Company Name: Xylem Inc. (XYL)
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<<Unidentified Analyst>>

Okay. So we'll get going again after the break. My pleasure to introduce Patrick Decker, President and CEO of Xylem. Obviously, water is one of the most hyped themes out there in multi-industry right now. I think Xylem takes a lot of the credit for improving the profile of the water space given its ratio on organic growth and M&A track record.

<<Patrick K. Decker, President and Chief Executive Officer>>

Okay. Good morning, everybody. So appreciate you all joining and having interest in Xylem. I thought rather than me droning on for 35 minutes and leaving you five minutes for Q&A. I'd flipped order. I'll only drone on for five to seven minutes, and then I'll take your Q&A because I really want to hear what's on your mind rather than me guessing what's on your mind.

So I'm not going to go through the slide deck. You all have it in front of you. I'm going to leave the one slide up here, which is the last slide of the deck, which is the investment thesis. And certainly, I'm sure you'll be looking through the slides, you'll have questions, and certainly, fire away when we get to that point.

I want to start with this slide because this really has remained true over the last few years since I've been here. And that is, we really do think that we've got a fairly powerful and unique investment thesis around Xylem, which really is not specifically tied to the water theme, but it is the fact that at one level we do benefit from playing in attractive end markets that do show growth over the long term.

Secondly, we put in strategies and we feel good about the strategies that have been driving faster than market growth. We can speak more of that in a moment. Something also unique to Xylem is, you'll remember that I talked about our self-help story on the margin side, which we are still in the middle innings of driving margin expansion and some opportunities in areas that we are quite proud of. But there is a unique margin expansion theme here as well.

We are a company that has begun to demonstrate very consistent attractive cash generation and cash conversion, which is certainly a powerful part of the thesis. And then lastly, we've been accelerating what we believe to be pretty attractive and smart capital deployment, whether it be smart M&A to build out the technology side of the portfolio or whether it be returning cash to shareholders by way of dividend increases.

I just want to spend a few minutes here touching on four of our top strategic priorities that being: what we're doing to drive commercial leadership? What we're doing to accelerate growth in emerging markets? What we're doing in the area of innovation and technology? And then where we are on the journey of Continuous Improvement or what we call CI.

First, on commercial leadership. I know as I was standing here last year, the single biggest question that people had in their mind was, at what point in time does the growth miracle occur for Xylem? You're talking about a long-term growth rate of 4% to 6%, but we haven't seen that since the time you spun out of ITT. And we were looking at about 1.5% growth in the first half of last year, that accelerated to 6% organic growth in the second half of the year, and orders outpaced organic revenue as we build backlog.

And then, we grew 7% organically in the first quarter. We're outlooking 4% to 6% organic plus another 2% of acquired growth from the Pure acquisition, so in that kind of 6% to 8% reported revenue growth. And more importantly, we saw orders growth of 10% in the first quarter. And that was growth across all of our end markets and all of our geographies. And so we are very pleased with the progress we made there.

Secondly, each of the acquisitions that we did, whether it be Sensus back in late 2016 or whether it be recently the addition of our Advanced Infrastructure Analytics platform, centered around Pure, each one of those acquisitions have performed in line with our expectations, both top line as well as our bottom line, including cost synergies.

Shifting to emerging markets. You may recall that when I first came onboard four years ago, I referred to the fact that while we already did about 20% of our revenue in emerging markets, that cut across about 55 different markets. It was almost like a composite index for emerging markets. We really were not focused in on a handful of critical markets and regions. We now are. Our priorities are predominantly China; India; the Middle East; Southeast Asia; and on a growing base now, certainly looking at opportunities in South America.

We've really been focused on localizing the products and services that we have so that they are designed for those markets, in those markets. And we've made fairly sizable investments in our R&D capabilities and commercial capabilities. We're also seeing, obviously, terrific market demand, especially given the fact that in these markets, these are top policy mandates around water quality and environmental quality that is driving improved market demand. So we are expecting to continue to see double-digit growth in those parts of the world and high single-digit growth in emerging markets overall.

