

American Water Works: Not yet at its high water mark

Ticker: AWK

Rating: BUY

Horizon: 13 months

- AWK is a recognized market leader, boasting a national presence (geographic diversity) and strong relationships with state and local utility regulators. It benefits from this favorable risk profile, but these positive characteristics are missing from share price.
- The company is delivering a clear organic and inorganic growth strategy. AWK targets long-term EPS growth of 7-10% anchored by \$800-\$1bn in yearly capital expenditures and is capable of executing on this plan. AWK also has pre-approved room to expand rates resulting from prior corporate parent's history of poor management. This drives a target price of \$48.41, 12% above current.
- The management team, lead by utility veteran Jeffrey Serba since the 2008 IPO, has track record of delivering on brokers' elevated price targets. AWK currently trades at P/E discount to peer group (18.1x to median 21.1x) and deserves P/E of 20.3x based on our DCF valuation.

Price:	43.1
Target Price:	48.4
Market Cap:	7.7b
52-wk high:	45.0
52-wk low:	36.5
Shares O/S:	178.3m
P/E TTM	20.4
Dividend/share:	0.2
Beta (levered):	0.2

Data as of COB November 15,
2013

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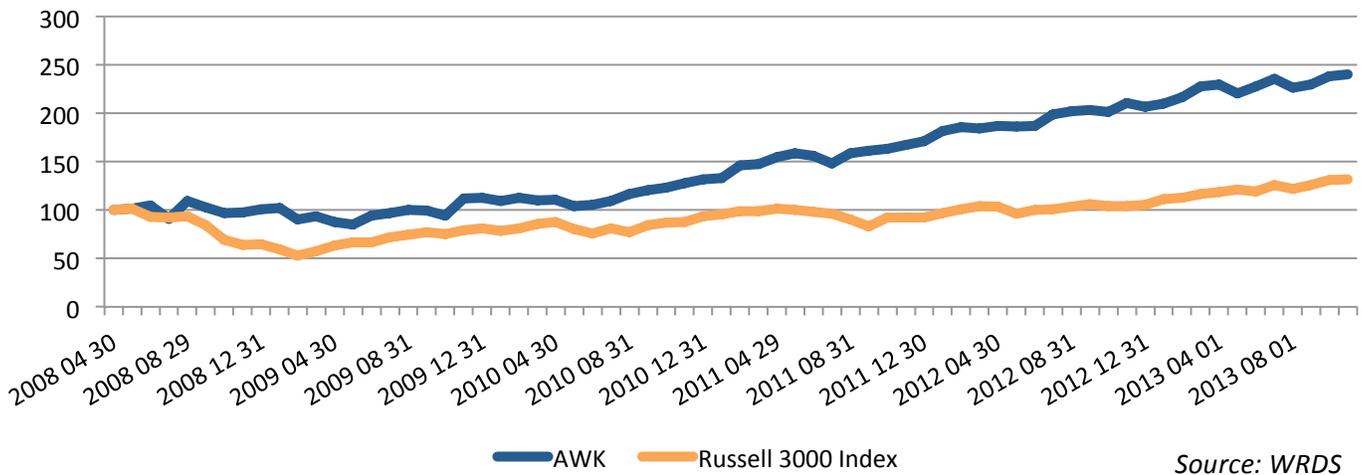
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RECENT PERFORMANCE

AWK has outperformed the Russell 3000 (represented by an index fund) since its IPO in April 2008 (Figure 1), but has underperformed the index in the last twelve months (Figure 2). The significance of AWK's low *prices* as shown in Figure 2 is that the story of AWK's undervaluation turns on its unwarranted low P/E ratio relative to peer companies. Despite brokers' consistent

Figure 1: AWK vs. Russell 3000 Index, \$100 investment



conclusion that AWK is underpriced, the gap has not closed. Our independent DCF valuation led us to reach the same recommendation. With continued robust capital expenditure driving revenues to grow at an historical average rate until 2020—a plan on which management has begun to demonstrate it *can* execute—AWK should be worth \$48.41 per share and trade at 20.3x P/E. Our predicted share price would bring AWK in line with the Russell 3000 for the last twelve months and further elevate its long-term superior returns over those of the index.

