Xylem Inc.

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Scott Davis: We have up next Xylem, and Patrick Decker, who's President and CEO, is kind enough to be here. And lots going on with Xylem, a big recent acquisition, which certainly looks interesting that we'll get into, and [plays] a lot of the trends that many of us are favorable towards as it relates to infrastructure and such.

Scott Davis: So, Patrick, I'll do what I've done with some of the other corporates, and we'll just start off with what are you doing differently in 2017 versus 2016? What does the Board have you focused on? What do you have your team focused on?

Patrick Decker: Sure. So, first of all, thanks, everybody, for joining. I know it's a busy day, long couple of days here, so I appreciate the interest.

I'd probably start with we came out at Investor Day a little more than a year and a half ago, September of 2015, and laid out some, I think, pretty compelling long-range goals for the Company. We talked a fair amount about larger-scale capital deployment. I know that was something that you had been looking for and pushing for for some time.

And so, I would say one of the things that we're doing differently in 2017 is executing on the large acquisition that we did of Sensus in end of October of last year. We had talked at Investor Day a year and a half ago that we believe that, over the course of the next three to five years from then, we would, after investing in our operations, we'd have north of $3.5 billion to $4 billion of a capital arsenal that we could put to work either in terms of M&A and/or share repurchase.

Well, we used half of that on the Sensus acquisition, and what I've been so pleased by is the incredibly attractive cash profile and growth profile that Sensus brings. What you're going to hear us talk about our Investor Day coming up on April the 4th in Raleigh-Durham, which is where Sensus is headquartered, is that that acquisition and the synergistic platform it brings with us, gets us right back into the same level of capital arsenal, $3.5 billion-plus, that we had before we even did that transaction. So, it really begins to build off itself.

So, the first thing we're doing differently this year is we are laser-focused on integrating Sensus into Xylem, capturing compelling cost synergies, as well as very compelling growth and revenue synergies from the application of technology. The things that are not different, that are not changing, is we are still very steadfast, focused on our margin expansion story and our improvement in our return on capital. We laid out a roadmap a year and a half ago that, over the course of three to four years, we would improve our operating margins by 300 to 400 basis points. And I'm happy to say that we are well ahead of pace in doing that as we go through what would now be our second year on that roadmap.

And I think we're still poised in our legacy Xylem businesses to continue to outpace the market. We're facing some challenging markets right now, but we are certainly gaining share in the majority of the markets that we're competing in.

Scott Davis: Let's back up a little bit, and I know we've got a number of people that are on the webcast, and a variable group of people in the audience. We have a lot of generalists and portfolio managers. Help explain to folks that are here, at least, what Sensus is and how it adds to the portfolio, where there were product gaps and such, and where you feel comfortable. And then, maybe just a 30-second pitch of what Xylem really -- what you're good at, what you think the core competencies are.

Patrick Decker: So, when I joined three years ago, we had done a lot of work for the best part of the first year I was here on mapping the market spaces that we currently serve, but also the white spaces that were out there, good old-fashioned value mapping work. And coming out of that, one of the most compelling areas that we saw that was high-growth, high-return, really addressing customer pain points, was in the whole notion of smart infrastructure in the water space.

And that's not just through utilities. That's also through the users of water, industrial users, commercial buildings, et cetera. And so, we embarked, both organically and inorganically, on this path of how do we accelerate building out basic systems intelligence capabilities, along with data analytics capabilities, to be applied in the water space. And we were doing that organically, but as you can appreciate, that always takes longer than going out and acquiring it.

And the timing happened to be very much to our fortune, as well as evaluation, that the Sensus opportunity was coming along. It had been previously owned by a combination of Goldman Sachs and the Jordan Group, long-held private equity. And the timing worked out perfectly that we were able to go in there with certainty of financing, not being competitive, and so go it at a really good valuation, about 10.5 times EBITDA. Great technology that Sensus brings with it.

So, historically, Sensus would have been seen as a traditional metering player in the water, gas, and electric utility space. But, over the last several years, they had begun to embark as the market had moved towards more advanced metering, smart meter design. They leapfrogged that and began to build out their own dedicated telecommunications platform. It's branded FlexNet. And I won't bore you with the details. We'll go through that at Investor Day as to why that's a competitive differentiator.