On the innovation of technology front, again just sticking with the metrics and the facts, our Vitality Index, which is a measure of that percentage of our revenue that is coming from products that were introduced in the last five years, increased 500 basis points this past year from 19% of our total revenue to 24%. The revenue coming from those products is growing between three to four times the rate of the rest of the portfolio, and the margins are around 50% higher than that of the rest of our portfolio. So we are now beginning to really see moves in innovation technology.

We're also using M&A as a proxy for R&D. So many times, the technologies that we're looking to bring into the portfolio, IP already exists around them. So we need to find ways to either partner with the owners of the IP or actually acquire them, and that's really what's been driving some of the activities you've seen here in the last couple of years.

Lastly, on Continuous Improvement. The self-help story continues. For those of you that may not be as familiar with the story, these businesses when spun out from ITT back in 2011 had all been managed as separate stand-alone businesses. And there had been little horizontal integration of back-offices and other things. So we've been on that journey the last four years. We have delivered a consistent 10% compounded annual growth on our productivity savings over the last four years. That's expected to continue. We've committed to $116 million of productivity savings this year. That is the midpoint of the guidance that we gave in our Investor Day last April and that too represents a double-digit increase year-over-year.

And we're now at a phase of our productivity journey where we are focused on what we call Global Business Services. This is really the next phase of integrating and outsourcing a fair amount of our back-office. So finance, IT, HR, parts of procurement. We're partnered with a company called Cognizant, that's helping us on that journey. This is a long-term journey, and we expect to see benefits begin to get realized, mainly in the line of G&A, beginning in really 2019 and 2020.

Lastly, in that area of CI is a focus on working capital. So when we started this journey about four years ago, our working capital as a percentage of revenue was close to 26%. We are now down to 1+9%. That helped drive a free cash flow conversion of 147% last year, and we're committed this year to at least 115% and expect us to have that kind of cash generation and conversion over time.

Last comment before I open up for Q&A is capital deployment. Our priorities there remain unchanged. It is first to invest in organic growth. Having said that, this is not a capital-intensive business. We only spend between 3.5% to 4% of our revenue in CapEx each year. Secondly, is to continue to look at smart M&A, and I can certainly talk about what our priorities are there in Q&A. Third, is to return all the free cash to shareholders by way of increasing our dividend in line with EPS growth, and right now, that will be in the high teens. And then, even yet again, we have cash remaining at that point in time for other ways to get cash back to shareholders if that makes sense.

So with that, let me pause, and I would be happy to open it up for any questions you’ve got.

Q&A

<A – Patrick K. Decker>: Yeah Dean.

<Q – Deane Dray>: Patrick, good morning.

<A – Patrick K. Decker>: Good morning.

<Q – Deane Dray>: We'd love for you to first start talking about your opportunities in these new smart water networks. By our estimation, you're basically at the starting line. You've got some interesting pilot programs set up. And if you just touch on what you see the biggest opportunities? I'm really interested in your pricing model, in the opportunity to get paid for the kind of cost savings that the – your utility customers will be realizing from these for the first time? So rather than just doing a SaaS licensing model that would dramatically underprice the value that you're creating so broader – whether did the smart water networks. And how do you go about valuing and pricing this so that you get paid for that value creation?

<A – Patrick K. Decker>: Sure. Terrific question. So for those that may not be as close to the water sector, the water story, there are a couple of big – so we're really talking right now first out around the water utility, which is about 50% of our revenue. We also played industrial and commercial buildings and resi, but this is really right now around the utility. And there are a few critical pain points about the utility space right now, which really is dealing with the issue of water affordability, not just for the utility themselves, but also for the ratepayers, the people actually paying for water such as us. But it's also an issue of water scarcity.

And so one of the biggest pain points of water utility is what's called nonrevenue water. And if you simply take the – and this is an issue that face – that both utilities and the developed markets and the developing markets face consistently. If you take the water that is produced at a treatment plant that is then put into the clean water distribution network and you apply that number of gallons, you apply against that in a given day or week or month, what the approved rate is from the regulator, that is what we call entitlement.