Figure 2: AWK daily price comparison to Russell 3000 Index, TTM



Our best guesses as to why the market consistently misprices are: (1) that the market does not believe in management's ability to execute on its turn-around of the company after years of

mismanagement by a foreign multinational (Germany's RWE); (2) incredulity regarding AWK's ability to sustain revenue growth above the assumed long-term national economic growth rate of 3.2% beyond 2020. We join other brokerage analysts in disagreeing with the market, citing historical record and market potential as evidence. Although the gap between analyst valuations (including our own) and stock price has persisted since mid-2011, we assert that it will close. The long-term persistence of obvious mispricing before correction has been noted by academic research.¹ A chart at the conclusion of this report also demonstrates that *even if the valuation gap does not close within our forecast period, this will be because valuation estimates rise as price rises, so an investor will nonetheless realize a gain.*

BACKGROUND²

American Water Works Company, Inc. (AWK) is the largest publicly traded, investor-owned water utility company in the United States. The company has two reportable operating segments: Regulated Businesses and Market-Based Operations. These operate in 1,500 communities across 30 states and 2 Canadian provinces. They run 80 surface water treatment plants; 500 groundwater treatment plants; 1,000 groundwater wells; 100 wastewater treatment facilities; 1,200 treated water storage facilities; 1,300 pumping stations; 90 dams; and 46,000 miles of mains and collection pipes. AWK serves over 14 million people and is headquartered in Voorhees, New Jersey.

Within Regulated Businesses, AWK owns the land and assets used to extract, store, transmit, deliver, collect, treat, and discharge water. This company segment generated 89.2% of net

Figure 1: AWK Corporate Structure

Source: AWK 10-K 2012

¹ Mitchell, M., T. Pulvino, and E. Stafford, 2002. "Limited arbitrage in equity markets." *Journal of Finance*, 62.

² AWK Q3 10-Q, filed 07 November 2013; Capital IQ

operating revenues for the first nine months of 2013, or \$1.96bn.

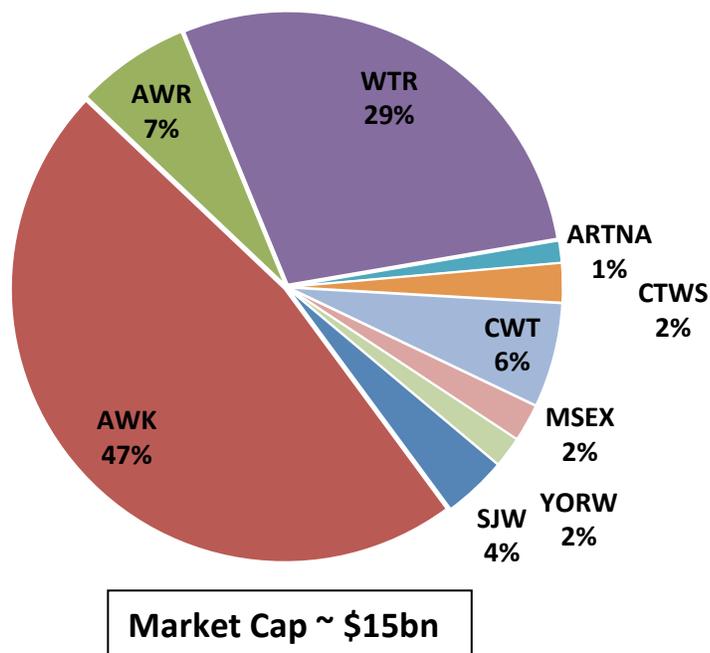
Market-Based Operations include subsidiaries that manage systems under contract and provide water resource management products and services. These businesses consist primarily of Contract Operations Group, Military Services Group, Homeowner Services Group and Emerging Technologies. In total, they generated 10.2% of net operating revenues during the first nine months of 2013, or \$249 million. The basic corporate structure is shown in Figure 3. Our valuation focuses on the regulated business because of the relative weights of each segment, measured by revenues.

AWK's current profitability stems from a recent history of poor management. From 2001 to 2008, AWK was a subsidiary of Germany's RWE AG. RWE is a gas and electric utility company serving approximately 20 million electricity and 10 million natural gas customers in Europe (in 2013). Purchasing AWK—already in 2001 the largest private water utility in the USA—was a risky and bold foray into a new market. Foreign ownership of a fundamental resource network made state and local regulators anxious, and these parties held the keys to AWK's potential profitability. To appease the regulators, RWE agreed to several rate *freezes* between 2003 and 2005. In essence, RWE agreed to forgo its ability to increase revenues.