But, in addition to that, they went out and acquired a data science, data analytics businesses a couple years ago, and they've been seeing growth rates in that 9% to 10% here [at] the last couple years, and continues to grow that way this year. So, a lot of excitement there. What it does for us, Scott, is we are large players. We're market leaders in the wastewater side of the public utility market, and we have a great presence in what we call the outdoor surface water market. Where we've never really had a strong position is in the clean water network, the distribution side of the network, which is where Sensus plays today.

We have a lot of customers that are in common, utilities that manage both clean water and wastewater, where they've already made an investment in this telecommunication platform. and now, it's a matter of connecting our devices on the wastewater side and the outdoor water side, and bringing the data science capabilities with that to really grow out that software as a service business, but also to be able to pull through a number of our hardcore equipment on the Xylem side through those utilities, as well.

Scott Davis: Can you give an example of how, technically, that really works? If you take a water authority in the US, what data do they really want that connects the -- I love how you refer to it, the dirty water and the clean water side of it. What data connects the two that's relevant? Is it more around loss ratios and (inaudible) quality?

Patrick Decker: Yes, there really are a few different pain points that a customer in a water utility faces. The single biggest cost they have is labor cost. This is beyond the capital investment. But, the operating expense is the labor cost. So, anything you can do to help them minimize unnecessary truck rolls of going out and actually doing a repair or a fix or an inspection is valuable to them. I'll come back to how we address that in a moment.

The second is energy cost, energy consumption. What many people don't realize is that several percentage points of the world's greenhouse gas emissions and the energy that is driven by that consumption comes from the water industry. So, it's a very energy-intensive industry. And so, any data that you're able to pull together and be able to do either predictive analysis of equipment failure, of energy consumption, how to optimize that, is very valuable to a water utility player.

The third, which you could argue is the biggest pain point the utility has, is a term commonly used in the water industry called non-revenue water. So, in the US, about 24% of all water that has been treated and is available to be consumed never gets either effectively to the point of use. It's maybe not appropriately metered accurately. It's leaking. It's being hijacked. There's a whole variety of reasons why it's never turned into a revenue for the utility.

And so, we'll demo -- we have a great demo that we'll show on Investor Day where we have now combined the data analytics capabilities with the software as a service module, where you've got a simple user interface on a utility operator's iPhone, iPad, or their desktop that will show them real-time where there have been a series of water main breaks or bursts in a network. And they're able to determine whether it is worthy of a truck roll, is there a non-revenue water issue being created. It's giving them real-time analytics to be able to work with.

Scott Davis: That's interesting. I want to go to the ARS system, because I'll forget. This is the last of my sessions for two days, and my head is starting to spin. But, let's go -- love it if you all could vote and participate here. Do you currently own this stock? And I think everyone knows how to vote by now, so grab one of those happy devices.

Patrick Decker: And I assume it's anonymous, so I don't know who says they're over-exposed.

Scott Davis: It is completely anonymous, except I'm going to do a fingerprint analysis and find the guy who's been voting less than 10 times earnings. Some of these guys know what I'm talking about, what I'll show you in a second.

Okay, interesting. Okay. So, the answer is yes for about -- call it a sixth or so of the group. That is not an uncommon answer. We've [heard] that for two days, so an awful lot of folks down here that don't own the names, which is good.

Patrick Decker: Well, you've all chosen the right timing to come in.

Scott Davis: Yes, exactly. So, question two, and we're going to talk about that in a second. What's the general bias towards the stock right now, positive, negative, or neutral? Let's vote on that.

Scott Davis: That's at 2.5 to one on [the negative]. That's not a bad ratio. Okay, and question three. In your opinion, [through cycle] EPS growth, Xylem will be above peers, in line with peers, or below peers. Let's vote on this one. That's actually a pretty good ratio of above peers to below peers, but then doesn't really match up with the sentiment as much in the previous slide.

So, let's talk about that. Your stock has lagged lately. It's been a fantastic stock since you've been on board, really, I think.

Patrick Decker: Thank you.

Scott Davis: Forget what the percent of change has been, but it's probably close to a double or something. I mean, it's really been a great stock. Well, we were there for some of it, and I made the mistake of downgrading it, then I ended upgraded on time. But, you've lagged, and that makes it interesting for I think all of us, that if there's something there in the story.

So, talk to us about some of the end markets that have been troubling, and some of the kind of air pocket in municipal spend that you referred to, and give us a comfort level that -- of duration, or what exactly -- what dynamic is going on?

