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PRESENTATION

Operator

Welcome to the Xylem first-quarter 2016 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, Christy, and good morning, everyone. Welcome to Xylem's first-quarter 2016 earnings conference call.

With me today are Chief Executive Officer Patrick Decker; Chief Financial Officer Mark Rajkowski; and Vice President of Finance Global Operations, Shashank Patel. They will provide their perspectives on Xylem's first-quarter 2016 results and discuss the full-year outlook for 2016.

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

Further, a replay of today's call will be available until midnight on June 7. Please note that the replay number is 800-585-8367, and the confirmation code is 29483779.

Additionally, the call will be available for playback via the Investors section of our website under the heading Presentations.

With that, please turn to slide 2. Just a few keynotes for today's presentation. 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.

Additionally, please note that references to 2016 metrics include the financial impacts attributable to previously closed acquisitions and have been adjusted to exclude nonrecurring acquisition-related costs.

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 report -- on 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 events or results could differ materially from those anticipated.

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

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

Thanks, Phil, and good morning, everyone. We appreciate you joining us to review our first-quarter results.

Before I begin, I want to welcome our new CFO Mark Rajkowski to Xylem.

Mark brings more than 30 years of diverse financial and operational experience, and importantly, he has significant significant experience in leading transformational change across operating models and product portfolio changes, M&A activity and capital markets transactions, all to create substantial shareholder value.

He's been here just over a month, but he's already hit the ground running, visiting the field and working closely with our senior leadership team to gain a better understanding of the business and our plans for future growth.

I know some of you already know Mark, but for those who don't, I'm sure over the coming months we'll find opportunities for you to get to meet him.

I'd also like to take this opportunity to thank Shashank Patel, who is here with us this morning, for his outstanding work as our interim CFO over the past seven months. Shashank is an incredibly effective executive who brought his financial acumen and deep knowledge of Xylem's businesses to bear to create a seamless transition in this important CFO role. He's been instrumental in bringing Mark up to speed, and I look forward to continuing to work with him as he takes on a new role here at Xylem.

Now let's move on to our first-quarter results. We had a solid start to 2016, which positions us well to deliver on our full-year commitments. The benefits of our diversified product portfolio and end market exposure helped us deliver 4% organic growth.

Our top-line growth exceeded our expectations with strong execution by our teams helping to drive share gains in key regions. But I do want to acknowledge that we benefited from some projects shifting from Q2 into Q1, as well as weather conditions that were favorable to the public utility market. I'll come back to that in a few minutes.

A significant driver of our growth was the continued momentum we saw in key end markets, namely public utilities where growth was seen across all key regions. The US was particularly strong, up 22% year over year.

The rising trend line on the break and fix side of the business continues, and the milder winter provided an opportunity for public utilities to accelerate some needed repairs and maintenance.

As I've mentioned previously, this area of the business has been suppressed for the last few years as municipalities have deferred activities due to budget constraints, but we are seeing some change in priorities and these smaller projects are being green-lit with greater frequency.

In addition, as I just mentioned, one of the contributing factors to our top-line growth in the quarter was the shift of treatment projects in the second quarter into the first. Given that treatment project installations generally deliver lower incremental margins relative to other parts of our business, this shift didn't have a significant impact on the bottom line.

On a macro level, mixed economic conditions do persist, but we remain focused on our growth objectives.

We are seeing stable market conditions in the US and the early signs of improvement in Europe. And while we've seen a significant slowdown in some emerging markets, we still generated 2% growth across these regions.

India and the Middle East were particular standouts in the quarter, generating 90% and 10% growth, respectively. That growth was partially offset by a significant year-over-year decline in China, which reflects both soft market conditions in certain sectors, as well as the variability in project work.

That said, China's performance was in line with our expectations. Based on what we're seeing in terms of quarter to quarter sequential order trends, we believe the local market may be stabilizing.

Importantly, we remain confident in the China market. Water infrastructure is a top priority of the government, something that was reaffirmed in the State Council's latest action plan released in April, and we see a robust pipeline of project activity.

So, as we begin to lap the steep declines we faced in commercial and industrial sectors, which became more pronounced in the fourth quarter of 2015, we will be well-positioned to further accelerate our growth performance. Net net, we are expecting China to deliver results of flat to low single-digit growth for the full year.

Organic order bookings in the quarter were flat versus last year, but this result reflects the variations and timing that occur with major project work. For example, if we adjusted for just two of the major orders won in Q1 of last year, year-over-year orders would have shown a 3% increase.

Our adjusted operating margin in the quarter expanded to 10.9%, up 40 basis points excluding the impact of our recent acquisitions of Hypack and Tideland.

Given our strong top-line growth and ongoing cost reduction actions, we have accelerated some investments in our growth initiatives. Let me provide a brief update on the strategic priorities that we laid out at our Investor Day last fall.

First, enhancing commercial leadership. As we continue to shift our center of gravity closer to our customers, we are engaged in a number of activities to improve the customer experience and expand our channel reach, which ultimately will increase our opportunities to generate more growth.

We're investing in additional capability building around a common set of tools and processes across our commercial teams.

Our second priority is to grow in emerging markets, and as I just mentioned, we are making good progress. In the Middle East, you'll recall that we are opening a new facility in Dubai in order to localize manufacturing and assembly of some of our products, beginning with our applied water portfolio.

This expansion will enable us to better serve our growing customer base in the region by bringing the supply chain closer to them, and we expect to be operational later this summer.

We are also encouraged by the momentum we see in India where we have a relatively smaller but growing presence. We are moving forward with our plans for localized product design to be more responsive to the needs of this market.

In the area of strengthening innovation and technology, we are starting to build good momentum. We've already begun to invest in several areas and expect to increase our 2016 full-year R&D spending by 50 basis points to more than 3% of revenue.