External factors relating to RWE's operations in Europe combined with the AWK rate freezes in the USA caused RWE to divest from the water utility via an IPO on 23 April 2008 at a price of \$21.50. Concurrent with the IPO, the Board invited Jeffrey Sterba to become CEO. Sterba brought with him both experience and vision. By 2008, Sterba had already spent a decade as an executive at various national energy and power companies, including several large utilities (e.g. Texas-New Mexico Power Company). Sterba has also set a recovery course from RWE's poor management and mistakes.

Figure 2: Private Water Utility Industry Universe

At the very least, Sterba has maintained AWK's huge market share (Figure 4). AWK has 47% of the \$15 billion market cap private water utility market. The next largest players decrease rapidly in size: Aqua America (WTR) accounts for 29%, American States (AWR) for 7%, California Water Services Group (CWT) for 6%, and none of the remaining companies breaks 5% of industry market capitalization. Nonetheless, these companies all have substantial room to



grow. In a recent investor report, AWK estimates that only 16% of US water supply systems and 2% of US wastewater systems are investor owned (the remainder—84% and 98% respectively—being either publicly owned by municipalities and states or privately owned by individuals and companies). In the context of strained public budgets since the 2008 financial crisis, there exist plentiful opportunities to grow inorganically by purchasing small public and private systems around the country. Organic growth is also available to AWK. For utilities, growth involves investing in infrastructure to qualify for higher allowed rates of return from regulators. Sterba has pursued this route also.

MANAGEMENT'S GOALS: ACHIEVEABLE

Per AWK's financial statements and investor presentations, management has outlined four strategic and operational goals. These are:

1. Focus on acquisitions/tuck-ins while continuing to expand markets organically. As discussed above, large utilities such as AWK (of which there are arguably only 2 others in the country) have many acquisition targets. Purchasing a public or private water utility has the benefits of: (A) immediately inflating the "rate base" (infrastructure designed to serve customers) on which the company's allowed rate of return is calculated. Rates of return are set by state and local regulators to protect customers, but many states allow substantial returns above costs (approx. 8-11% in most states with the weight of jurisdictions allowing between 10-11%)³ in order to incentivize private investment; and (B) adding to geographic diversity, which provides a natural hedge against strains on a company's operations in any one area due to extremely high or low demand.
2. Address regulatory lag and favorably manage rate cases by leveraging supportive regulatory environment. State regulatory commissions permit water utilities to add surcharges to their bills in order to recoup expenses and earn a rate of return over and above capital investment costs. The time between when an expense is incurred or capital investment made and a surcharge is applied to revenues constitutes the "regulatory lag." Multi-year regulatory lag in some states can severely damage a utility's liquidity and investment campaign. Some states have therefore adopted policies to reduce regulatory lag. As a national player, AWK has actively encouraged the states in which it operates to adopt reduced-lag policies. AWK was also saddled with low frozen rates from the RWE days, and a major component of the company's strategy is to "true up" the rates it receives in some states to the maximum allowable amount, a process that is projected to be complete by year-end 2014 because of rate case scheduling.
3. Continue to improve Operation and Maintenance efficiency (below 40% by 2015) in order to redeploy capital. As will be discussed below, the structure of regulatory rate regimes is such that O&M expenses can be *recouped*, but *profit* can only be generated by returns on investment. Commissions enforce this distinction via rate cases and

³ Credit Suisse, "American Water Works: A Sustained Growth Story," 11 February 2011.

interim reviews. AWK would like to continue to reduce its O&M expenses and use the freed-up capital in rate base investments, thereby boosting profits.

4. Upgrade infrastructure through \$800mm-\$1bn in yearly capital expenditures as part of a business transformation project. In connection with (3) above, AWK aims to focus the use of funds on activities (expenses and investments) that will generate increased profit and value, not only revenues.

In combination, these goals are to be realized through “visible growth” of long-term EPS, defined as revenues’ 7-10% CAGR. Our DCF assumes 7.0% revenue growth until 2020 in line with both management’s goals and average historical revenue growth.

PERFORMANCE ASSESSMENT: SUCCESS ON ALL FRONTS

1. Inorganic Growth

Performance Appraisal



YTD 2013, AWK has spent \$16.6 million on acquisitions, purchasing 8 water systems and 4 waste water systems. This compares to 10 systems in 2012; 11 water and 48 small wastewater systems in 2011; 6 systems in 2010; 7 in 2009; and 10 in 2008. Meanwhile, AWK also optimized its asset/subsidiary portfolio by selling off a large number of unprofitable systems or those that did not generate synergy or other value with AWK. The end result is higher concentration in states with higher allowable rates and an intentional approach to geographic diversification across the country.