Patrick Decker: Yes, so I'd have us focus really on three primary end markets that really define Xylem. First is the public utility space, and of course, now with Sensus, that's a larger exposure than we had before, which is a good thing, but slightly different dynamics. And so, if I set aside Sensus for a moment, which that metering market and certainly what they're doing on the software-as-a-service side, that business we expect is going to grow at least 6% to 7% this year coming off a couple years of 10% growth. And that's without any revenue synergies that we would be driving there. So, that's going to continue to be a very solid story for us.

On the historical Xylem piece, a public utility, we did hit an air pocket here in the fourth quarter, and we called that for Q1 where we've been really flattish against the backdrop of very aggressive growth the last year or more.

So, we're calling the public utility growth this year globally in the low to mid-single digits. That's off of the backdrop of 17% growth last year in the US public utility. I think roughly double-digit overall globally. So, part of that's simply just lapping a tough compare and normalizing. And so, that continues to be a very healthy industry. We continue to see increases in our bidding pipeline. It was up double-digit in the last quarter. So, it really is a matter of timing.

I do think there is a little bit of wait-and-see right now on the infrastructure side, and localities looking to see whether they're going to have to fund projects or it's going to come from the state or federal level. That happened last time. Eight years ago, when the former president talked about an infrastructure bill, but it's all still very net-net positive sentiment for us reading through that.

On the industrial side, we are saying we're going to be growing low single digits this year, I'd say flat to low single digit this year. And there, the big chunk of our revenue in that market is really tied to light industry, which is really kind of a 2% to 3% steady annual growth. It's a replacement business. The part that's really been continuing to weigh on us is that part of our business that serves the oil and gas and mining piece, which is not a large percentage. It's only 5% of our revenue, but it continues to have very difficult comps there as we go forward.

Commercial building's going to be in that low single-digit range for us, as well, again pretty steady business. So, we're calling this 1% to 3% growth this year for our historical Xylem business, and then overlay on top of that 6% to 7% growth for Sensus, and that gets you into our guidance range of 2% to 4% for the year.

Scott Davis: Let's go to the next question on the ARS system, please. In your opinion, what should Xylem do with excess cash? Which is interesting, since you did a big transaction. [Let's] hear what people's response is going to be. So, let's vote on this, please. We'll be able to build a time series here. Been doing it for about six years. Well, debt paydown seems [somewhat natural], just given the acquisition that you did.

Remind us -- I think I've had 22 presentations the last couple days that I've been at, and my head's, as I said, spinning, but remind us of where you want your debt ratios to be.

Patrick Decker: Yes, debt ratio should be -- so, investment-grade, which for us would be around roughly 2.5 times EBITDA. We were up just above three, again, the way the agencies look at that. With the cash profile that we've got from Sensus and the great cash conversion we've got going on in Xylem right now, we're comfortable we're going to have that back in line by the end of this year and still be able to -- we increase our dividend. We have been growing our dividend 10% per year for the last number of years since spin. We just took that up to 16% here this past quarter. So, it really should demonstrate the confidence we've got in our cash conversion and the ability to pay down that debt, and then get ourselves back where we wanted to and still have that capital arsenal do to smart M&A.

Scott Davis: That makes sense. Can you help us understand? And not everyone in here is going to be intimate to your story, but help us understand the currency exposures you have and how you think about -- historically how you've booked profits and such has impacted your currency translation maybe more so than most. And are there ways to think about mitigating that, or does some of it have to do with the US tax rates and how things change that you can adjust your currency exposures based on what happens with tax rates and such?

Patrick Decker: Yes. So, we've historically been probably a bit more exposed to currency movements, just given our global nature of the business. Certainly part of that profile changes considerably with the Sensus acquisition, given its heavy US concentration and its relatively high level of profitability. So, on an overall apples-to-apples basis, that's going to help mitigate some of that exposure for us, going forward.

But, one of the reasons why we've been a little overweighted in terms of currency exposure is we've got historically, before the Sensus acquisition, we had about 40% of our revenues, and a little more of that of our profits, in Europe. And we have a very tax-efficient structure in Europe for our European supply chain. So, we've got a heavy euro-dominated exposure there, seconded only by a Swedish kroner exposure, and I would say to some extent right now a sterling-pound exposure, because we're right in the middle of a five-year infrastructure investment program in the UK. So, we've got a higher level of profits going through that currency than we would normally do.