In a perfect world, when the utility measures what they ultimately bill and collect at the end of the stream, in a perfect world, it'd be 100% of revenue for that water produced. Well, it's not a perfect world, it's far from a perfect world. And the average loss, it ranges anywhere between 25% to 60%, it's a massive issue for the utility. That's one pain point they have.

I'll come back to that in a moment. The second is what's called combined sewer overflows or storm water overflows. And it's happening at an increased rate where with these dramatic weather events, you're seeing a sewage backup, sewage overflows, it's a big issue, not only in the U.S. but around the world. Here in the U.S., the EPA is all over this, and they are mandating that Works Departments in cities and utilities make significant capital investments to be able to address that.

The issue is the money does not always exist, and it's hard for them to get this built in their rate base. So taking those two problems as you will note, Deane, there are a number of technologies that now exist to be able to help the utility address that issue. On the nonrevenue water side, there are three big drivers: its leaks in the pipes underground; its people hijacking water off the network; and third, it is inaccurate metering and/or leading to inaccurate billing.

Those are the three big drivers of the nonrevenue water issue. We now have technologies in our portfolio holistically that we can have those conversations with utility holistically and let them know, we don't know until we get into work with you, which of these three drivers are the biggest driver. But we're going to help you understand that, that you're not throwing good money at bad. I could go on, Deane, for hours on this issue, but that being one.

The second is we have technologies now with our EmNet acquisition that can work with utility to help them optimize their existing sewer network so that in the event of a storm event, they're actually able to fit the system, the network is actually able to self-regulate itself and optimize its current form to avoid large capital outlays that are oftentimes required to add capacity to the network.

Well, in both of these areas, clean water and the wastewater side, we're going to be helping utilities avoid significant capital outlay. And so the Deane's question, how do you put revenue on that besides a classic consulting fee or SaaS model? We are in this – we've been in this for 45 days. We're studying it as we speak. We are working with a number of pilots, including looking at different revenue-generation models with utilities. And we're targeting on those utilities that are most advanced in our thinking and will be more creative with us on how do you think about pricing this. So there is more to come, Deane. But this is something that is absolutely top priority for me and my team.

<Q – Deane Michael Dray>: Great. Just a quick follow-up. I appreciate the comments on highlighting the free cash flow because there was one time you were barely 90% and made this a priority. If you'd just clarify on the sustainability of the free cash flow conversion at 115% or higher, you mentioned working capital, but can you just size for us the impact of organic revenue growth and margin improvement on the free cash flow?

<A – Patrick K. Decker>: Yes, so we – when we look at the opportunities to continue to expand our cash conversion, they really fall into a few key areas, as you mentioned, Deane: one is, we believe that even though we're at 19% of our working capital as a percentage of revenue, we expect to get that down to at least the mid-teens over the next couple of years. That in and of itself will continue to drive free cash flow conversions at that level.

Secondly, when you look at the portfolio and how we are reshaping the portfolio, the businesses that we brought in, whether it be Sensus or Pure, have even more attractive cash profiles than the legacy Xylem business. And that's really by way of the types of contracts and deployments they do and the billing strategy we have in terms of getting significant advanced payments on those businesses, which is always helpful.

And then third, when we look at our incremental margins that we've modeled over time, you'll see a healthy level of incremental margin that falls through to the bottom line as well. So those three things are what we see as really sustaining cash conversion at that level.

<Q – Clifford F. Ransom>: Patrick, Cliff Ransom. First of all, thank you for finally making me right in my 35 years of recommending a water industry where really no one has ever been successful as a stock.

<A – Patrick K. Decker>: Thank you.

<Q – Clifford F. Ransom>: The list of people that flunked is quite amazing.

<A – Patrick K. Decker>: It's a team sport.

<Q – Clifford F. Ransom>: I got it. But what specific things as you came into a company that didn't understand how Conley [ph] had fussed around with Kaizen.

<A – Patrick K. Decker>: Yeah.

<Q – Clifford F. Ransom>: What was it that made this first couple of years so dramatic as you look back on it? And there is a follow-up question.

<A – Patrick K. Decker>: Yeah.

<Q – Clifford F. Ransom>: What really you'll have to change over the next three years to be as successful?