Our core areas of focus are smart technologies, systems intelligence and advanced treatment and industrial services. We expect these investments to drive not only top-line growth, but also to improve the gross margin profile of our business.

Coming up, we are looking forward to a significant new product introduction in our water infrastructure segment later this month.

Our next priority, continuous improvement, includes lean, global procurement, and a sharper focus on driving business simplification. We expect these efforts to generate significant cost savings and operating margin improvement this year and over the next several years.

As I've discussed before, we are instilling a productivity for growth mindset throughout the business so we can fund the necessary investments to achieve our longer term, value creation objectives.

In the first quarter, we achieved $22 million in cost savings through continuous improvement, global procurement and business simplification initiatives, and we are on track to reach our full-year goal.

I am pleased with the momentum our teams are building in this area and would highlight that we expect to achieve another consecutive year of record savings in 2016.

Our final strategic priority is to cultivate leadership and talent development. On the leadership front, with the addition of Mark as our CFO, I now have my senior team in place and working together toward our common goals.

We've also launched the Xylem Learning Center, a global platform for training and knowledge management throughout the organization, as well as two concentrated development programs for high-performing managers and leaders.

Shifting back to our results. At the bottom line, we generated adjusted earnings per share of $0.35 in the quarter, an increase of 9% year over year, excluding the impact of acquisitions. Also, a strong focus on our working capital performance drove 130 basis point improvement as a percentage of revenue and an increase of $23 million in operating cash flow. These efforts position us well to deliver another year of free cash flow conversion in excess of 100% of net income.

Finally, as we announced this morning, we are raising our full-year earnings guidance to $1.98 to $2.08. We will cover this in more detail later on the call, but let me give you some perspective.

Our guidance increase today reflects the incremental interest savings from the refinancing of a portion of our long-term debt. There is no change in our expectations regarding the performance of our core business. We expect stable conditions across roughly 90% of our portfolio, and we anticipate generating growth across all key regions. Given that, we believe we are positioned to exceed market growth rates.

We're certainly off to a good start for the year, delivering solid top-line growth and executing well across our businesses. But we are one quarter into the year, and we recognize that we are still operating in a mixed macro environment.

One last point, we could potentially recognize some favorability benefit from foreign exchange movements if rates hold over the balance of the year. However, we believe it's too early to make those types of changes, so we did not change our underlying foreign exchange assumptions in providing today's earnings update. Mark will give some additional color on our FX sensitivity later in the call.

Now with that, I'll turn it over to Mark for more details on the quarter.

Mark Rajkowski - *Xylem Inc. - SVP and CFO*

Thanks, Patrick. Now please turn to slide 4.

We generated revenue of $847 million in the quarter, up $10 million from the prior-year, despite FX headwind of $27 million. Recent acquisitions added $6 million to the top line in the quarter.

Organic revenue increased $31 million or 4%, which exceeded our expectations and was largely driven by the 12% increase in the global public utility market.

Looking at the rest of our end markets, our industrial vertical was flat as expected. Commercial was up 5%, but residential was down 5%. Sales to our ag customers were down 1%.

From a regional perspective, we generated growth in each of our key regions with Western Europe up 5%, the US up 4% and emerging markets growing at 2%. Operating margin increased 10 basis points to 10.9% for the quarter.

Excluding the impact of acquisitions, margins increased by 40 basis points year over year. Strong execution and cost reductions enabled us to fund the strategic investments we need to further accelerate profitable growth.

Let me provide a little more detail on our margin expansion. Continuous improvement, global procurement and business simplification initiatives reduced our costs by $22 million in the quarter, resulting in 260 basis points of margin improvement.

Our operating margin increased 100 basis points due to volume leverage, modest price realization and favorable mix. Partially offsetting these items were cost inflation of 190 basis points and strategic investments of 130 basis points.

These investments included increased R&D spend to fund new product development, expansion of our organization's selling and continuous improvement capabilities, and the localization of assembly and production in attractive, faster growth regions.

Earnings per share of $0.35 grew 6% year over year, but were up 9% excluding the acquisitions of Hypack and Tideland, which were $0.01 dilutive in the first quarter as expected due to the seasonality of these businesses. These acquisitions are tracking to plan and are expected to be earnings neutral for the full-year 2016 and accretive to earnings in 2017.

One final item, we have excluded from adjusted earnings a net tax benefit of $14 million during the quarter, which is primarily the result of closing out a prior year tax audit.

Now let me cover each of our reporting segments. Please turn to slide 5.

Water infrastructure recorded orders of $534 million, down 2% organically, as we lapped a prior-year quarter that included two large project wins totaling approximately $25 million. Excluding these unusually large orders from last year, orders would have been up 3%.

We exited the quarter with total backlog of $580 million, about the same as last year on an organic basis. Of this total, we expect to ship approximately 75% over the next three quarters. This is up 3% organically year over year and relatively consistent with our sales outlook for the segment.

Revenue of $514 million represents a 6% increase year over year on an organic basis. Acquisitions added an additional $6 million to the top line, but foreign exchange was a $21 million headwind.

Now let me provide you with some color on this quarter's performance. We generated 12% growth in the global public utility market. This increase reflects the continued market recovery we've seen over the past few quarters, as well as milder winter weather, which enabled municipalities to accelerate maintenance activities.

Additionally, strong execution and the timing of a few treatment project deliveries also contributed to better than expected performance. In the US, where our public utility business grew 22%, our teams perform very well, driving share gains in the water and wastewater pump market. We also saw benefits from our investment in sales capability as demonstrated by an increase in mixer and mixer aftermarket sales.

Strength in Western Europe came from the early stages of the UK Public Utility AMP6 cycle. Emerging market results were favorable despite mixed market conditions.

Our overall growth was driven by a large custom pump project in India and continued investment in water and wastewater infrastructure in the Middle East.

