THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

XYL - Q1 2014 Xylem Inc. Earnings Conference Call

EVENT DATE/TIME: APRIL 29, 2014 / 1:00PM GMT

CORPORATE PARTICIPANTS

Phil De Sousa *Xylem Inc. - VP-IR*

Patrick Decker *Xylem Inc. - President and CEO*

Michael Speetzen *Xylem Inc. - SVP and CFO*

CONFERENCE CALL PARTICIPANTS

Deane Dray *Citigroup - Analyst*

Ryan Connors *Janney Montgomery Scott - Analyst*

Mike Halloran *Robert W. Baird & Company, Inc. - Analyst*

Nathan Jones *Stifel Nicolaus - Analyst*

Scott Davis *Barclays Capital - Analyst*

Joe Radigan *KeyBanc Capital Markets - Analyst*

Brian Konigsberg *Vertical Research Partners - Analyst*

David Rose *Wedbush Securities - Analyst*

PRESENTATION

Operator

Welcome to Xylem's first-quarter 2014 earnings conference call. (Operator Instructions). I would now like to turn the call over to Phil De Sousa, Vice President of Investor Relations.

Phil De Sousa - *Xylem Inc. - VP-IR*

Thank you, Susan. Good morning, everyone, and welcome to Xylem's first-quarter 2014 earnings conference call. With me today are Chief Executive Officer Patrick Decker, and Chief Financial Officer Michael Speetzen. They will provide their perspective on Xylem's quarterly results and discuss the full-year outlook for 2014.

Following our prepared remarks, we will address questions related to the information covered on the call at which time I will ask that you please keep to one question and a follow-up and then return to the queue so that we will have enough time to address everyone on the call.

We anticipate that today's call will last approximately one hour. As a reminder, this call and our webcast are accompanied by a slide presentation available in the Investors section of our website at www.xyleminc.com.

All references today will be on an adjusted basis unless otherwise indicated and non-GAAP financials are reconciled for you in the Appendix section of the presentation.

A replay of today's call will be available until midnight on May 13. Please note the replay number, 404-537-3406, and the confirmation code is 223-452-40. Additionally, the call will be available for playback via the Investors section of our website under the heading Presentation.

With that said, please turn to slide 2.

We will make some forward-looking statements on today's call, including references to future events or developments that we anticipate will or may occur in the future. These statements are subject to future risks and uncertainties, such as those factors described in Xylem's most recent

Annual Report on Form 10-K and in subsequent reports filed with the SEC. Please note that the Company undertakes no obligation to update any forward-looking statements publicly to reflect subsequent events or circumstances, and actual evidence or results could differ materially from those anticipated.

Now please turn to slide 3 and I will turn the call over to our CEO, Patrick Decker.

Patrick Decker - *Xylem Inc. - President and CEO*

Thanks, Phil, and thank you all for joining us this morning.

Today we announced our first-quarter 2014 results. In a moment I will give you some headline comments and perspective on the quarter. I will then share some perspective on what I've seen and heard thus far since joining the Company six weeks ago, and then I'll turn it over to Mike to share more details on the quarter and our full-year outlook.

Given the slow start to the year, which was driven in large part by severe winter weather conditions in North America, the team certainly closed the quarter strong and delivered a solid performance. Heading into the last month of the quarter, we understood it would be critical to drive hard to recover from the slow January and February to get back on track. I'm very pleased with the way the team embraced the challenge, particularly during the CEO leadership transition and challenging market conditions.

During the quarter, orders and revenue grew 3% overall and organically, with strong performance coming from emerging markets. We enter the second quarter with backlog of $793 million and 2014 shippable backlog of $679 million, which is up 6% year over year.

We continue to invest for growth. During the first quarter we spent $27 million in R&D, up 4% from the prior year, and we expect those spend levels to continue through the year. And we see prior years' investments in product development paying off.

For example, sales of Flygt Experior, embedded with new Smartrun technologies grew approximately 50%. This demonstrates the continued adoption of smart technology and Flygt's capability and market-leading product development.

Additionally, our investment in Multitrode is also driving growth. For example, we just recently completed the release of our Multismart controller in 12 additional languages, enabling us to expand sales of this line to approximately 20 new countries.

Just as critical are our ongoing cost reduction initiatives, such as the $18 million of restructuring and realignment costs in the quarter targeted at reducing our overall cost base. We will see the benefit from those actions in the latter half of the year, and we continue to realize significant savings from the actions the team completed last year which resulted in a 150 basis point improvement in operating margins in the first quarter.

To wrap up the first-quarter results, volume growth and improved operating performance drove earnings per share of $0.34, up 26% over the prior year.

Free cash flow was negative $3 million, primarily reflecting typical seasonality and working capital dynamics. We are confident in achieving our full-year free cash flow target of 100% conversion of net income.

Finally, on the capital deployment front, we increased our first-quarter dividend by 10% and opportunistically repurchased $50 million in common stock.

We will cover some of my initial observations since joining the Company on the next slide, but I will highlight one message I've already stressed. The importance to get off to a good start which, in my view, is key to delivering on the full-year commitments.

So we are off to a nice start, headed in the right direction and have laid a strong foundation for the rest of the year. Thanks to the entire Xylem team worldwide for getting us off on the right foot in 2014.