AWK is strategically poised for further tuck-ins, in part due to its SET meter reading technology. The SET Data Aggregation Platform makes data and systems interoperable. This has helped the company overcome proprietary issues concomitant with managing a host of discrepant software. SET technology also enables remote meter reading for reduced O&M costs. As various meter-reading systems become commoditized and data collection becomes cheap and real-time, AWK’s acquisition costs will drop, as will its operating costs.

However, it is very difficult to model potential acquisitions, and so these are not included explicitly in the below DCF valuation. First, AWK has so many potential targets—especially in the wastewater segment, which currently makes up only 4% of AWK’s rate base—that it is difficult to say which management will next pursue and its impact on the bottom line. Second, the time and regulatory risk associated with acquiring a new utility are such that without concrete discussions in the works, value is highly uncertain. Third, the volatility of historical acquisition activity year-to-year and the mere 5 years of operational independence combine to complicate attempts to either measure previous gains from acquisitions or forecast future acquisition rates. Instead of attempting to forecast specific value from acquisition activity, value from inorganic growth is assumed in the 7.0% growth rate to 2019.

2. Reducing lag and managing rate cases

Performance Appraisal



AWK has a long history of dealing with myriad regulatory bodies for over a century. Although its relationships with regulators were complicated while AWK was a subsidiary of RWE, it has restored cooperative operations with regulators since its 2008 IPO and “true up” campaign. Two achievements stand out as evidence of management’s success in this regard.

The first is that as of February 2011, AWK had filed 50 rate cases since 2008. During that three-year period, 41 of the rate cases were decided favorably such that, on average, AWK earned returns rates within 1.5% of its requested rates (10.25% vs. 11.66%, which is an aggregate maximum allowable rate of return). There is no data on the other 9 cases. Information scarcity also makes it challenging to chart successful negotiations with the regulators since 2011, however we assume that relationships remain productive. Management forecast a completion of the “truing-up” process (the reduction of the gap left by RWE between earned rates and allowable rates) before year-end 2014.

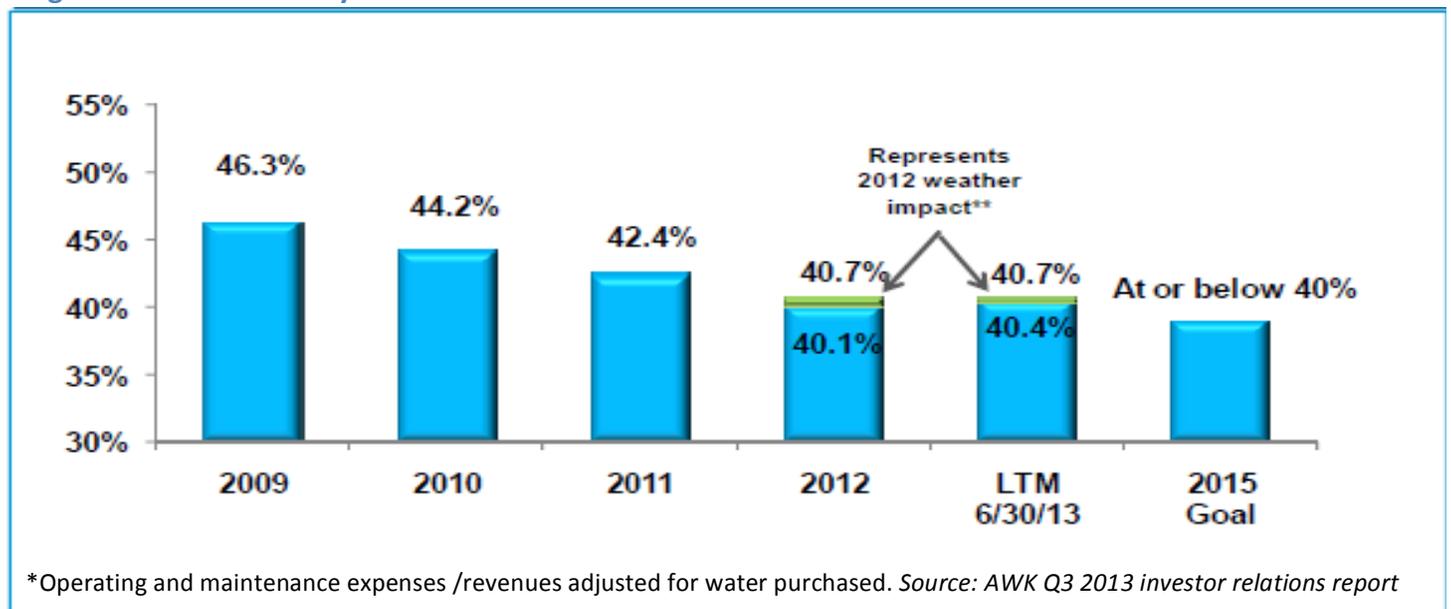
The second, more recent, indicator of a successful lobbying effort—either singly or as part of larger coalitions, it is not clear—New Jersey adopted a Distribution System Improvement Charge (DSIC) mechanism as of 1 January 2013. A DSIC mechanism allows the utility to apply for surcharges in response to capital expenses in between general rate case reviews, thereby reducing regulatory lag. Such mechanisms are particularly useful to a utility when it wants to recoup repair and maintenance costs, which are less likely than acquisitions to be predicted and considered in a general rate case situation. Further driving home the significance, historically 2/3rds of AWK’s annual capex budget is for infrastructure *replacement* rather than expansion. DSIC mechanisms therefore greatly improve AWK’s general cash position. New Jersey’s adoption of this mechanism is therefore a substantial boon to AWK.