Finally, our industrial end market was flat as low single-digit growth in the general industrial and construction markets was muted by the negative impact of the oil and gas and mining sectors.

Operating margin increased 150 basis points from 10.6% to 12.1%. Excluding the impact of acquisitions, operating margin increased 200 basis points driven by volume leverage, favorable mix, modest price realization and cost reductions, partially offset by increases in cost inflation and increased strategic growth investments.

Please turn to slide 6. Applied water recorded orders of $354 million, up 2% organically over the prior-year period. We entered the second quarter with total backlog of $197 million, down 5% on an organic basis, primarily due to the delivery of a large project in the fourth quarter of 2015.

Of that total, approximately $105 million is expected to ship within the second quarter.

Applied water segment revenue was $333 million, up 1% organically from the prior year.

Highlights of our revenue performance include the following. Commercial and industrial market strength drove 5% growth in Western Europe. Here we are seeing the continued traction from energy-efficient product launches and our investment in building our regional sales capabilities.

In the US, commercial was up 3%, driven by continued strength in the institutional building sector. We also saw 3% growth in residential, but with an unfavorable mix in demand within our product offerings. Here, as a result of a relatively warm winter, demand for our higher margin hot water circulators declined, while demand for lower margin well pumps increased.

The segment's US industrial revenue declined 7%. This primarily reflects lower demand for specialty pump applications serving the food and beverage and marine sectors and drove the overall 1% decline in the US.

Segment revenue was down 3% in our emerging markets, due primarily to the anticipated slowdown in commercial and industrial end markets in China.

Sequentially, we've seen modest improvement in orders in China, thanks in part to what we believe are stabilizing end market conditions, as well as strong execution by our local team.

Partially offsetting the year-over-year decline in China was double-digit growth in Eastern Europe and the Middle East, again driven by the strategic growth investment that we're making to build our sales capabilities in these regions.

Segment operating margin declined 130 basis points from 13.9% to 12.6% year over year. Cost reductions drove a 270 basis point improvement, more than offsetting inflation and the impact of unfavorable residential mix in the quarter.

However, increased spend on strategic growth investments reduced margins by 180 basis points. These investments are funding the localization of product assembly in the Middle East and include higher investments in innovation and technology for new product development.

Looking at the full-year 2016, we continue to expect segment margin expansion in the range of 30 to 50 basis points.

To summarize this quarter's performance, we delivered modest top-line growth as we manage the near-term slowdown and tough year-over-year comparisons in China, as well as sluggish US industrial market conditions. At the same time, we remain focused on delivering productivity gains to fund our growth investments.

Now let's turn to slide 7 where I'll cover the Company's cash flow and financial position. The first thing you will likely notice on our balance sheet is our unusually large cash position of $1.2 billion at the end of the quarter. This reflects the proceeds from our very successful European debt issuance in March, which we used to redeem our 3.55% senior notes on April 11.

Our net debt to net capital ratio is healthy at 24%, and our commercial paper and revolving credit facilities remain in place and unutilized. This underscores our financial strength and flexibility.

In that regard, we remain committed to a balanced capital deployment strategy, which is to profitably grow the business through organic investments and M&A, while enhancing shareholder returns through dividends and opportunistic share repurchases.

During the first quarter, we invested $37 million for capital expenditures, much of this for growth projects. We acquired Tideland for $70 million, and we returned to $28 million to our shareholders through dividends.

The first quarter included a 10% increase in dividends per share, marking the fifth consecutive year that we've increased our dividend.

Historically, our first-quarter free cash flow generation is seasonally low and impacted by the timing of annual incentive payments, as well as lower sales leverage.

Free cash flow was $4 million in the quarter, representing a modest improvement from the prior year. Year over year, free cash flow benefited from a $23 million reduction in working capital, largely offset by the timing of additional interest and tax payments in the quarter. We continue to expect to deliver at least 100% cash conversion this year.

It's worth highlighting that we improved working capital as a percentage of revenue by 130 basis points in the quarter, excluding the impact of acquisitions. The improvement was driven by better inventory management and receivables collections.

Please move to slide 8, and I'll turn the call back over to Patrick to cover our 2016 guidance. Patrick?

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

Thanks, Mark. I'll begin by making two quick points. First, the growth rates I refer to on this slide all exclude the anticipated negative foreign exchange impact that we discussed on our last earnings call.

Second, and more importantly, as I said in my opening remarks, there is no change in the outlook for the performance of our core business. We continue to expect to generate faster than market growth, delivering organic revenue growth of 2% to 4%.

While I'll cover specific details by end market on the next slide, let me highlight that we continue to expect stable conditions across roughly 90% of our portfolio, including growth across all key geographies.

Additionally, we expect acquisitions will provide an additional 1% of revenue growth.

Our adjusted operating margin is still expected to grow in the range of 50 to 80 basis points overall, with roughly 20 basis points of margin dilution from the acquisitions of Hypack and Tideland. Excluding the dilutive impact of acquisitions, our operating margin is expected to expand by 70 to 100 basis points. This expansion will be realized after the impact of investments we are making to accelerate profitable growth.

As I mentioned earlier, we continue to drive our continuous improvement work deeper into the organization with very good results. We expect our lean and global procurement initiatives to generate full-year growth savings of $120 million, an increase of roughly 20% year over year.

We are raising our earnings per share guidance to $1.98 to $2.08 to reflect the interest savings from our debt market refinancing. This range excludes restructuring and realignment costs of about $25 million, but this projection does include $0.04 of negative foreign currency translation impact. Excluding this impact, EPS growth is now expected to be in a range of 9% to 15%.

We will continue to execute a disciplined approach to capital deployment, which is expected to result in free cash flow conversion greater than 100% after investing $120 million to $130 million in CapEx.