Now turning to slide 4, I will turn it over to Mike to cover the first-quarter results in more depth in a few minutes. But before that, I would like to share with you some of what I have seen and learned so far and what my early stage priorities are for the business.

One of the things that attracted me to Xylem in the first place beyond the opportunity to be part of something that has the potential to make a big difference globally, is to be part of a young company with a tremendously bright future.

That makes Xylem unique. We have a lot of experience to leverage within our business and it is important to me to tap into that experience, to listen and learn and use that knowledge to help shape our future.

Let me give you a sense of where I'm focusing my attention as I settle into my new role.

After joining on March 17, I convened a set of briefings on key strategic topics with Steve Loranger and the team. These meetings were crucial for me to gain an even deeper perspective on the business and to make sure I thoroughly understood our financial commitments and the actions necessary to deliver them. And I want to thank Steve Loranger once again publicly for his tremendous leadership and sacrifice during his tenure as the CEO and for the very smooth transaction he has worked hard to provide me.

Now I was excited to hit the road and develop an early sense for the strengths and opportunities in our business. Over the course of the first month, I visited more than a dozen locations in five countries. The sites I visited represent some portion of all of our business lines and cover more than 20% of our global workforce.

I'll be visiting more sites in the next few months with a particular focus on a number of our key emerging markets.

While pushing hard to get to know the business and our people, my primary responsibility, of course, is to direct our performance. As we move through the second quarter, it is critical that we stay laser-focused on driving our performance so we meet the targets we set.

So, let's move on to recap what we have to do in 2014 because there is much work still ahead.

We need to maintain and grow the confidence of our investors in Xylem by delivered on our commitments. So, let's start with our financial commitments.

In 2014, we must generate topline growth and at the same time improve our operating efficiency and align our cost structure to be more competitive. For the year, we expect to achieve nearly $4 billion in revenues.

As you already know, we are a company that addresses challenges around the entire cycle of water.

The world is changing rapidly and the world's problems related to water productivity, quality, and resilience are changing too. It is exciting to think about our potential to take our innovative products and services and our strong relationships with our customers and solve these new and evolving water challenges.

To do that, we will need to continue to drive productivity that will enable further investment in innovation and our people in order to capture new growth opportunities.

In terms of operating income, we expect margin to improve to the 13% range. This would result in earnings per share between $1.85 to $2.00 as we've previously guided and would represent somewhere between 11% and 20% growth.

To make or exceed our 2014 operating income goal, we need to execute on our initiatives and Lean Six Sigma and get the maximum leverage from our global strategic sourcing capability. I am a big believer in the returns we can see from Lean Six Sigma. I have seen it work. And the benefits go well beyond productivity and we shouldn't think of lean applications as only for the factory. Every business and every function within Xylem can and will benefit.

We want to achieve a high level of incremental efficiencies. The great thing about the progress we make in this area is that it sets us up to be more efficient and competitive. Improvements in our cost structure that carry to the bottom line will certainly have a positive effect, not just on 2014, but on 2015 and beyond.

In addition to our financial goals, we have a few other top level priorities for the Company this year. Among them, optimizing our integrated front end to accelerate our growth and improve our sales force effectiveness. It is one of our most important initiatives. It is a big lever and it will enable us to present a more informed, more focused, single phase to our customers and allow us to cross sell our portfolio of leading products and services.

Integrating the front end and implementing the associated sales force effectiveness tools we are putting into place like a Customer Relation Management System is no small task for a company with our geographic breadth. But it will enable us to significantly raise our game in the market.

Next, under the umbrella of advancing and institutionalizing a high-performing organization and culture, we are reigniting the Xylem Management System or XMS. We want to drive this disciplined approach even further into the organization, carving out and standardizing our key business processes, ensuring accountability and alignment. This helps ensure that we move seamlessly from strategy to execution.

Next is rebalancing our portfolio and our product investments to ensure that we have got the right allocation of resources in the areas that we think will create most meaningful value. We can be more disciplined in our allocation of financial and human resources. This is about investing our money and our time where it matters most, focusing on increasing return on invested capital and enhancing long-term shareholder return.

And I believe in benefits we can realize by developing stronger global strategic sourcing and Lean Six Sigma capabilities. There are companies in and out of the industrial water space of similar size and geographic footprint that do this really well. We are not one of them -- at least not yet -- but we will be.

Moving beyond our financial and operational objectives for this year, there are three top focus areas. Ways of doing business, if you will, that are very important to me. I shared these in my Day One message to all employees and want to speak about them again briefly to you as well so you understand what is most important to me.

These three concepts can be applied to any businesses, but I believe they are particularly applicable to our Company. The first is putting customers at our center. To me, this means listening to customers, understanding them, and even anticipating their needs. A lot of companies say they do this. But not all of them do it very well. I oftentimes use the expression keeping our center of gravity squarely around the customer.

I know many of Xylem's employees share that same view because I've seen that firsthand over the last few weeks. But we must capture the voice of our customer and integrate it not only in how we sell to and service our customers, but how we tie the voice of the customer into how we innovate and further expand our portfolio of products and solutions.

The second area is investing in our people. We have very talented people around the world with expertise and devotion to solving our customers' most critical water issues. We're a recognized market leader because of our people.