But, it's manageable for us. We do a lot of hedges on our FX transaction exposure. Some of that is internal hedging activity, and then we do some external. We've done a pretty good job of managing that, and we do have a pretty flexible global supply chain. So, we're able to move our production and volumes around as need be, and I know that's on people's minds as it relates to some of the tenets of policy that may be coming out of the new administration, what that might mean for us. And we don't feel as exposed to that kind of challenge as people might think we would, given our supply chain.

Scott Davis: And based on what you've heard out of Washington or some of the preliminary infrastructure, I've seen a list of projects, but I haven't spent much time on it yet. What does water infrastructure to the government look like? Is it more about Southern California and some of the drought-exposed areas, or is it more about clean water? Is it more about decreasing loss rates? I mean, how do they think about that?

Patrick Decker: So, we were part of a founding group about almost two years ago now called the Bipartisan Council on Infrastructure out of D.C., and it was eight different CEOs of various public companies, and a couple private companies, and it runs the gamut from S&P to CalSTRS to companies [theirselves], FedEx, others. And it was generically focused on the infrastructure deficit overall in the US.

It quickly became a conversation around beyond just airports, roads, and buildings to water. And even within that council, there was not a lot of knowledge coming in as to how critical the water infrastructure gap was to be sustainable. And so, it quickly began to move and evolve. We led a lot of research there over the last year or so. We had bipartisan councils, bipartisan support. As you all know, there was a water resource development bill that was pending in front of Congress before the election. There is bipartisan support for that, so this is not a highly controversial move for the President to move forward, if he so chooses to do so.

But, the basic tenets of that, Scott, were a combination of the role that public/private partnerships have in funding some of that infrastructure deficit. Secondly, it was what is the role of the federal government versus at a state level in terms of financing these projects, because the needs vary greatly depending upon where you are across the country, as do the state of affairs and the muni budgets differ greatly across the country, as well.

So, there is a fair amount of actions that could be taken in tandem that we think could move that forward considerably. And when you think about the incredibly low historical financing rates right now, there is no better time in our history to be investing in this infrastructure than now. But, it will not be purely at a federal level. There's going to be a role for the local and state to play, as well.

Scott Davis: Yes, I would imagine so. So, let's do the next question, because I'll forget, and then I'll get to audience questions in a sec here. In your opinion, at what multiple of 2017 earnings should Xylem trade? Let's vote on that. There's somebody in the audience -- there are a couple people in the audience who keep clicking the less than 10 times earnings. And I know they're just screwing with me, or they're just super-bearish, which may be true, too. I suspect they're just trying to get us to chuckle.

Patrick Decker: Maybe it's Jake. Jake, is it you?

Scott Davis: Okay, so that's that. We don't have a time series with you guys yet, but, I mean, those are pretty hefty levels, not number three, but number five and number six.

Patrick Decker: They look more like technology multiples.

Scott Davis: Yes. I mean, that's a third of the audience thinks you should trade fairly high levels. I would imagine that's pretty healthy. So, let's go to question six. We'll compare this to all the other companies and share that data when we collect it. What do you see as the most significant investment issue for Xylem? Is it core growth? Is it margins? Is it capital deployment? Is it execution? Let's vote on this one.

Patrick Decker: These are terrific questions.

Scott Davis: It's fun. They're the same questions we've asked in the beginning, and we got a lot of pushback. It was funny. We had some companies that walk of here almost crying because of the answers (inaudible). When buys are out of favor -- I mean, the first year we did it, one of the companies who is here said, "We will never, ever come back to your conference, ever." And then, they came back, and they said, "Well, we'll come back, but we don't want any ARS." And then, the same company -- I'm not going to name who it is, but the same company was here yesterday, had these glowingly positive results, and they're like, "Oh, we love your system. Great tool."

Patrick Decker: [How timely for us] ahead of Investor Day.

Scott Davis: Yes, for sure. So, core growth, that's probably double what we've seen at the other companies, so people want you to grow, which makes sense. And you should have a fair amount of operating leverage, I would imagine, right? Do you feel like you have costs that [maybe need] to come back into your system, and businesses like maybe rental and things like that?

Patrick Decker: Yes. I think that our capital outlay is actually pretty modest in terms of as a company. We're not starved for capital. We're not capital-intensive. It's about 3% of our total revenue. With the Sensus acquisition, obviously we've changed our R&D profile. Sensus spends about 10% of its revenue on R&D. it's more of a technology company. And so, blended out now, we'll be around 4%. We'll continue to invest in that. I'd say that, if there's an area that we do need to continue to invest, it is in that area, to be more like the technology play.