Finally, we currently anticipate returning a minimum of $150 million to shareholders through dividends and share repurchases.

Now please turn to slide 9. Let me summarize our updated full-year performance by end market and highlight a few changes since our previous outlook in February.

Beginning with industrial, which represents 44% of total revenue, we continue to expect this market to be flat to up low single digits. Our projection assumes that low single-digit growth in general industrial will be partially offset by headwinds in the mining and oil and gas sectors.

While first-quarter performance in mining, which represents approximately 5% of total revenue, was generally in line with our expectations, we continue to closely monitor market trends.

Oil and gas, which now represents less than 3% of total revenue, is forecast to decline through the first half of this year before we lap last year's second half of nearly 40% declines.

Public utility, which represents 33% of our total revenue, is now anticipated to grow at a mid to high single digit rate. Here we've raised our outlook following a strong first-quarter start and with the expectation of continued momentum in the US.

We also see encouraging signs for improved European market conditions, including strong contributions from the AMP6 cycle in the UK. And in the emerging markets, we expect to see continued project growth.

For the commercial end market, no change to our expectation of mid single digit range growth. We see solid contributions from both the US and Europe and double digit growth in the Middle East.

The relatively warmer winter led to a slow start to the year for residential heating applications and tougher macro conditions in Australia. As a result, we now expect the residential market to be flat year over year.

And finally, our smallest sector, agriculture, we anticipate will be up low single digits for the year.

Please turn to slide 10 and Mark will provide some calendarization insight for the rest of the year.

Mark Rajkowski - *Xylem Inc. - SVP and CFO*

Thanks, Patrick. For the second quarter of 2016, we expect total revenue of approximately $920 million, flat versus the prior year. This includes organic growth of approximately $20 million or 2%, revenue from our acquisitions of approximately $10 million, and approximately $30 million of headwind from foreign exchange translation.

We anticipate operating income to be up modestly year over year with operating margins up 40 to 60 basis points as volume leverage and cost reductions more than offset inflation, growth investments and unfavorable mix.

Looking out to the second half of the year, we anticipate year-over-year organic growth of approximately 3%, with acquisitions adding just over $30 million and FX headwind of nearly $45 million.

Operating margins in the second half are expected to increase in the range of 80 to 130 basis points year over year. This improvement reflects volume leverage and the net incremental savings from restructuring and continuous improvement cost actions in excess of increased R&D and growth investments.

Relative to the first half of the year, we also anticipate favorable mix given that we will lap oil and gas headwinds as we exit the second quarter.

To wrap up, let me make a few points about the foreign exchange assumptions in our full-year guidance. As Patrick mentioned earlier, we have not reflected any potential benefit from foreign exchange variability in our updated outlook. We did not see any significant benefit in the first quarter, and it's too early to update any full-year assumptions at this point in the year given the volatility of currencies.

Having said that, we have provided a table in the appendix that outlines the potential full-year impact to those assumptions, which is $0.01 of EPS per quarter based on exchange rates late last week.

With that, I'll turn the call back over to Patrick for closing comments. Patrick?

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

Thanks, Mark. So we feel good about our start to the year and are pleased to be on track to deliver on our financial commitments.

Our teams are executing well and remain focused on improving the customer experience. We continue to be encouraged by a strengthening public utility market.

We're making measurable progress on our strategic priorities, particularly in the area of continuous improvement, accelerating our investments in innovation and technology and investing in faster growth markets.

We've made good strides in improving our working capital performance, which will lead to another year of strong free cash flow conversion.

With that, operator, we can now begin the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Deane Dray, RBC Capital.

Deane Dray - *RBC Capital Markets - Analyst*

Hey, we had a lot of references about warmer weather and a pull in from the second quarter into the first quarter. Can you give any quantification? Can you point to any specifics on how that might be calibrated?

And then since we're on weather, lots of headline news, flooding in the South again, and has there been any opportunities there for Godwin dewatering? Not just on the one-time rentals, but this is happening with higher frequency. Is there any longer term permanent type of projects that we saw after -- in the Northeast after Sandy, thank you.

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

Sure, Deane. This is Patrick. Yes, to put a total on the combination of timing on some of the project deliveries and treatment that we alluded to, as well as the weather impact, we'd say it was roughly about $8 million of revenue. So just under a point of top-line growth. And I'd say probably a little less than a third of that was the actual impact of the weather, albeit at high margin given the impact that it had on our Godwin business.

To the second part of your question, we certainly see the weather patterns that are happening here as an opportunity both in the immediate term, but there is a systemic move here, as you see, happening. And so we certainly have deployed our [recents] on the ground, not only tactically but strategically.

Part of the things we've been doing there is leveraging what we're doing in the deployment of salesforce.com and making sure that our teams, not just in Godwin but also on the light side of the business, are sharing leads and making sure that we are maximizing the opportunity there.

Deane Dray - *RBC Capital Markets - Analyst*

Great and then just a second question. I'd like you to expand on this R&D investment increase. Really interesting in how you identify three areas for further investment. I think I've got them smart water technology systems and advanced water treatment.

So it really looks like you're deliberately moving up the technology curve in the portfolio. What kind of specific opportunities do you see? And is this -- are you doing this build versus buy type of decision-making and what's to say about M&A opportunities?

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

Sure. Great question, Deane. So, as you know, I've spoken much about I do think that there is a great opportunity for us to continue to move our offerings up the technology curve. It really comes out of the value mapping work that we did over the course of the first year or so that I was here.

That definitely has informed our priorities both in terms of organic investment in R&D and the innovation technology roadmaps that Jay, our new Innovation Technology Officer, and our R&D teams are really focused on.

But, at the same time, it's also informing our M&A pipeline. Certainly the acquisitions of Hypack and Tideland were a demonstration of that, and we see a very rich pipeline, further opportunities to be able to do that.