But more than having expert individuals, our power comes when we operate as a global team, leveraging everyone's important role and what we are aiming to accomplish. I believe in empowering our people to do their jobs. This empowerment includes providing the right training and development as well as honest and constructive feedback around performance to goals.

But most important, I believe in providing an environment that ensures everyone's safety. In my experience, strong safety performance almost always coincides with good employee engagement, which ultimately translates into strong financial performance.

The third area involves driving for peak performance. It bears repeating. Lean Six Sigma, or continuous improvement, works. It is important that we embed all of these tools in what we do every day. Equipping our people around the world with continuous improvement skills will be a key part of our training development efforts.

It is not lost on me or any of my team that we have faced significant challenges but I am convinced that we are well on our way to overcoming these. I don't expect that road ahead will be entirely smooth, nor should you. But I am excited about the direction we are heading, confident in the future, and very excited to be leading this team.

So with that, let me turn the call over to our CFO, Mike Speetzen, to walk you through the results and full-year guidance in more detail. Mike.

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Thanks, Patrick. Please turn to slide 5.

We generated revenues of $906 million, up 3% from the prior quarter. It is worth noting that we are comparing to first quarter last year where we experienced 7% organic revenue contraction. The public utility, industrial, and residential end markets showed strength, relative to poor performance last year. The public utility end market was up 5%, driven by continued infrastructure investment in emerging markets. And while we did have some sizable projects deliver in Europe and the US, customers remain focused on operational expenditures and small project activities.

Growth of 1% in industrial stemmed primarily from emerging market demand, including the delivery of several projects for the power market in Korea and heavy industry in China.

While the commercial market came in flat for the quarter, residential continued to demonstrate growth, up 6% over the prior year driven by growth in both the US and emerging markets. I'll cover off more specifics by segment, but generally speaking, we [saw] strong growth from emerging markets up 18%, modest growth of 1% in (technical difficulty) and the US was down 1%, most significantly impacted by weather.

We delivered strong operational performance. Operating income of $94 million was up $16 million or 21% over last year, and operating margins increased 150 basis points or 10.4%. The first-quarter performance was driven by the increase in organic volume and savings from cost reduction initiatives across our businesses.

Cost reductions totaled $31 million and included approximately $10 million of restructuring savings, with the balance coming from sourcing and Lean initiatives. Partially offsetting these tailwinds was inflation of nearly 2%, an unfavorable mix due to lower dewatering rental revenue, which stemmed from the severe weather conditions experienced early in the quarter.

Incremental margins were 59%, including the benefit from restructuring savings and unfavorable foreign exchange. Excluding these items, incremental margins were still strong at 42%.

EPS expanded 26% to $0.34, better than we anticipated, driven by favorable revenue performance and accelerated cost actions given the slow start to the year. Core operations drove the year-over-year EPS improvement, computing $0.10 driven by organic volume growth combined with execution on productivity and cost management, including restructuring savings of $0.04.

Now, let me provide more detail on each of our reporting segments. Please turn to slide 6.

Water infrastructure reported revenue of $568 million, up 4% organically. Additionally, we had 1 percentage point growth from acquisitions and foreign exchange was a 2-point headwind. We expressed organic growth in all of our applications with transport up 3%, treatment up 9%, and test up 5% year over year.

Regionally, we saw the most significant growth come from emerging markets which were up 24%. Europe was positive up 2% and slightly better than our expectations, but was more than offset by the US, which was down 6%.

I would summarize our revenue performance as follows: growth was driven by water and wastewater infrastructure investment in emerging markets -- for example, China, which was up more than 50% year over year.

Increased demand for mixers and project deliveries drove mid-teens treatment growth in Europe, which was partially offset by the slow recovery of the US CapEx market.

Test was up 5% for the quarter driven by project shipments into the emerging markets, such as a $3 million order to Brazil's national water agency, ANA, our largest analytics delivery into this region to date. In addition, test had two large shipments to China's Ministry of Environmental Protection.

And lastly, our dewatering business was down low single digits as we lapped a tough compare with Superstorm Sandy and saw the negative impact to our rental business due to the severe weather in the US.

Operating margin increased 80 basis points from 9.4% to 10.2% due to increased volume and cost reductions. Restructuring savings of $7 million, coupled with sourcing and Lean initiatives, more than offset the negative effect of inflation, unfavorable mix due to weather impacts on our rental business, and foreign exchange.

Let me now turn to slide number 7 and talk to our applied water segment.

Revenue was up 3% overall with organic growth at 2%. As you can see, building service applications grew 2% driven by strength in the US market. Irrigation, while relatively small, was up 7% and industrial water was flat year over year. Regionally, we saw growth across the US and emerging markets which were up 3% and 6%, respectively, while soft market conditions continued in Europe, which was down 4% for the quarter.

I would summarize our revenue performance as follows: growth was driven by continued strength in US residential and agriculture markets while industrial projects and residential investment fueled growth in emerging markets such as Asia-Pacific and the Middle East.

While we saw low single-digit growth in our US commercial building services business, we were flat overall with weakness coming from Europe.

Operating margin expanded 100 basis points from 12.2% to 13.2% year over year. Margin improvement was driven by volume leverage, coupled with the favorable impact of cost reductions. Although price was positive, we continue to see downward pressure, given current market conditions.