But, in terms of investments in fleet rental and sales force capacity, that's not a big issue for us. And we've been spending more and more on refreshing our products in the legacy side of the business.

Scott Davis: What's oil and gas as a percent of your mix now?

Patrick Decker: So, oil and gas and mining together is less than 5%. Oil and gas would be about 3% of our total.

Scott Davis: What did it peak out at?

Patrick Decker: [Phil], before I got here, was probably 10%.

Scott Davis: I was going to say, probably close, yes. And that business, I mean, the de-watering side of it, like fracking and stuff, that's got to be starting to come back, right?

Patrick Decker: We're seeing some early signs. And I think that part of the oil and gas recovery tends to be a little bit longer cycle. You're talking about some smaller players that tend to be more conservative on the capital side. So, we're seeing pockets in some of the basins where they are beginning to ramp up, but we're not calling that as a recovery this year. If it does, that'll be great. It'll be upside, but we're trying to be conservative in our guide there.

Scott Davis: When you think about emerging markets, some of the guys in quality companies like yours that are known for quality products and such, play fairly high-end, sometimes struggle in some of the emerging markets, where the solution is just dumping a bunch of chemicals. Is that market transitioning at all to a higher-end solution? And how do they pay for it if they are? What's their funding mechanism?

Patrick Decker: Sure, yes. So, emerging markets for us are a big deal. I really made that as one of my kind of top priorities when I came into the Company three years ago. And we've had some really good momentum and progress. And from my experience, it's all about localizing what your product design and your supply chain capabilities are. It's almost virtually impossible to be winning in those markets where you're importing from a high-cost jurisdiction with a long lead-time supply chain, and quite frankly with features and benefits that customers in those markets don't necessarily value.

So, we've gone through a fundamental kind of redesign of our offering in places like China, India, and we just opened a factory some months ago in Middle East. And those businesses, while they were flat all [in] this past year, they had grown close to double-digit the previous year. And orders in China last year for us were up 17%, so we're set for a really attractive 2017. So, we're expecting emerging markets to grow in the mid-single digits-plus this year, which I think in this current context is pretty healthy, all-in.

What's critical? I think, Scott, beyond the localization is we're playing into themes that are top policy mandates for the governments in India and China. And so, the money is there. They're going to pay for quality. But, they're typically going to pay for quality with companies they view as being local. So, if you visited our facilities in China or India, other than the name Xylem, you wouldn't know that it was a US company, completely localized management and teams. The branding locally is very much in China and India. Same in the Middle East. And so, that's been one of our secrets to success there.

Scott Davis: So, let's take any questions from the audience that we have, and you can e-mail to the address at the bottom, as we're doing the last couple days, and Jake would -- we want to hear Jake's radio voice anyways, right, Jake?

Unidentified Analyst: Well, I have one for you, actually.

Scott Davis: Talk a little louder so you've got the radio voice in high--.

Patrick Decker: --It's like I'm listening to the Dan Patrick Show here.

Unidentified Analyst: I'm curious, your customer base is fairly conservative, somewhat slower moving. What do you think catalyzes spending on the data analytics side (inaudible)? Is it just the value proposition, or is it -- what gets things moving here, is the question.

Patrick Decker: Yes. So, I'd say that roughly now 40%, 45% of our revenue that is going through public utility, they do tend to be a rather conservative customer base. And there's good and bad associated with that. The bad, or the down side, is they could be slow to adopt new technologies and solutions. The good news is they're extremely sticky. And so, they're very loathe to change out suppliers along the way.

So, in the utility space, what's really critical is to get reference customers, big thought leaders in the utility space to buy into the model, adopt the model, invest in the model, and then you use them as a reference case to others. A good example of that is the work that we already did, and Sensus does with Thames Water in London, what we both do together with Singapore Public Utility Board, with BC Water, with Suez here in the US. These are big-ticket utility and operators that, when you have them as your reference set, others will follow when they are showing that there's real value in this proposition.

On the industrial side of our business, it's much easier to get those players to adopt new things because they're very much focused on give me a business case, total cost of ownership over the lifecycle, and I can buy into that. So, that's a faster adoption. But, it is using reference customers in the utility space to make the change.

Scott Davis: Anything else, Jake? Okay. Well, we're out of time, so let's wrap it up. Thank you, Patrick. Thanks a lot.

Patrick Decker: Thank you, Scott, appreciate it. Thanks, Jake.