You know that we set out some pretty ambitious goals at Investor Day on where we can take our vitality index in terms of revenue generated from new offerings over the last five years. And so we're expecting for several hundred basis points of improvement and expansion in that over the next four to five years.

Deane Dray - *RBC Capital Markets - Analyst*

Great. Thank you very much.

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

Thank you.

Operator

Nathan Jones, Stifel.

Nathan Jones - *Stifel Nicolaus - Analyst*

[There's a lot] of difference in the way you're reporting on the slide deck there where you are specifically breaking out the strategic investments, 130 basis points in the quarter.

Can you talk about how that compares to historically for Xylem what the expectations are for the benefits out of that, maybe an ROI or any color you can give on that?

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

Sure, yes. It is a -- we are purposefully breaking it out because I think it's important for our investors to understand what we are doing in driving productivity support, larger (technical difficulty). I do want to point out that we've got very good line of sight and visibility obviously on the rate and pace of those investments.

And so we are not just opening the floodgates here. We are very focused on investing in very attractive return opportunities, margin expansion. They need to be accretive. A big theme of ours here is not only to move the operating margin expansion but to improve our gross margins as a Company as well.

So that would be the color I would give you is that we are very much focused on them being accretive. We've got good line of sight on what they are. We are rating and pacing them, and you'll continue to see us break those out as we go forward.

I don't know, Mark, if you want to add any color?

Mark Rajkowski - *Xylem Inc. - SVP and CFO*

Yes, I think while it's still early days, we are starting to see some returns, particularly on the commercial capabilities and some investments we've made in our sales teams. We've seen that in both in Europe, as well as some of our emerging markets.

So the R&D is a little bit -- it takes a little bit longer in terms of the time when it pays back, but some of the quick hits on the commercial side we are already seeing benefits.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. And how does it compare to a historical rate of these strategic investments? Is it a significant increase?

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

From my perspective, I think it's a sizable increase. If you look at the level of productivity we drove in the quarter and have over the course of the last year and you see us making those investments here, it's hard for me to put a specific number on exactly how much we've done in the past.

I would say we're probably talking close to 2X the amount of what we've seen historically, and again that's being funded by what we are doing on the productivity side while still committing to operating margin expansion.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. That 2X is helpful, and you're clearly paying for it.

My second question was the public utility in Europe. In the slide deck there, there's an expectation that public utility in Europe is improving. Is that all better AMP6 out of the UK, or how is the public utility market looking in the rest of Europe?

Shashank Patel - *Xylem Inc. - VP, Finance Global Operations*

This is Shashank. On the AMP6 cycle, we saw a little bit of benefit in March, but the stronger benefit will come for the balance of the year. So really what we saw in Q1 was everything but the AMP6 cycle, and our expectation is that that continues at that pace for the balance of the year in Europe.

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

We saw some continued encouraging signs, Nathan, in other parts of Europe. Southern Europe continues to be basically flattish, but we did see pretty good growth in the rest of Central and Northern Europe.

Nathan Jones - *Stifel Nicolaus - Analyst*

That's helpful. Thank you.

Operator

Mike Halloran, Robert Baird.

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

So two quick ones here. First, on the guidance, what's the assumption for underlying demand? How does that track through the year when you look at the 2% expectations organically 2Q, 3% back half of the year? Is there any assumption for improvement outside of the public utility market where you've got a pretty positive outlook, or is it pretty stable from here?

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

I would say it's pretty much stable from here, Mike. You know what you hear us talking about in Q2 really is just the impact of the shift of the projects and some of the acceleration of work in the public utility space due to the weather to Q1.

So you're looking really at basically 3% over the first half of the year, which is pretty much in line with our guidance, and we'd look for similar performance in the back half of the year.

So no real uptick. I mean come you heard us talk about some improvement in public utility versus our previous outlook, but that's really being mitigated a little bit by some of the softness that we continue to see in mining oil and gas and a little bit in resi that we called out.

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

So pretty normal sequential patterns then?

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

Yes, that's correct.

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

And then second one is, when you look at over the last five or so quarters, orders versus revenues, revenues obviously outpace the order side. Some normalization on that this quarter.

Maybe you could just talk about the dynamic there? Obviously a positive outlook for growth that's been outpacing where the orders have been. Is that short cycle? Is that project timing? Maybe you could just talk about that dynamic.

Shashank Patel - *Xylem Inc. - VP, Finance Global Operations*

And, as you noted, there's several pieces to that. And when you take a look at some parts of the business like the applied water segment is a heavier portion of book and ship business that typically happens, and the second quarter ends up being the strongest quarter there.

But there's also some seasonality, I mean, there's is also some impact with project shipments. As we talked, there was pooling of project shipments in the first quarter.

And on the order side, we also talked about on the water infrastructure side, a year ago we had strong activity with a couple of large projects that impacted the year-over-year dynamic. So it is a mix of when the projects actually book, when they actually ship out, as well as the level of the book and ship activity.

And then the last piece is also the lapping of the oil and gas headwind we saw last year, and that laps in the second quarter. So we'll see favorability in Q3 and Q4 as we have a good prior year comparison on oil and gas.

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

I would just add here, we -- another bit of color on the backlog is, as we look at the treatment pipeline, which is a good leading indicator for the rest of our public utility business here, it is lumpy. And so you do see these kind of quarter-to-quarter comparisons that can be challenging. But the actual bid pipeline that we are going after is actually up 10% year over year.

And so we continue to see very healthy trends in terms of the projects that are coming to market, and so that bodes well for the back half of this year into 2017.

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

Great. Appreciate the time.

Operator

Chip Moore, Canaccord.

Chip Moore - *Canaccord Genuity - Analyst*

I guess the emerging markets you talked about some stabilization in bookings in China. Can you maybe give us little more color on what you're seeing there?