Now let's turn to slide 8 and I will cover the Company's financial position. Xylem maintains a strong cash position with a balance of $466 million at the end of Q1 and approximately 71% held outside of the US, consistent with our geographic business mix. Our net-debt to net-capital ratio is a healthy 26% and our commercial paper and revolving credit facilities remain in place and continue to be unutilized.

We remain committed to our balanced capital deployment strategy, which is to maintain and grow the business while enhancing shareholder returns through dividends and share repurchases.

During the first quarter, we invested $25 million into capital expenditures and we returned $74 million to shareholders through dividends and share repurchases which is up substantially from $37 million in 2013.

The increased cap -- return of capital to shareholders was driven by the 10% increase in dividends per share we announced earlier this year and an increase in share repurchases of $36 million. Free cash flow was a negative $3 million and reflects typical seasonality and working capital dynamics. Relative to the prior year, our free cash flow performance improved by $7 million.

With that said, please turn to slide 9 and I will cover our 2014 guidance. This slide summarizes our expected 2014 organic revenue performance by end market. Overall, we continue to see low single-digit growth across the majority of our end markets.

Beginning with industrial, our largest end market revisiting 45% of our total revenues -- in the US, the industrial market continues to slowly recover and market reports suggest that demand conditions are generally improving. In Europe, macro indicators suggest that the market may have bottomed out, and lastly, partially offsetting growth in these regions is a continued weak global mining market.

Public utility at 34% of our total revenues is our second largest market. We continue to expect growth in emerging markets. While we are currently expecting a slow recovery in the US and European CapEx markets, we have seen market indicators suggesting conditions could be improving. We have already seen some of this activity in our bookings and we still have a robust pipeline of projects we are actively pursuing. We expect to continue to see strength in maintenance and repair activity.

While we expect building service applications in the commercial and residential markets to be up low single digits in 2014, commercial growth is expected to come from emerging markets and the successful launch of new products. However, we expect to continue to see soft conditions in the US institutional building market and a slow recovery in Europe.

We have seen slightly better performance from residential in the US, but anticipate this will subside as the housing recovery moderates. In Europe, we expect conditions to continue to stabilize and it is also important to note that last year we posted very strong residential growth, creating a tough year-over-year compare.

Lastly, our bookings and backlog position coming out of Q1 supports a low single-digit revenue growth trajectory. Our backlog position, as a percentage of the balance of the full-year revenue, is 22%. So while encouraging, we still have to see consistently improving book and bill rates throughout the balance of 2014.

I would also like to note that we are encouraged by the strength and backlog deliverable in 2015, which is up 34%.

Please turn to slide 10.

Let me spend a few minutes covering our full-year guidance in detail. We anticipate 2014 revenues in the range of $3.9 billion to nearly $4 billion, which reflects organic growth of 1% to 3%.

For water infrastructure we expect revenues of approximately $2.5 billion, reflecting organic growth of 2% to 3%. And for applied water we expect revenues of approximately $1.5 billion, reflecting organic growth of 1% to 2%.

Segment margins are anticipated to be in the range of 14.1% to 14.6% and operating margins are projected to be in the range of 12.6% to 13.2%.

We anticipate earnings per share of $1.85 to $2.00, excluding 2014 restructuring and realignment costs of approximately $40 million to $50 million.

We expect approximately $15 million of the savings from restructuring to be realized in 2014 from these actions. This is in addition to the carryover savings of $25 million from the actions executed in 2013.

Our operating tax rate is expected to be approximately 21% and fully diluted share count is expected to be approximately 185 million which takes into account anticipated share repurchases of approximately $130 million in 2014, of which, $50 million has been completed.

Please turn to slide 11.

I'd like to spend a minute calibrating everyone on the call around what we expect our first- and second-half revenue and operating income profile to be in 2014. While we do not provide quarterly guidance, we recognize that it is helpful to highlight trends and expectations to assist in modeling.

For revenue, we see the first half representing approximately 48% of our full year, which is consistent with our typical seasonal profile. This reflects sequential growth in Q2 of 8% to 10% with growth balance between both segments. While our backlog is up 10% year over year, Q2 shippable backlog is up only 3% versus last year, supporting a Q2 organic growth rate range of 1% to 3%.

Operating income performance in the second half will be driven by volume leverage and incremental cost improvements in areas such as global sourcing and Lean. We see second-quarter margins improving sequentially from the first quarter by 130 basis points to 170 basis points. We are on track to deliver the $40 million in restructuring savings which is equally split between first and second half. Although corporate expense was below the full-year run rate, we do anticipate spending between $55 million and $60 million for the year.

In summary, backlog trends are supportive of the 1% to 3% organic growth target and we are pleased with the progress being made thus far on cost reductions to ensure we meet our profit expectations.

With that said, please turn to slide 12 and let me hand the call back over to Patrick for some final comments. Patrick?

Patrick Decker - *Xylem Inc. - President and CEO*

Thanks, Mike. We delivered a solid first quarter which gets us off to a good start to the year and we are very excited by the direction Xylem is headed. As Mike indicated, we see stable market conditions and are gaining momentum in orders activity.

Operational performance is improving. While we are not where we need to be yet, I am pleased with the progress the team has made and the trajectory we are on.

And as I mentioned in my opening comments, we are clear about our focus areas and remain committed to delivering on our financial commitments and recognizing the full potential this Company is capable of delivering.