3. Improve O&M Efficiency

Performance Appraisal

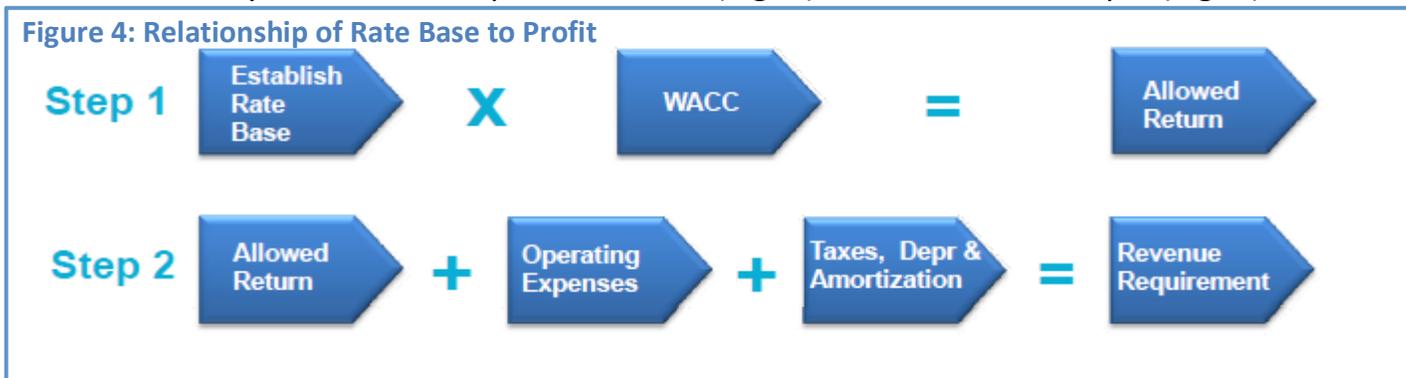


Figure 3: O&M Efficiency Ratio*



AWK has improved its O&M ratio over the last several years, with the aim of achieving sub-40% levels (of adjusted revenue) by 2015. Currently, the ratio hovers between 40 and 41%. This ratio is important to profitability because the more capital that can be deployed toward infrastructure investment (instead of operating expenses), the more EPS improves. This is demonstrated by the relationships in the chart (Fig. 4) and numeric example (Fig. 5) below.