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

Sure, yes. So, as expected, China was down both in terms of top-line growth and orders year over year because we are lapping the drop off there that really occurred mid to late last year.

But quarter sequential, we saw 20% plus growth in orders, and so that's very encouraging for us. It looks like it appears to be stabilizing.

What's really driving that, again, as we talked about in our prepared remarks, is this being the number one policy issue right now or one of the top policy issues for the China government. And so we continue to see a very attractive pipeline there of projects coming forward and good order trends.

Chip Moore - *Canaccord Genuity - Analyst*

Okay. And then on India, maybe can just give us an update on that large projects and then also how you're thinking about timeframes for localizing product there? Thanks.

Shashank Patel - *Xylem Inc. - VP, Finance Global Operations*

So, on India, we talked late last year on a couple of large projects that we won. We started delivering on some of those. The pipeline on the quotation activity remains very high, and it tends to be large projects in infrastructure primarily on the water infrastructure side. So that continues strong.

As far as localization initiatives, a lot of the large projects we are doing, they are almost 90% plus localized. Quite frankly, that's how we stay competitive in the India market, which is an extremely competitive market. So we see continued growth in that market space.

We are also looking on the applied water segment, opportunities on the building commercial building side with the Smart Cities initiative. And, again, a lot of that will be driven by localization initiatives as well.

Operator

Kevin Maczka, BB&T Capital Markets.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Back on the cost inflation item, the 190 basis points headwind this quarter, is that more comp or commodities? And I'm just wondering in the back half as some of these commodities have started to increase again, does that line item maybe become an even bigger headwind?

Shashank Patel - *Xylem Inc. - VP, Finance Global Operations*

Yes, primarily -- and we've talked about this I think this last several quarters -- the bulk of our inflation is from compensation and benefits, and then there is a little bit coming out of commodities.

As you noted, commodities were soft all the way through last year. In the first quarter, they did pick up a little bit.

But the way we get impacted by pure commodity, because it's only a piece of the components we use to make our product, isn't that significant. But to your point, as we go through the rest of the year, there could be a little bit of headwind on the 190. Maybe 20 or 30 basis points is what we've historically seen above the 190 level as we go forward. So there could be a little bit of that.

Quite frankly, some of that should also help our pricing in the market because commodity does support pricing levels as well.

Kevin Maczka - *BB&T Capital Markets - Analyst*

I think pricing lately has not been as robust as it historically has been. So are you starting to see some of that reverse and maybe see some pricing tailwind offsetting? Are you seeing that already?

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

Yes, in the quarter, we saw about 30 to 40 bps of pricing benefit in the water infrastructure business, which is really the business that is benefiting the most from kind of the rising tide of public utility.

And so that was really the first time we've seen that in quite a while. So we're pretty encouraged by that.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Okay. Great. Thank you.

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

Thank you.

Operator

Jim Giannakouros, Oppenheimer.

Jim Giannakouros - *Oppenheimer - Analyst*

Just on the public utility, I'm sorry if I missed it, but broad-based strength, well understood, but are there any areas, geographic areas worthy of note where you're seeing particular strength or weakness to call out in the US?

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

Sure, yes. So the biggest -- far and away, the biggest area of strength for us right now is the US. We are -- we saw a 22% growth in the quarter coming from the US. Now, again, that was a combination of some of the benefits of the warmer weather conditions, some of the increase in repair and maintenance activity and also some project strength. So that's certainly not going to hold for the full year at that level, but we are expecting that to continue to be very attractive.

And then secondly, we saw, again, some returning strength in Europe. As Shashank mentioned earlier, we haven't really begun to see the full impact of the AMP6 cycle in the UK, but we are seeing some activity coming through in Q2 now and expect that to really begin to ramp up for us here over the course of the year.

You know, India was another real big bright spot for us. I mean up 90%, and the pipeline is continuing to grow there. I'd say that no real areas of weakness that I would call out in public utility. It is pretty broad-based. We were up 12% overall as a company. So I'd say that's one of our biggest bright spots across the board.

Jim Giannakouros - *Oppenheimer - Analyst*

Got it. I'm sorry if I was unclear. I meant specifically in the US, but nothing to call out in the US by region?

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

No, nothing really to speak of. I mean it's pretty broad-based across the board. We didn't see any areas where we saw low single digits or flattish or down. Everything was growing at least mid-single digits. I think it's a matter of relative bright spots.

Jim Giannakouros - *Oppenheimer - Analyst*

Got it. Okay. And by product line, call it, transport treatment tests, you're showing obviously different growth rates given project activity, timing, and that's understandable. But can you discuss any impact you're seeing specifically from upgrading your go-to-market strategies, your more unified sales approach, etc. Just checking that that's the driver of the share gains that you are speaking of and anticipating?

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

Yes, I mean we certainly feel very confident about the bright spots we are seeing early on here as we've, whether it be revision of some of our incentives, whether it be the implementation of salesforce.com, whether it be our teams getting more time together. We have co-located some of our offices and our sales teams. There's a lot of ingredients that go into that. An increase in training that we've done and just being very proud of how hard our teams are working in the fields. They're getting at it, and I think that's where leveraging our combined efforts are important. I also think that's where having a definitive market-leading brand or brands that we've got. You tend to benefit in a rising tide. And we just can't -- you know, there's no rest for the weary here. So we can't -- we've got to keep looking over our shoulder and working as hard as possible.

Jim Giannakouros - *Oppenheimer - Analyst*

Great. Thank you.

Operator

Brent Thielman, D.A. Davidson.

Brent Thielman - *D.A. Davidson & Co. - Analyst*

On the dewatering business, it seems like some of the challenging sectors there should be nearing the bottom at least. And I understand the mix headwind today, but can you speak to how the overall pricing environment is evolving there? And is it realistic to think as the business reaccelerates we should start to see a net positive for water infrastructure margins?