Operator, we can now begin the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Deane Dray, Citi Research.

Deane Dray - *Citigroup - Analyst*

That was a nice, clean quarter. I had a couple of questions, the first will be on the emerging markets. Seeing an 18% organic revenue is very impressive as well as 50% up in China.

So if you could give us some additional color, how much of that -- is it a lumpy business? Are these big projects? Is there any MRO associated with them and then how does that play out the balance of the year?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Yes. The 18% growth was terrific and, as you indicated, there's definitely project activity that comes with that. And it was pretty balanced across various regions. I think the key point I would make is that we are anticipating that it will decelerate. We anticipate the full-year emerging markets will be in the high single digits.

So although it will continue to be very positive for the business, we do see it moderating a bit. And as you indicated, we are dealing with some of the project deliveries and saw a couple of those accelerate into the first quarter, which created a little bit of a distortion in the growth rate.

Patrick Decker - *Xylem Inc. - President and CEO*

And, Deane, I would only -- I would just add that the emerging market, that whole area in my mind from a strategic standpoint is, I think, a big area of opportunity for us. I am actually going to be traveling over to Asia for the first couple of weeks of June, [to aid] a number of our markets over there and just get a better feel for the pulse of the business.

But I am very pleased with the quarter, but I am also very much focused on what the long-term potential is for us in those markets.

Deane Dray - *Citigroup - Analyst*

And I should have also added you had rather be in a position of explaining why the emerging markets are up so much rather than the other way around.

And the second question for Mike. I know you alluded to the fact that corporate expense came in light this quarter. Maybe if you could calibrate for us what some of the puts and takes were. I know from our estimates it came in light by about $0.025 favorable. So was there some discretionary spending that you pulled back and what other puts and takes might there be?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Yes, there's always puts and takes relative to things like compensation accruals and things like that. But I think, given that we saw the year starting off slow and saw the weather having a pretty heavy impact on our very profitable dewatering business, we made some discretionary decisions around deferring certain costs out of corporate. And that was really consistent with what you have seen us do in the past where we are keeping a very quick pulse on the business and reacting quickly as well.

We do anticipate some of that coming back into the business. So, as I mentioned in my prepared remarks, we see corporate gain in the range of [$55 million to $60 million] for the year. So you ought to anticipate us being around $15 million to $16 million per quarter.

Deane Dray - *Citigroup - Analyst*

And then -- perfect. Last one for me is maybe you can address how the cadence of the quarter played out? You said January and February were light, March came in strong. Can you give that to us on an organic revenue growth basis, by chance?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Yes, so I guess maybe I will put it in these terms. When we looked at February, as I mentioned in Patrick's introduction call, we were actually flat year over year. And when we looked at how much we had delivered through that point, we were at about roughly $500 million worth of revenue. We were anywhere from 2 to 3 percentage points behind where we have historically been.

So by default, March came through a couple points better than we had originally anticipated. And I really give a lot of credit to the teams. Given the weather conditions improved, teams went back out at it. Dewatering, for example, we had seen utilization rates in the low 40s, 40% range in January and February. And we saw those utilization rates improve back up into the high 40s.

We did not recover the January and February missed revenue particularly in that business, but the teams really took advantage of the weather being back. We didn't run special promotions or anything like that. The team just went out and made sure that we were executing on the business.

Patrick Decker - *Xylem Inc. - President and CEO*

And I would just add, having come in in the middle of the month and knowing and seeing firsthand the level of focus and intensity that the team was placing on this, I was very impressed by how they came together. And rather than making excuses were really going out and just, as Mike said, doubling down and the teamwork across the organization was very impressive those last three to four weeks of the month.

Operator

Ryan Connors, Janney Montgomery Scott.

Ryan Connors - *Janney Montgomery Scott - Analyst*

Thank you. Yes, this question is for Patrick.

Patrick, you have mentioned the top three focused areas on slide 4 and the number one focus area there is putting customers at the center. And there has been some level of chatter in the marketplace, maybe some of it opportunistic by your competitors that, given the last few years, there has been a lot of distraction. The spin out, multiple changes at the top.

Is the fact that that goes at the top of your list any reflection that you think there is merit to that distraction and now it's need to refocus or is something else that you saw in your travels that led you to put that at the top?

Patrick Decker - *Xylem Inc. - President and CEO*

Yes, well, I appreciate the question. I would say first of all throughout my entire career, it has always been very clear to me that keeping customers at the center has got to be at the forefront for any organization and company. I will then add that I think any organization that is going through a number of changes and transitions a company like Xylem has done, naturally there are going to be magnetic forces that pull people away sometimes from focusing on the customer.

But I have been very impressed by what I have seen out at the local level in terms of people's passion for the customer. The whole passion for being very entrepreneurial at a local level. And all I am trying to do here is really elevate that.

You have heard Steve talk in previous calls about the importance of us investing in innovation, and that also is very much a centerpiece for me. Because I do think we have opportunities here to, again, leverage our productivity to invest even more in innovation over time.

Ryan Connors - *Janney Montgomery Scott - Analyst*

And then a related follow-up is in terms of compensation structures and incentives, both for I guess in both the manufacturing side of the house and maybe more importantly in the customer facing side of the house. As you look at the way things are structured, are there any changes or tweaks do you think that need to be made in terms of how the teams are incentivized to drive the business?