Figure 4: Relationship of Rate Base to Profit



The rate base is the capital AWK has invested in infrastructure, which, in turn, drives their allowed revenue return. Items such as [recouped] operating expenses and taxes, depreciation, and amortization supplement the allowed return in the final revenue figure. Of these revenue sources, only the allowed return associated with the rate base is over-and-above costs, and so

Figure 5: O&M Efficient Translation into EPS

Conceptual	\$0.90 of O&M Expense	\$6 ^{(1) (2)} of Invested Capital	Same Revenue Requirement. Rates do not change.
Revenue Requirement	\$0.90	\$0.90	
Expenses			
O&M	\$0.82	\$0.00	
Depreciation	-	\$0.15	
Interest Expense	-	\$0.18 ^{(4) (5)}	
Prop & Gen Taxes	\$0.08 ⁽³⁾	\$0.08	
Total Expenses	\$0.90	\$0.41	
Operating Income	-	\$0.49	
Federal Taxes	-	\$0.19 ⁽⁶⁾	
Net Income to Shareholder	-	\$0.30	

Notes:

- (1) Assumes 12.5% WACC and 2.5% Depreciation
- (2) \$6 in Capital x (12.5% WACC + 2.5% Depreciation) = \$0.90 cents Revenue Requirement
- (3) Assumes Property & General Taxes are 8% of Revenue
- (4) Assumes \$6 in Capital financed 50% Equity and 50% Debt
- (5) Assumes cost of debt of 6%
- (6) Assumes effective tax rate of 39%

Saving \$0.90 in costs vs investing \$6 in Capital at allowed ROE, keeps Customer Rates neutral and can create \$0.30 in Sustainable Earnings

only this amount can be plugged back into capital investments to grow the rate base. Once the rate base grows, so does the allowed return (contingent upon the public utility commission's consent). The result is added value. Figure 5, from the most recent AWK investor report (Q3 2013) provides a numeric example of the relationship.

The example above illustrates that while operating expenses are, indeed, recovered for a net-zero effect on profitability (assuming no regulatory lag, which remains a strong assumption despite improving conditions), capital is better utilized through infrastructure investment because of the way in which expenses and recovery mechanisms align. In fact, the fewer dollars spent on operating expenses (i.e. lower O&M ratio, assuming constant revenue), the more net income will eventually flow to shareholders.

Although states differ in their support for water efficiency, a US EPA circular notes that many states have either voluntary or mandatory efficiency targets and have established dedicated funds to finance efficiency projects (including but not limited to CO, FL, KS, NE, NV, PA, TX, and WA).⁴ It is *not* safe to assume that AWK will see 100% of the value of efficiency gains reflected in customer surcharges in all states. However, federal support for efficiency makes it likely that in a large and increasing number of states, AWK will realize top and bottom-line growth (increased revenues and reduced costs) by means of efficiency investments.

It is interesting to note that while this behavior drives EPS growth, it is not necessarily the most efficient usage of capital from a public perspective. This phenomenon, known as the Averch–Johnson effect, reflects a utility's tendency to expand its rate base, regardless of the optimal level of capital investment. The firm's objective function is to maximize profits by maximizing capital investments and the associated return. The state's objective is to induce the private sector to provide safe, clean water *at the lowest cost to the users and state*. When the firm inflates capital investments, either the customers or state—almost always the customers—shoulder a surcharge in order to generate the utility's allowed return.

We are concerned that AWK's huge capital expenditure campaign, described in (4) next, is an example of the Averch-Johnson effect, suggesting that not all of its capital investments are necessary. However, even if we are correct, it is highly unlikely that AWK will not be reimbursed by the utility by some pricing mechanism. A failure to reimburse AWK would damage the relationship between regulatory commissions and utilities and make it more difficult to attract private sector investment into the water space. Therefore, we see no effect on share price.

4. *Infrastructure Upgrade (\$800mm-\$1bn)*

Performance Appraisal



AWK consistently expands its rate base through infrastructure upgrades. Over the last five years, capex as a percentage of sales remained relatively steady (average 32%, Figure 8).

⁴ United States EPA, "Water Efficiency for Public Water Systems," July 2013.

Moreover, in 2013 the level of investment is on-target to meet the stated goal of \$950mm

Figure 6: Capex as % of Sales, 2008-2013

For the Fiscal Period Ending	LTM					
	12 months					
	Sep-30-2013	Dec-31-2012	Dec-31-2011	Dec-31-2010	Dec-31-2009	Dec-31-2008
Capital Expenditures	(913.5)	(928.6)	(924.9)	(765.6)	(785.3)	(1,008.8)
% of Sales	31.82%	32.28%	34.69%	29.96%	34.29%	43.17%

(between \$800mm and \$1bn). Management is therefore both meeting targets and using capital in such a way as to boost EPS growth in the next few years.

Beyond operational improvements, AWK has also harnessed rate base expansion to abet profitability. The company has improved on virtually all measures (Return on Assets, Capital, Equity, and Common Equity) each year since its IPO.