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

Yes, sure. So certainly we have -- given the oil and gas and mining exposure that our dewatering team has been facing there, that was a big body blow for us last year and really provided a headwind for against all the other great margin expansion efforts that we were doing.

The team within that business did a fantastic job of at least holding their margins flat, despite a significant drop off last year in revenue. And I think we are confident that, as that business rebounds, hard to make a call as to when oil and gas might rebound. Certainly as that business laps that and begins to get some additional top-line growth, we would expect to see quite sizable incremental margins fall through, but given a number of the cost actions the team took last year to manage the bottom. And that certainly would be an increase of impact for water infrastructure.

Brent Thielman - *D.A. Davidson & Co. - Analyst*

Sure. Okay. And then, Patrick, the 10% increase in the bid pipeline for treatment you referenced, was that for the US or globally?

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

That is global.

Brent Thielman - *D.A. Davidson & Co. - Analyst*

And is it fair to say it's higher in the US?

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

I'd say that growth rates are higher in the US, yes.

Brent Thielman - *D.A. Davidson & Co. - Analyst*

Thank you.

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

Okay, you're welcome.

Mark Rajkowski - *Xylem Inc. - SVP and CFO*

Thanks, Brent.

Operator

Robert Barry, Susquehanna.

Robert Barry - *Susquehanna Financial Group - Analyst*

I just wanted to circle back and make sure I was clear on what you were feeling about the order momentum and how it's tracking versus your plan. I know the commentary in the last couple of quarters has seemed very positive. Certainly maybe a lot of that is just the muni, but it doesn't feel like the momentum is really building here in the orders.

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

I think we feel quite comfortable and good about the outlook. I think the momentum that we see is very much in line with our plan and kind of where we've guided, too.

As we talked about, we've got a number of these big projects last year. So when you're looking at year-over-year comparisons, there's going to be some lumpiness there. You know, I know that people can look at orders within applied water. That's not a big backlog business, and so it really is heavily skewed towards book and ship business.

So, again, we feel positive. Again, we are keeping our expectations in check here. We are in the early stages of a public utility recovery, and hopefully we're seeing things stabilize in the emerging markets. You know, China obviously had a significant impact in the order book in Q1 on a year-over-year basis as well.

Mark Rajkowski - *Xylem Inc. - SVP and CFO*

Yes and I'd add, as I mentioned in our prepared remarks, that when you exclude a couple of unusually large projects that we had in the first quarter of last year, water infrastructure would have been up 3% year over year.

Robert Barry - *Susquehanna Financial Group - Analyst*

Okay. Fair enough. And then just a question on line of sight to that 80 to 130 bps of up margin improvement you are expecting in the back half? It sounds like it's a combination of volume and restructuring.

I mean, how much of what you need to see that is in the backlog and just general line of sight on the restructuring coming through?

Mark Rajkowski - *Xylem Inc. - SVP and CFO*

You know, as we look at the back half, a big part of that acceleration is cost reductions. So we will see a ramp-up from our 260 basis points that we saw in Q1 to closer to 380 basis points in the second half.

So we are expecting to see acceleration in cost out as well as those periods are seasonally stronger in terms of volumes. So we'll see more volume leverage. And we'll also benefit -- part of that cost reduction will be additional restructuring benefits, $8 million in the second half of the year. That work is underway.

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

I would just add that within that guide, we've also got about 100 basis points going the other direction from strategic investments. And so obviously, as I mentioned earlier, we've got line of sight to that. We'll rate and pace that accordingly, but right now we feel confident about making those investments.

Robert Barry - *Susquehanna Financial Group - Analyst*

Got you. So that's something that you can dial up or down a little bit depending on how things (multiple speakers).

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

That's correct.

Robert Barry - *Susquehanna Financial Group - Analyst*

Great. That's helpful. Thank you.

Operator

Kevin Bennett, Sterne Agee.

Kevin Bennett - *Sterne Agee - Analyst*

Patrick, I would like to dig in a little bit on your industrial market overall. I guess I think we all know what's going on in oil and gas and mining, but within the rest of it and I know you guys serve a ton of different end markets, but would like any color you can provide on what may be strong within that and what may be weak?

And then more specifically on your industrial water treatment business, which I know is kind of an increased focus of you guys going forward, so I was wondering if you've made any progress there?

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

Sure. So very quickly on the industrial piece, it's good to pull it out as you did. So in that 44% of overall industrial revenue for us, 8% of that is tied to oil and gas and mining. So the other, let's call it, 36% of our total revenue, we really refer to that as more light industrial, and that's been up 3% and are expecting that to continue.

It is heavily tied to GDP in the US. It's over weighted to the US. It is a broad swath of exposure ranging from food and beverage to pharma to chemicals to marine to a wide variety -- car washes. It's a wide variety of areas.

The nice thing about that business is that is historically been very, very steady. We're not tied to capital spend. We're not tied to industrial output. As long as people's operations are up and running, they are going to burn through these small pumps that we sell them. And so it's a good steady business.

The tweaks that we typically see there is when there can be adjustments in inventory or stock. We saw a little bit of that last year, but, again, expect that business to be pretty stable here in that low single-digit range for 2016.

On the industrial treatment business, only about 25% of our treatment business today is sold into industrial. We are heavily weighted toward muni and wastewater and that is a business that tends to be lower margin for us. Hence the discussion around shifting even more of our weight toward the industrial sector where it's higher technology, more regulations, deeper pockets, people willing to spend based on lifecycle costs.

And so it is an area of focus for us both as it relates to our own internal R&D efforts and the pipeline there. Again, those tend to be slower to come to fruition, but we are working on those right now as we speak.

And, as we've mentioned before, it is an area of focus for us in terms of M&A down the path.

