by the corrected R2 value of 0.413. While the corrected R2 was 0.505, the R2 value for innovation capability was 0.509, meaning that the predictor factors accounted for 50.9% of the variance in INC. Overall, the findings show that the structural model has a moderate amount of explanatory power for both innovation capability and business performance.

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SUMMARY OF THE FINDINGS

Overall, the results showed that intellectual capital is crucial for improving Malaysian SMEs' commercial success. The findings show that while innovation capability has a major positive impact on business performance, intellectual capital also has a considerable impact. Additionally, innovation capability substantially mediates the relationship between intellectual capital and business performance. These findings emphasize the need to build intellectual capital and boost innovation capability to improve SME performance.

CONCLUSION

According to the study's findings, intellectual capital is crucial for improving SMEs' business performance in Malaysia. The results show that intellectual capital significantly improves business performance, suggesting that SMEs' knowledge, abilities, organizational resources, and affiliations are important tools for improving performance. In the manufacturing sector, intellectual capital is especially important as SMEs rely on employees' technical expertise, organizational knowledge, technological capabilities, and external relationships to improve production processes, improve product quality, foster innovation, and maintain competitive performance.

The study also demonstrates that innovation capability has a major positive impact on business performance, and intellectual capital plays a major role in fostering innovation capability. More significantly, the results show that the relationship between intellectual capital and business performance is mediated by innovation capability. This implies that SMEs can enhance their business performance by efficiently converting their knowledge and resources into novel goods, procedures, and methods in addition to directly expanding their intellectual capital.

Overall, the results emphasize how crucial it is for Malaysian SMEs to develop their capacity for innovation and intellectual capital as strategic assets. Therefore, SME managers should make investments in the knowledge and abilities of their staff, bolster organizational structures, uphold solid customer and business partner relationships, and promote innovation-oriented activities. These qualities are especially crucial for manufacturing SMEs because they enable them to improve production processes, implement new technologies, improve product quality, and respond effectively to changing market needs. By accomplishing this, SMEs might be in a better position to maintain their competitiveness in a business climate that is becoming more and more dynamic and to achieve sustainable business performance.

RECOMMENDATIONS

1. Invest in employee knowledge and skills

   To enhance workers' technical, managerial, and problem-solving abilities, manufacturing SMEs should regularly offer training and development programs. Innovation and process enhancements can be facilitated by skilled workers.

2. Strengthen innovation capability

   Employees at SMEs should be encouraged to create new concepts, enhance current goods and procedures, and implement cutting-edge production techniques. This can assist businesses in adapting to shifting consumer demands and competitive market conditions.

3. Adopt new technologies

   Manufacturing SMEs could consider investing in digital technology, automation, and advanced manufacturing methods as needed. Technology can boost manufacturing efficiency, product quality, and operational performance.

4. Strengthen organisational knowledge

   Manufacturing SMEs should develop effective processes for preserving and sharing knowledge inside

their organizations. This ensures that valuable knowledge and expertise do not disappear when staff leave.

5. Strengthen external relationships

   SMEs should have good relationships with their suppliers, customers, business partners, and other stakeholders. These relationships can give you access to market intelligence, new technology, resources, and chances for innovation.

Appendix A

Table A1: Research Variable's Measurements

Variables Name	Code	Item's Measurements
Human Capital (HC)	HC01	Our employees are highly skilled.
	HC02	Our employees are well experienced in their job.
	HC03	Our employees are creative.
	HC04	Our employees are knowledgeable.
	HC05	Our employees are quick in problem-solving.
Structural Capital (SC)	SC01	Our firm's overall operational procedures are very efficient.
	SC02	Our firm responds to changes very quickly.
	SC03	Our firm has an easily accessible information system.
	SC04	Our firm has systems and procedures that support innovation.
	SC05	Our firm's culture and atmosphere are flexible and comfortable.
Relational Capital (RC)	RC01	Our firm discovers and solves problems through intimate communication and effective collaboration.
	RC02	Our firm maintains appropriate interactions with its stakeholders.
	RC03	Our firm maintains long-term relationships with customers.
	RC04	Our firm has many excellent suppliers.
	RC05	Our firm has stable and good relationships with strategic partners.
Innovation Capability	IC01	Our firm tries out new ideas.
	IC02	Our firm seeks new ways of doing things.
	IC03	Our firm is creative in its operating methods.
	IC04	Our firm develops new products and services.
	IC05	Our firm introduced new products/service in the last five years.
Business Performance	BP01	Our firm's revenue is continuously increasing over the past five years.
	BP02	Our firm's profit is continuously increasing over the past five years.
	BP03	Our firm has been continuously reducing cost per revenue unit over the past five years.
	BP04	Our firm's net return on assets has been increasing over the past five years.
	BP05	Our firm's net return on sales has been increasing over the past five years.

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