Figure 7: Performance Metrics, longitudinal

For the Fiscal Period Ending	LTM					
	12 months					
	Sep-30-2013	Dec-31-2012	Dec-31-2011	Dec-31-2010	Dec-31-2009	Dec-31-2008
Profitability						
Return on Assets %	3.8%	3.9%	3.5%	3.3%	2.9%	2.7%
Return on Capital %	5.5%	5.7%	5.0%	4.7%	4.1%	3.7%
Return on Equity %	8.0%	8.6%	7.3%	6.3%	(5.4%)	(13.0%)
Return on Common Equity %	8.0%	8.6%	7.3%	6.3%	(5.4%)	(13.0%)

The upshot of this analysis & discussion is that we are confident that management will meet its targets over the projection period in our DCF (below). However, given the difficulty of building a bottom-up model as a result of the opacity between rate decisions and revenues, the multiples discussion is also of critical importance to the valuation. It is on this aspect that many other brokers base their recommendations.

DISCOUNTED CASH FLOW USING APV

Our DCF (Figure 10) valuation is driven by 7% revenue annual growth. This the lower of management's two goal posts (7-10%), but we believe it is the more realistic. From 1998 to 2013, revenue grew at an average 7.12%. The conformity of history and aspirations gives us confidence in the 7% figure at least until 2020. Thereafter we reduce growth stepwise to a long-term terminal rate of 3.2%, the assumed long-term growth rate of the economy.

The remainder of the model is driven by EBITDA and EBIT margins, which are held constant at the average of the 2010-2012 rate. The choice to base our projections on these 3 recent years reflects (1) the abnormality of the preceding years because of both RWE management and the financial crisis; and also (2) the concept that the cost structure has changed as management invests more in infrastructure and reduces O&M.

The effective tax rate is assumed at 41.8%, the long-term (1998-2012) historical average for the company. Change in capex and net working capital are both calculated by projecting the relevant balance sheet and income statement line items as consistent percentages of sales and then calculating changes year-to-year. This is modified in the case of the capex in that we also add \$900mm of additional investment each year, in keeping with management’s plans.

Most of the remaining assumptions of our APV-based model are clearly presented. For CAPM, our risk-free rate is 5.3% and our market risk premium is 5.4%; these are Aswath Damodaran’s estimates of average rates in the USA. We prefer these figures to current estimates based on St. Louis Fed data because we believe the prevailing rates are exceptionally low and will revert to a historical average. Our beta equity is calculated from historical returns data and an assumption about the most relevant time period.

Figure 11: AWK beta (equity)

Source: WRDS

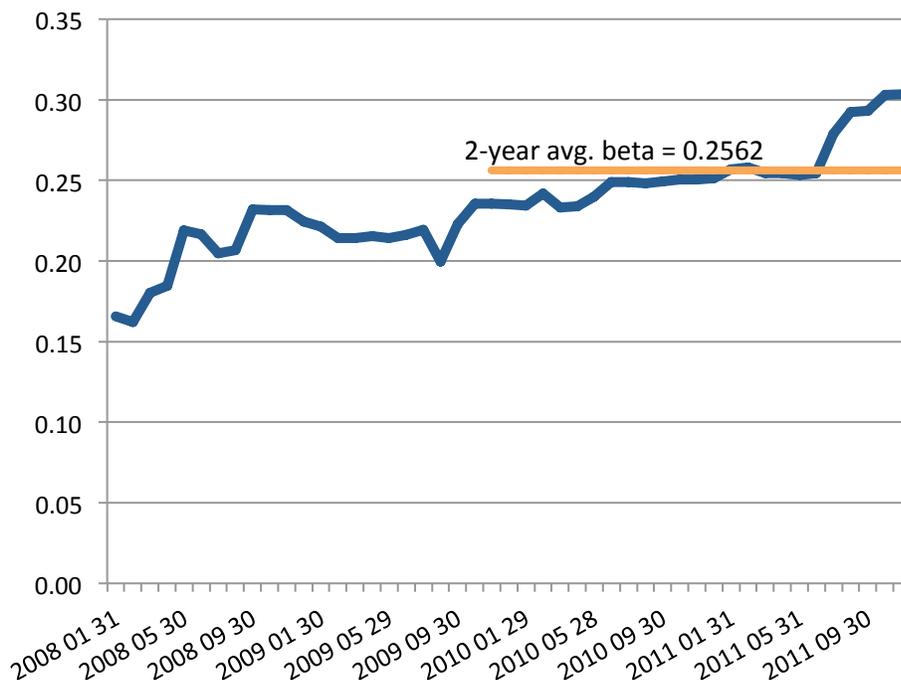


Figure 11 shows that AWK’s beta has been increasing. Due to uncertainty about whether the most recent observed rise is a sign of further increase or a blip that will revert to a previous level, we use the 2-year average beta, which conforms roughly to the plateau from 2010 to mid-2011. This gives us a beta equity value of 0.2562.