<A – Patrick K. Decker>: Yeah. So you know the – so I would start with one of the frustrations that I think that investors had back at the time of the split from ITT, and certainly, when I joined back in 2014, frustration even on the part of our board was, Let's Solve Water is a great tagline, but it's not strategy. And the water sector is littered with people that have tried to grow and make money, but you really have to pick and choose your spots. And so we spent the better part of the first nine months that I was here going through some very extensive, we call, value mapping of the water sector looking at 22 different subsectors of the water space through the lens of the actual producers of water or the users of water to understand which one had the best growth rates, the best margin profiles and map that against our existing portfolio. And that's really what led to some of the inorganic moves that we've made, but also where we prioritized our R&D investments internally.

As you mentioned, Cliff, this is all a change journey and that's where we really anchored it and what we call Continuous Improvement. When I first got here, we had it in pockets.

But it was really a few pockets that you would see Lean or Six Sigma or other tools being deployed. But as you probably said before, Cliff, it was like wallpaper. I mean it will get on the wall. But when you ask people, when is the last time you worked in a project? Well, three years. Okay, well, that's not Continuous Improvement culture.

And so we embarked upon how could we change the culture through the adoption of a Continuous Improvement mindset knowing this is going to be a multiyear journey. As you said before, Cliff, you never actually get there, and you just got to continue to drive leadership around this. And so one of the programs that we're most proud of is we took our top 300 leaders over the last 18 to 24 months and put them in groups of 20 out at different locations, working on a real-live business challenges that could be a margin issue, a working capital issue, something in the customer service department.

And my view was rather than sending them off to some case studies somewhere at universities, let's actually have them work in on real stuff that actually pay for the trip. Let's actually make money while we're doing this. And so that live action of them actually doing the Gemba Walk actually out there where the work is actually happening really began to fuel a change in leadership mindset when they realized how powerful this was to engage our people in the frontline. And you just continue one foot in the front of the other, keep doing that.

And look, we've changed that close to half of our leaders over the course of the last four years. And at the end of the day, this is not something you opt in or opt out on. If you have the privilege of being a leader in a company like this, there's expectations that come with that and that's been part of the journey as well, Cliff. What we do to keep going is the leadership side, just continue driving it deeper and holding our leaders accountable. But we are so in the early innings, as you know, Cliff.

<Q>: Patrick, so as you build out the technology platform, like how much is too much in terms of tech given that most of your customer base even if it's a really interesting technology, is it very slow doing that something like that? And then more on the macro side, separate question, what has to happen to enable kind of more large-scale private financings into the CapEx world? I mean, things like really long approval processes and inability to drive price like is there some sort of catalyst that you can look for? Or is there something that we need to see before you can incentivize like bigger private money to come in?

<A – Patrick K. Decker>: Sure. So on the first question, I think it is important for me to reiterate the fact that when you're dealing with customers in the water space, whether it be the utility, whether it be industrial uses of water, commercial buildings, while they are in the early stages of understanding the power of data and intelligent solutions, the reality is there are a lot of people that talk a good game about being a consultant or we're going to bring in this software off the shelf, we're going to give you loads of data, that all sounds great when you say it real fast. But the bottom line is they want to deal with people that have subject-matter expertise around the actual physical equipment that they are trying to make smart.

So once the utilities, example, gets the data, unless they're actually still working with the person who actually is building the physical network, it's no good for them. They need to know what to do with it. And so I start with that, Joe, because I would want everyone to understand, including those from Xylem that might be listening in, this is not about moving away from hardware to software. This is about overlaying software on hardware to make it smart.

And so we will always find – strive to find that right balance in terms of how much of the soft side do we have embedded in our revenues. We would estimate that right now it's probably about 20% of our total revenue is either through connected devices or some type of a SaaS model. I certainly want to significantly accelerate that. But I never envision this being surely a data-driven, technology-driven SaaS kind of business model, no way. We need to be deep subject-matter expertise around the equipment as well.