Patrick Decker - *Xylem Inc. - President and CEO*

Well, I would say -- again, good question. It is early days for me. It is my seventh week in the organization. Obviously making sure that we have got the right organization model in place, which I feel good about in terms of the changes that have been made here. Making sure that the incent structure is aligned with that are clearly very much on my radar screen. But I think it is premature for me to comment right now on that.

Operator

Mike Halloran, Robert W. Baird.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

Good morning, everyone. So, could we go through the puts and takes when looking at the front half of the year versus the guidance for the back half of the year? Obviously, a large portion, a little over half of that is going to be the sequential volume uptick that you are projecting, but what are some of the other puts and takes there sequentially from a mix perspective as you see restructuring layering in and any other items like that?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Yes, I think a couple of things, Mike. Restructuring is going to be pretty even throughout the year. It is going to be about $20 million in the first half and the second half.

What you really see is a couple of things and you can it. It is the volume leverage as we get into the back half of the year. We are going to end up delivering call it another $150 million worth of revenue and it is going to have a pretty hard mix in our water infrastructure segment which as we have indicated drops at a pretty high rate.

In addition to that, as we laid out in our guidance, we talked about the $100 million worth of cost reductions. It is a little more biased towards the back end of the year.

If you look at our first quarter, we got about 22% of the total savings including restructuring. So we are going to end up picking up another call it $15 million to $20 million in the back half, which is really the work we are doing to accelerate a lot of the sourcing savings is that we think the business has the potential to recognize as well as just getting the Lean projects up and going. So, you have got the volume leverage coupled with a higher level of the profitability coming through in the productivity savings.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

Makes sense. Then on the dewatering platform, obviously mining is a little bit of a headwind. Weather was a headwind in the first quarter.

Maybe you could talk a little bit by end markets what you are seeing there as weather and trends start normalizing and which of the areas of strength are improved and which areas are still soft?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Yes and I think you are right. The mining is going to continue to be a headwind especially in the first half. Because then we will start to lap some of the things we saw playing out last year.

For us the first quarter and whether it was public utilities or construction, given the freezing conditions, the fact that we had, I think, over 20 Godwin branches that were shut down due to weather and construction sites being down. We saw that part of the dewatering business down call it mid-single digits. As we go through the balance of the year, we are not anticipating a recovery in mining.

We definitely see the construction markets improving and we will definitely see public utilities getting back to a more stable environment. I think that will really help from a mix perspective back to your first question with the rental business picking up momentum through the course of the year.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

Appreciate the time.

Operator

Nathan Jones, Stifel.

Nathan Jones - *Stifel Nicolaus - Analyst*

Good morning. Patrick, during your prepared comments, you spent a fair bit of time talking about your philosophy and your approach to management in terms of Lean Six Sigma, voice of the customer. It is probably unfair to ask you about where the opportunities are within Xylem at this point, but could you expand on that a little bit more and how you intend to drive those changes down through the organization?

Patrick Decker - *Xylem Inc. - President and CEO*

Sure. Again, thanks for the question. I would summarize it as this. As I have traveled around, I have clearly seen some pockets of real strength and excellence as it relates to the application of Lean Six Sigma and also even in the area of sourcing activity. But I do believe that there is an opportunity for us to make that more consistent in its application, to also make it deeper in its application.

So, for example, what I have not seen as much of is the application of Lean Six Sigma beyond the four walls of the factory. So when you start getting into the sales and marketing area, the R&D area, I have seen pockets of it. But I think there is more opportunity for us in that area that will also help us enable to drive growth.

In terms of how I would go about doing it, again, I think messaging across the organization and making sure that people understand it is a number one priority for me is where it starts. And also making sure that we are investing adequate resources in terms of training, certification, but also how we deploy the resources across the organization. So there is a multitude of things that I will be driving in that area as we go forward.

As you know, very well, this is a journey. It is a journey that is never ended and I think that we are well on the path to realizing it. But there is still opportunity in front of us.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. And my follow-up is on the test, strong growth there. You did call out some large project shipments in that business. Is that something that you are expecting to recur or are we expecting to see a moderation of the growth rates there?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Yes, I think there will be a little bit of a moderation. As I commented overall for around the emerging markets with us up 18% in the first quarter. We are going to see that moderating down into what I will say is the high single digits as we move forward.

Again, it could move around within the quarters, but at this point I don't anticipate seeing anything significant for that particular business unit anyway.

Nathan Jones - *Stifel Nicolaus - Analyst*

Great. Thanks.

THOMSON REUTERS

Operator

Scott Davis, Barclays.

Scott Davis - *Barclays Capital - Analyst*

Good morning. Patrick, I know it is early days, so it is hard to answer some of these questions, I'm guessing, but I wanted to touch on a couple of topics. And first is just a cost base. It was always our understanding, at least, that the high fixed cost base in Europe needed to be chipped down at.

Have you dug into that or at least have an early read and whether that cost out? It -- take out the past restructuring that is already done, but whether that cost base can, in fact, be brought down to better levels or do you just need volumes to come back to make that business look better? I guess it is -- I will just open it up to that.