Our conclusion is that AWK is worth \$48.41 per share, \$5.2 (>12%) above its recent close. The difference warrants a **BUY** recommendation.

MULTIPLES

From Figure 12 (next page), it is clear that AWK trades significantly below its publicly traded peers on the basis of price-to-consensus NTM earnings. In fact, it has the lowest multiple in the pure-play universe. We assert that this is an unwarranted discount based on historic performance under RWE control and the accompanying shocks of the financial crisis.

Looking at the last five years of consistent, improved performance and AWK's attainable reasonable goals, the company should trade more in line with its peers. As determined above, the intrinsic valuation would place AWK's multiple at 20.3x rather than 18.1x. This would still be at the low end of the multiple spectrum (19.8x floor-Artesian), but our projections in the DCF also used the lower-bound of probable revenue growth. Thus, there is potential upside beyond our calculated price differential. That is, if full convergence of multiples does occur, our target price still underestimates AWK's value.

Although the multiples gap has not narrowed in recent history, (peers have enjoyed multiples that have moved upward, AWK, has done a good job of chasing higher price targets set by industry analysts. In Figure 13, we see that such prices are actually achieved within roughly a year's time. The iterative lag grants the investor predictive power, setting the stage for arbitrage. We are confident that aforementioned stock price behavior will persist through 2014, our investing time horizon.

Figure 13: Barclays Chart of Historical Analysis Accuracy
Rating and Price Target Chart - USD (as of 26-Feb-2013)



Figure 12: Multiples

Trading Multiples Summary

American Water Works, Inc.

(\$ in millions, except per share data)

Company	Stock Price as of: 11/15/2013	Market Value of Equity	Enterprise Value (a)	EV as a Multiple of:			Price as a Multiple of:		Statistics		
				LTM Sales	LTM EBITDA	LTM EBIT	LTM EPS	NTM EPS	LTM EBITDA	LTM EBIT	LTM Dil. EPS
Pure Play Water Utilities											
Aqua America Inc. (NYSE:WTR)	\$25.09	\$4,434	\$6,064	7.9	14.0	19.7	19.8	20.9	433.0	307.7	1.3
American States Water Company (NYSE:AWR)	\$28.55	\$1,105	\$1,415	3.0	8.9	11.9	18.2	20.1	159.4	118.9	1.6
California Water Service Group (NYSE:CWT)	\$22.67	\$1,082	\$1,523	2.7	10.0	16.4	22.0	21.4	152.3	93.1	1.0
SJW Corp. (NYSE:SJW)	\$27.57	\$556	\$895	3.3	9.7	15.9	23.0	22.2	92.3	56.2	1.2
Connecticut Water Service Inc. (NasdaqGS:CTWS)	\$33.37	\$362	\$542	6.1	13.7	19.0	19.5	21.1	39.6	28.5	1.7
Middlesex Water Co. (NasdaqGS:MSEX)	\$21.22	\$338	\$505	4.4	12.2	16.8	21.2	20.4	41.4	30.0	1.0
The York Water Company (NasdaqGS:YORW)	\$20.36	\$264	\$344	8.2	13.0	16.5	27.9	24.2	26.4	20.8	0.7
Artesian Resources Corp. (NasdaqGS:ARTN.A)	\$22.42	\$197	\$313	4.5	10.9	15.3	23.1	19.8	28.6	20.4	1.0
			High	8.2	14.0	19.7	27.9	24.2	433.0	307.7	1.7
			Average	5.0	11.6	16.4	21.8	21.3	134.9	93.6	1.2
			Median	4.5	11.6	16.4	21.6	21.0	66.9	43.1	1.1
			Low	2.7	8.9	11.9	18.2	19.8	26.4	20.4	0.7
American Water Works Company, Inc. (NYSE:AWK)	\$43.18	\$7,698	\$13,360	4.7	10.3	14.9	21.3	18.1	1301.9	897.3	2.0



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