On the affordability and funding, that's the billion dollar question. And so it differs by utility, it differs by country. And the emerging market is a bit easier to get the financing to flow. It's top policy mandate. And therefore, they're putting money behind this in China, India, the Middle East, et cetera. In Europe – in the case of Europe, it's less of a financing issue and that they've typically done a better job of maintaining their water infrastructure over the long run. So they don't have this kind of from guardrail to guardrail, pulling back, heavily investing like what you do here in the U.S.

So really, it's predominantly a U.S. issue. And in that regard, we're certainly trying to do a lot of work around helping people understand the power of a P3 model, public-private partnership, as one way of financing. We do not believe that there is going to be some big federal infrastructure build that targets the water sector. I wouldn't encourage any of you to be investing in that thesis. And so this – the good news is, this is a long-term play. And therefore, you see steady growth in the utility sector over the long run because all the money does not show up at one time, and that actually is a good thing for the investment thesis.

<Q>: Hi, Patrick. I'll start with the first question on the margins here. The 400 to 500 basis points by 2020 is a little bit backloaded and it sounds like you have a big step-up coming in the G&A savings. Can you talk about the ground work that's been laid there? Any targets you can give us on G&A you guys were making as percent of sales and to watch the share sales and how that progresses?

<A – Patrick K. Decker>: Sure. Yes. So when you look at our margin expansion story, it really is driven by four different layers and I almost wish I had a elaborate chart which is going to show you how each one kind of phases in and where we are in each one of them. So I'll do my best to kind of voice over that. So there's about a 100 basis points of our margin expansion that comes from the incremental margins on our organic growth that we've targeted in that long-range plan. And those incremental margins we've modeled at around 25% to 30%, which is below our historical average of 30% to 35%, and that's specifically because of the mix of that revenue, and we're seeing that this year in terms of

a heavier portion of treatment business as well as in emerging markets, both of which are project orientation. And therefore, we will get project-tight margins right now and next year until 2020, we'll be getting next year and onward, then you'll start to get the aftermarket, very attractive aftermarket margins that flow through on that part of the business.

Second driver is the productivity that we've been driving, which is predominantly driven by procurement as well as our Lean and CI deployments. I would say there, we are in the middle to later innings of the procurement side because the teams have done a fantastic job, they are squeezing stuff out of the lemon. That will begin to kind of flat line within next probably couple of years, but we still have a few years left of that. But we are in the early innings on the Lean deployment and the Six Sigma deployment, and so that will continue to ramp and there's about 150 basis points of margin that comes just from productivity over that time frame.

The third area is the synergies that we committed to with the acquisitions, that being predominantly Sensus. Those hit our margin last year and this year. And that's what drives a meaningful part of our margin expansion second half of this year. And we're very confident we'll deliver on those synergies this year. And then, the fourth bucket is getting out the G&A through Global Business Services. And so the groundwork lay there is, we brought on board about 18 months ago a gentleman that had followed Mark Rajkowski, CFO, over, who had driven this program at MeadWestvaco and, prior to that, at IBM in Europe, and so has extensive experience in how do you take a largely decentralized sort of back-offices and put them on a common platform. I'm not talking about one ERP system, but a common platform that you're then able to begin outsourcing meaningful chunks of that work.

For example, today, in an organization of 17,000 people, we have 840 finance people. Now I lost finance, but 840 people that are predominantly a big chunk are working on things like payables, payroll, heavy transaction processings, important works, but in today's world not working typically own internally and insource, that's just one example of what we are addressing, including our IT perform. So that work is already underway. We expect to begin to see a little bit of savings later this year, but it really begins to ramp up in 2019 and 2020.

What we've committed to externally is somewhere between $60 million to $75 million of cost savings on a recurring basis, and the large majority of that would actually come from our G&A line, which today is just north of 8%, and we believe that should be down around 6% of total revenue.

<Q>: And my follow-up, we were talking last night about the limited number of very important decisions that a CEO makes. I wonder if you could talk about what you think of those limited number of very important decisions that you're going to have to make over the next couple of years.