Patrick Decker - *Xylem Inc. - President and CEO*

Sure. Yes, volume always helps. Certainly and we have shown -- certainly this quarter -- that leveraging that volume growth is a great way to expand margins. But my assessment right now is that I think that the commentary that has been made in the past around there being a couple hundred basis points or so of SG&A opportunity that is still in front of us I think is very fair. I have seen opportunities as I have traveled around that I do believe we can drive that number down.

In terms of margin expansion, again, I still believe that through again some of the Lean work that we can do there will be opportunities in that area as well as we go forward.

In terms of any other cost take-out actions, I think, again, there's opportunities there in terms of helping us get this business to that mid-teen margin that has been put out there in the past as a long-term goal.

Scott Davis - *Barclays Capital - Analyst*

Okay, fair enough. As a follow-up, one thing that was missing in your slides and again, early days was really the portfolio in M&A. How do you think of driving the M&A organization? Do you have to take a backseat for a while until you make the cultural changes you are looking for or can you proceed on continuing to look at assets and maybe even potentially getting more aggressive?

Patrick Decker - *Xylem Inc. - President and CEO*

Sure, yes. Well, I think that acquisitions are and definitely will be a key element of our growth strategy in terms of getting our growth rate up to where we have stated we want it to be. We have continued and I have seen the teams continue to cultivate opportunities even while we have been in this slight pause for a while.

And so I think now that we have made a lot of progress on the operating improvement actions obviously we still have work to do there, that gives the increased confidence in execution. Obviously we no longer have the lingering questions around CEO change. I am very pleased the team has maintained a pipeline of candidates and continue to have a strong balance sheet that we can obviously leverage when the time is right.

So, again, a little bit more time for me to spend with the team and of course the market factors always come into play here and when the right opportunity is available. But I can reinforce that acquisitions will be a key element of our growth strategy.

Scott Davis - *Barclays Capital - Analyst*

Okay, great. Welcome, and good luck, Patrick.

Patrick Decker - *Xylem Inc. - President and CEO*

Thank you.

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Thanks, Scott.

Operator

Matt Summerville, KeyBanc.

Joe Radigan - *KeyBanc Capital Markets - Analyst*

Good morning. This is Joe Radigan, on for Matt. My first question is a follow-up on an earlier answer. Have you seen a -- the pickup in March has that carried through into April so far? What are you seeing in more up-to-date trends?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

We are actually right on the forefront of getting results for the month of April. But based on what we have seen and heard, and there is a little bit of softness -- some of that is the project delivery that is accelerated into March. But otherwise we really haven't seen any significant deviation from the trends that we saw in the month of March.

Joe Radigan - *KeyBanc Capital Markets - Analyst*

Okay and, Mike, I think you said in your prepared comments that you have seen some early signs of the CapEx related business improving. Was that a US comment or global comment? And what are you seeing there that gives you more confidence that maybe we could be seeing a recovery at some point on the horizon here?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

I think it is between both regions and as you know Europe is a number of different regions. So we tend to see more of the strength in -- the call it western and northern part of Europe. But the reason that we have, I guess, increased competence is when you look at the backlog that is shippable for 2015, it is up 34%. And when you look at it between the two segments, it is actually up over 40% in water infrastructure.

So, that obviously has some projects that are in emerging markets, but it does also contain the work that we see going on and we have seen it -- I will comment more specifically around the treatment market and the US, where last year, as you know, we continue to see declines in the order rates. That is impacting our revenue as we get into 2014, but we are seeing order rate starting to pick up. That will obviously bode well for 2015.

So we are not ready to call that we are out of the woods yet, but it certainly feels like things are moving in the right direction. The bid pipeline is still very active and we feel like we are competitively positioned to take advantage of that.

Joe Radigan - *KeyBanc Capital Markets - Analyst*

Great. Appreciate it.

Operator

Brian Konigsberg, Vertical Research.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Good morning, everyone. Mike, maybe can you just touch a little bit more on price cost? It was a little bit mixed in the quarter. I know -- I think you had some decent opportunities in the second half of 2013, maybe it decelerated a little bit in Q1. I just want to know what your thoughts were for the remainder of the year particularly through the channel.

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Yes. So I think we saw a little bit (technical difficulty) price about 20 basis points in Q1 and it was actually more biased towards applied water, water infrastructure was essentially flat. It was better than we were anticipating slightly.

But I do expect that the competitive pressures that we see in the market are going to still weigh on us through the balance of the year. So the discussion that we had around pricing being anywhere from 25 basis points to 50 basis point headwind for the year still holds. But from a cost standpoint we are actively pushing from a productivity standpoint.

So even though pricing isn't pulling its share of the weight that it was in the past, we have made up for that not only with the restructuring, but also pushing forward more on the sourcing and the Lean savings in the business. And creating a nice spread that is going to give us the margin uplift that we need for the year.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Got you. Then going over to the Customer Relationship Management System. Where are you on that installation process? Are those costs embedded in Q1 numbers? And if not, I guess maybe touch on the cadence of the spending and potentially even the benefits?

Patrick Decker - *Xylem Inc. - President and CEO*

Yes. The implementation is really right at the beginning at the early stages right now. And so the team had been studying alternatives for a while, certainly before I joined. And I am very supportive of the decision that we have made to move forward. It is a big enabler to our whole integrated front end. Getting our sales organizations able to talk to each other, get visibility to what our opportunities are with customers across the portfolio, and sharing those leads.