Kevin Bennett - *Sterne Agee - Analyst*

Got it. That's helpful. And then one quick question on the commercial market. I guess you said in your slides that you expect the US to moderate and was wondering if you've seen that, or is that based on orders, or I guess what makes you think that US will moderate?

Shashank Patel - *Xylem Inc. - VP, Finance Global Operations*

That is based on the first-quarter order activity. And, as we mentioned on the residential side where we had strength in the groundwater side, but on the residential circulators which fall on to the commercial side, there was a little bit of softness because of the relatively warm winter. So we did see moderate growth in the first quarter, and we expect that to continue for the balance of the year.

Kevin Bennett - *Sterne Agee - Analyst*

Okay. Thank you.

Operator

Joe Giordano, Cowen.

Joe Giordano - *Cowen and Company - Analyst*

I guess if I had to ding you somewhere, maybe you'd start talking about the incrementals on organic growth being a little bit lower? And can you just kind of flesh out how much of that is from mix shifts towards treatment, which is lower margin but kind of a good problem? How much is M&A? How much is FX? Can you kind of talk about that a little bit?

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

Sure, yes. So most certainly in the first quarter, you know the biggest driver of that lower incremental margins than one would historically have expected would be treatment mix and, again, some of the projects that moved into the quarter at lower margins. So that was one big impact.

If you look at the overall certainly, what we saw in terms of the investment in the Middle East in the quarter, which hit applied water only because that's the first business that was going in there in terms of product localization. And, as we mentioned in the prepared comments, applied water will more than recover that and expand margins for the full year. So it really is the timing of the investment that hit in the quarter.

Those would be the two biggest impact. Obviously, we had a little bit of dilution from the acquisitions, but that was not so large and will be as expected. And that becomes neutral over the course of the full year.

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

Joe, it's Phil, and I'd just highlight. So, if you're looking just on the face, it looks like we've got 20% incrementals for the quarter. But if you back out the acquisition impacts, we are right in the sweet spot of the norm of about 35% incrementals overall. So pretty much in line with what we would've expected.

Joe Giordano - *Cowen and Company - Analyst*

Okay. Fair enough. I wanted to talk higher level about municipalities and what you're seeing. Are you seeing more of a willingness to invest in newer technology? Like are you able to avail yourself maybe a more expensive project if you can convince them that it's a better long-term benefit? Are you seeing a shift (technical difficulty) there?

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

I would say, Joe, it differs. It clearly differs by customer. I think that those water authorities that are privately owned and privately managed, they tend to focus much more on the pure economics and the longer-term lifecycle and, therefore, definitely play up the technology curve and are willing to adopt more of a solution sale there.

But I would also say there are -- even in the public sector, there are a number of water authorities that are becoming much more progressive. It's not limited to here in the US. It's actually been faster adoption in some of the emerging markets in parts of Europe. So it really depends on the customer itself, but we are encouraged by their willingness to adopt new technology and to really focus in on the value proposition.

Joe Giordano - *Cowen and Company - Analyst*

Awesome. And then one last question, I'm sorry if I missed this earlier. Can you talk about your M&A pipeline and what you're seeing out there in terms of potential targets on the technology side and what you're thinking in terms of size?

Mark Rajkowski - *Xylem Inc. - SVP and CFO*

Let me share my observations on that since I'm the new guy on the team. You know, one of my early observations is that very impressed with the strategic work around the value mapping and targeting where to play and how to win. And one of the benefits of that is having a very clear roadmap to informing our capital allocation changes, including M&A.

And as I got up to speed on the M&A pipeline, very clear that both in terms of the number, as well as the relative attractiveness of those opportunities that are in the sweet spot relative to smart infrastructure monitoring and control of the technology stack, if you will, just it's robust and I think there's a lot of opportunity there.

Joe Giordano - *Cowen and Company - Analyst*

Thank you.

Operator

David Rose, Wedbush Securities.

David Rose - *Wedbush Securities - Analyst*

Just two quick questions. On the aftermarket, I was hoping maybe you can quantify the growth you've seen in the aftermarket and maybe some of the impact from total care and maybe you could provide us a little bit more color on the margin impact that we can expect over the rest of 2016 and 2017? I know it's probably pretty small this year, but how should we think about that?

And then the second question will be water reuse.

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

Sure, yes. On the aftermarket service side, we have seen growth of about 5% organically, and that's a pretty good spot to be. Obviously we're looking to grow that even more, but it's good to have a steady mid-high, single-digit kind of piece of business there that generates margins that are historically about 1.5 times the level of our original equipment sales on the project.

So we do believe that we've seen some share gains in that area as well, but hard to quantify, and it's a very, very fragmented market. So that is an area of the business that we have prioritized in terms of focusing our teams, our work structure, etc. to make sure that we get at that and to make sure that we win more than our fair share of that aftermarket service business.

On reuse, reuse continues to be a very attractive spot for us in our treatment business. Obviously the flashpoints in California and other areas that are now looking at reuse as a truly viable alternative, whether it be to de-sal or other forms of treatment, it well positions us to play in that sector.

It's still a very small piece of our business. And so I wouldn't put too much on in terms of financial impact in the immediate term, but I think it's a very positive trend line for our business from a technology standpoint.

David Rose - *Wedbush Securities - Analyst*

Okay. Great. Thank you very much.

Operator

Thank you. I will now turn the floor back over to Patrick Decker for any additional or closing remarks.

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

Sure. Well, thank you all for joining, thanks for your continued interest, and thanks for your patience on the call today, and we're looking forward to catching up with you soon. So, in the meantime, safe travels and we'll speak to you soon. Thank you.

Operator

Thank you. This does conclude today's Xylem first-quarter 2016 earnings conference call. Please disconnect your lines at this time, and have a wonderful day.