<A – Patrick K. Decker>: Great question. So for the rest of the audience, we were having a great conversation last night around. There's a lot of things that a CEO and their team can gets attracted by and spends your time on what seems important in the moment, but when you look back over the course of the year, you realize there's probably only about six to eight big, big decisions that only you could make, you can delegate. And so keeping your eye on that, but also keeping your energy level on the right spot so that when they come along, you know them, you recognize them and you try to make the best decision you can. It was in that context that I think, Nate, your question is coming. It's always around the portfolio. So do you have the right assets in the portfolio or not? Just always what you're adding, but how you're shaping these things together and are they working in tandem to the extent they should be? And if not, are there changes in the portfolio, but more importantly, are there changes in your structure? And the way you go-to-market is certainly one of those.

Secondly, is around this whole notion of, with the platform of analytics that we built right now, our biggest opportunity and our biggest challenge there is how we both won scale the support of that business from a software development and data analytics perspective. So we'll have 20 of these locations around the world working on their own stuff. So we're building centers of excellence that will do that across the company. But getting that to scale is going to be top of mind for me. And then the question, certainly, that Deane had raised around, what is the optimal revenue generation model for these disruptive capabilities that we're bringing to market? and how we get the right billing structure right on that is going to be certainly top priority for me.

And then I would say, lastly, you're always evaluating your leadership team, your leadership structure. You always have people that are retiring or -- at different levels of the organization. So managing the succession and retention in the organization, especially when you are a company and this is not just something at all because we have a lots of too in front of us. But there are people that are looking at our talent now. And so you've got to make sure that you're taking care of your people because at the end of the day, happy employees make happy customers. And so you've always got to be thinking about what you're doing on the culture side of things to make sure you sustain it.

<Q>: Patrick, maybe a question here over e-mail is really on pricing.

<A – Patrick K. Decker>: Yeah.

<Q>: Maybe short-term, just how you see that delta of price versus various types of inflationary cost pressure? And then longer-term, there is obviously a bunch of changes underway in your portfolio as well as the water industry.

<A – Patrick K. Decker>: Yeah.

<Q>: How do you see you own approach to pricing changing looking out over the next five years?

<A – Patrick K. Decker>: Yeah. So, we go out every year with our annualized price increases and so we did that back at the beginning of the year. And then as we began to see a little bit of uptick in some of the input costs, in our case, it's less around steel, aluminum tariffs that have virtually minimal impact on us. But it was more – we see an increased demand for electronic components in our, what we call, MCS segment and a little bit of pressure in some of the other parts of the supply chain, but it was really in that area that we saw.

And then two, in anticipation of what might be in other tariffs depending upon the day, we decided at that point in time to go ahead and go out with a second round of price increases back in the March timeframe and are doing that even as we speak pretty much across all of our business lines to get ahead of it.

And historically, as we look back at this, we were trying to get a good feel for where do we have pricing power in the portfolio. And we're actually in quite a good spot across the portfolio. I mean there are a couple of pieces that represent maybe 10% of our revenue that are a bit more challenged in terms of being big at price. But in those areas, we are unique and that we still have a lot of self-help margin opportunity to mitigate that.

But across the rest of our portfolio, whether it be in the utility side or in the industrial or commercial building side, for various reasons, historically, we've had good pricing power in a period of inflation. That's not been the case the last few years because we've not been in an inflationary environment. But certainly, when we look back at 2011, 2012, these businesses were able to largely offset inflations in price. And that was before we really even had a big productivity program underway.

So that's what gives us the confidence that inflation really will not have a meaningful impact on our net margins at the end of the day. I think as we go forward, both in the utility space as well as in the industrial space, what I like about the combination of adding the analytics platform, which today is only – that new platform we built is only about $130 million of revenue. So our opportunity there is scaled by dramatically over time, but then also serves as a very nice moat around the rest of our legacy Xylem portfolio from a pricing standpoint because of the extra value we're bringing to the conversation.

Therefore, we don't have to play as much on price to be able to sustain that business. And then, I would say secondly, certainly the industrial side of our market has historically been willing to absorb price increases. They get it. As long as you have good story, they understand you're being consistent. And we're market leaders in most of our categories. And so we have to behave like the market leader and go out and get price. And we are seeing that our competitors for the most part are following.

<<Unidentified Analyst>>

I think that's it.

<<Patrick K. Decker, President and Chief Executive Officer>>

Thank you all very much.