The money itself, again, is not going to be incremental to what we have guided to before. It has all been embedded in our outlook for the year. But again, at the end of the day, we expect that this is going to have a pretty meaningful impact for us over time in terms of driving topline growth and is well obviously margin expansion.

Brian Konigsberg - *Vertical Research Partners - Analyst*

If I can just ask one more. Maybe I am remissing correctly, but it looks like the FX headwind, it was a $0.03 headwind in the quarter, but it was only a $4 million revenue headwind. How do I reconcile those two things?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Yes. So, Brian, there's two components. There is the translation which is the smaller impact this quarter and, as we anticipated, we saw a heavier transaction impact and while we do hedge, that only ended up smoothing out the eventual impact that you have from a foreign exchange perspective and we are hedging about 75% to 80% of the total.

And for us it is really around the mix of where you drive revenue and where your costs are based. So not to get into a lot of the details, but we have got a lot of euro-based revenue, but a cost base based in Sweden. And so you end up with some differential there.

And then we obviously have a bunch of cross-currency issues with Australia and the Canadian dollar which have both been heavily impacted this past quarter.

But I think the key message is, this is consistent with what we built into the guidance. We don't see any issues as we go through the balance of the year either.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Just curious. I imagine these are hedges that were put in place, but do you have an offset that hits gross margin? A couple of quarters down the line as these things are delivered or does that not really play?

Michael Speetzen - *Xylem Inc. - SVP and CFO*

No. This is more what actually lives through and what is what I will call a differential in the cost space. So the hedging handles all the transactional pieces, but over time all that does is smooth you out. If you end up with an imbalance between two regions, you are ultimately going to have that impact your P&L and that is essentially what this is.

Brian Konigsberg - *Vertical Research Partners - Analyst*

I see. All right, thank you very much.

Operator

David Rose, Wedbush.

David Rose - *Wedbush Securities - Analyst*

Good morning. This is a follow-up question on the margin side. SG&A was, I think, lower than many of us anticipated and given the gross margins were essentially flat, how should we think about the gross margin pressure going forward? I think the implication is it is pretty hard to get the leverage there if sales are flat on the gross margin side, given what you talked about in terms of pricing.

Am I missing something there? And that is the first part and the second part is if we think about the -- I wouldn't call it aggressiveness, but I think there was -- Steve had put it before on -- in a prior call that the team was more aggressive in seeking out orders and I guess you were going to be a little bit more competitive on pricing.

What is it in terms of comfort level on the backlog, how do you get comfort with that backlog? Maybe that question is for both of you, Patrick and Mike, that you don't see further margin pressure in what is in the backlog.

Michael Speetzen - *Xylem Inc. - SVP and CFO*

Yes. So, on the gross margin, I guess a couple of comments. One, Q1 was heavily impacted by the fact that we came up a bit short on the dewatering rental and we were a bit overweight to the emerging markets where we tend to see a little bit lower gross margin in terms of what that revenue comes through at. As you know it is project-based so it tends to be on the lower end of the margin scale.

As we progress through the year, though, a couple of things. One, there is improving mix as we see the water infrastructure business ramp up. That starts as we get into the second quarter. But we are also working a number of initiatives that I have talked to in prior calls around the Lean, but also sourcing where we think that there is more capability to drive sourcing savings throughout the business.

So that would tell you that our gross margin will improve on a year-over-year basis at the full-year level. Probably around 50 plus basis points despite what we anticipated as some pricing headwind.

On your second question around the orders, it is a good question and it is something that we are pretty active in reviewing all the bid activities. So when you think about that improvement in the backlog that is shippable going out beyond next year, the review process we have is to make sure that we are bidding at the right level of margins. But given that there is project activity, there is going to be some pricing pressure there relative to what we would see coming through some more of the developed regions.

But, not a surprise and it is something that we build in as we think about our cost plans and our margin improvement plans as we go forward. So, we are adjusting our cost base accordingly and I think there's plenty of opportunity for us to continue to see the margin expansion.

Patrick Decker - *Xylem Inc. - President and CEO*

I would just reinforce what Mike said here around, again, the opportunities in global sourcing are very real. And that really has been underleveraged in my view. So, the commentary Steven made in past quarters I think is spot on and we are working hard in that area.

And then again, the opportunities around Lean deployment. While those tend to be longer term, I think there are some near-term opportunities there. The team is working as hard as Mike pointed out. We all know the pricing environment that we are operating in and we want to do what we can to really use our productivity to drive growth both investment as well as being competitive from a margin standpoint.

David Rose - *Wedbush Securities - Analyst*

Okay, great. Thank you.

Operator

And there are no further questions at this time. I would now like to turn the floor back over to Patrick Decker for any additional or closing remarks.

Patrick Decker - *Xylem Inc. - President and CEO*

Thank you. As I mentioned in my opening comments, we are very clear about our focus areas and remain committed to delivering our financial commitments and recognizing the full potential the Company is capable of delivering. We are pleased with our performance in Q1. We have a lot of work yet to do to deliver 2014, but we are confident the plans and actions are in place to do exactly that.

So, again, I want to thank you all for joining today and for your support and interest and look forward to connecting with you again in the near future.

Operator

Thank you. This does conclude today's Xylem first-quarter 2014 earnings conference call. Please disconnect your lines at this time and have a wonderful day.
