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PRESENTATION

Operator

Welcome to the Xylem third-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*

Thanks, Crystal. Good morning, everyone, and welcome to Xylem's third-quarter 2016 earnings conference call. With me today are Chief Executive Officer Patrick Decker and Chief Financial Mark Rajkowski. They will provide their perspective on Xylem's third-quarter 2016 results and discuss the full-year outlook for 2016 as well.

Following our prepared remarks, we will address questions related to information covered on the call. In order to have enough time to address everyone on the call, I will 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 investor section of our website at www.xylem.com. Also, a replay of today's call will be available until midnight December 6. Please note the replay number is 800-585-8367, and the confirmation code is 29494780. Additionally, the call will be available for playback via the investor section of our website under the heading presentations.

Now please turn to slide two.

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 the 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 events or results could differ materially from those anticipated. With that said, please turn to slide 3 for a few keynotes regarding today's presentation.

First, I would like to highlight that we have provided you with a summary of our key performance metrics we reported earlier this morning in our release. This includes both GAAP and non-GAAP metrics. For purposes of today's call, all references will be on an adjusted basis unless otherwise indicated. And non-GAAP financials have been reconciled for you and are included in the appendix section of the presentation. Additionally, please note that references to 2015 metrics include the financial impact attributable to previously announced acquisitions and have been adjusted to exclude nonrecurring transaction costs.

Now please turn to slide 4, and I will turn the call over to our CEO, Patrick Decker.

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

Thanks, Phil, and good morning, everyone. Thanks for joining us to discuss our third-quarter performance. Today marks a significant new chapter for Xylem. Yesterday, October 31, was the fifth anniversary of Xylem spinning out of ITT and embarking on its journey as a new Company. We have evolved since that day and made substantial progress, creating significant value for our shareholders. So today, on the first day of our sixth year, we begin as a larger, stronger and more focused enterprise.

We have a clear long-term strategy that we laid out last year at investor day, one in which Xylem becomes the definitive market leader and a leading provider of advanced technologies and integrated solutions across the water sector to drive long-term growth, margin expansion and value creation. We know where we want to take this Company, and we're making meaningful progress in executing those plans. I am pleased with what our team has accomplished, but I know we're still in the early innings.

This morning, we announced we have successfully completed our acquisition of Sensus, a global leader in smart meters, network technologies and advanced data analytics. As I explained in August, this business is squarely aligned with our strategy of becoming a leading provider of systems intelligence solutions to our customers, which we laid out at our investor day last year. Their portfolio includes the type of advanced technologies that are fueling the transition of the water sector to smart infrastructure.

The transaction closing process was smooth, with no unexpected hurdles and the various regulatory reviews. Our highly successful debt offering -- it was 10 times oversubscribed -- was a sign of great confidence in Xylem and in this transaction. Our teams did a great job all around in bringing this deal to a prompt close. Now we're focused on accelerating the integration process so we can realize the full value of this combination. I will come back to the integration in a few moments.

We had another announcement today, and I'm speaking of our acquisition of Visenti, which we completed in October as well. Visenti, based in Singapore, has developed a suite of products and services that focus on increasing the productivity of water distribution networks. They primarily target the perennial challenge of leak detection, pressure management and water quality monitoring in the distribution network. While small, this Company's solutions are complementary to both the Xylem and Sensus portfolio.

We know them well. We entered into a strategic partnership in 2012 at the request of the Singapore Public Utilities Board. The Public Utilities Board, which is widely recognized as a definitive thought leader in the water space, asked us to partner with them to pilot a comprehensive solution to monitor the drinking water network throughout Singapore, which was highly successful. Now that they are part of Xylem, with the global support and infrastructure we bring to the table, we will help them scale their business. I will have more comments on the Visenti business in a few moments as well.

Now let's review our third-quarter results. Our teams once again delivered a solid performance in a very mixed economic environment. While organic revenue was flat year over year, strong execution and accelerated productivity initiatives helped drive 90 basis points of margin expansion and 10% earnings growth. Orders in the quarter increased 1% year over year and were up 2% sequentially, boosted by some large new orders in emerging markets.

Overall, we had expected the oil and gas sector trajectory to begin to level off. But to our disappointment, the declines continued, and we now expect that trend to extend at least into next year. This continues to impact our dewatering business as well as portions of our analytics portfolio.

This prolonged weakness is having a disproportionate impact on regions that are highly dependent on commodities as a source of funding for other industries such as the Middle East. We saw this play out in our results this quarter as the major project work there dropped off significantly.

On the positive side, the opening of our new factory in Dubai last month will enable us to be a more active participant in the book-and-bill business because we now can meet the quick lead times required by customers.

Let me address some other market conditions. We are operating in certain end-markets that are experiencing growth. Public utility is our best example at the moment, and we are aggressively going after the business and, in many regions, capturing share. And with the addition of Sensus, we are increasing our exposure to this sector with a broader portfolio of solutions and enhancing our leadership position in one of the faster-growing, higher-margin areas of the industry.

In the quarter, we delivered 10% growth in the global public utilities sector and that momentum is continuing. The US continues to be the hottest market in this space, and there we generated a 25% increase over last year's performance of 7% growth. This growth reflects the realization of pent-up demand in this space. But I also want to acknowledge the tremendous effort of our teams. They are taking nothing for granted, and that is evident in their performance and capturing share.

The industrial segment, which represents our largest end-market, is a different story. This sector continues to be a challenge, and we are closely monitoring a mixed macro environment. We realize that we cannot control market conditions. However, we are taking steps to mitigate some of the impact. We are evaluating conditions by subsector and by region so we can optimize our cost basis and ensure that we are well-positioned when market positions begin to improve.

Moving to our emerging markets, overall, our revenue was down 4% in the quarter, driven primarily by a decline in the Middle East. One of the bright spots was China, where we generated growth in our infrastructure business. Additionally, our team is building backlog there with sequential improvement of 19%, primarily in the water infrastructure business. They delivered a significant win in the quarter of $13 million for our Wedeco ozone systems that will be used in two pulp and paper plants. This will be the first ozone bleaching application in this sector in China and opens the door to new potential business with a far more environmentally friendly and sustainable solution than was previously used. This is driven in part by China's increasing regulations for more sustainable practices and industrial operations.

Another noteworthy region is India. There, we continued to deliver on the $39 million custom pump job that we won last year in the third quarter. This installation will be used for the world's largest lift irrigation system, which will bring water to farms serving thousands of rural villages.

As we noted when we announced the win, this major project is providing a sound foundation for other, similar projects in power and irrigation. This past quarter, we won a $37 million contract for a pumping station that will be part of a $1 billion mega-lift irrigation project in the Telangana region in Southern India. This project will ship substantially over the course of 2017. Once again, this success was the result of strong collaboration between our local team in India and our flight custom pump team in the US. They customized the design to meet the customer's exact specifications and ensure that the complex solutions can be sourced completely with local supply.

As we've done all year, our focus on cost controls and increasing productivity remain steadfast. In the third quarter, we delivered $35 million in gross cost reductions, which brings our year-to-date total to $87 million. Our global procurement group continues to leverage Xylem's scale to deliver sustainable savings across multiple categories. These actions helped to mitigate some of the impact of the challenging market conditions we faced. In keeping with our productivity for growth mindset, the savings also funded strategic investments for growth.

Additionally, we are accelerating targeted restructuring actions that will deliver incremental savings in the fourth quarter and greater savings in 2017. These results position us well to easily surpass our full-year goal for cost savings and productivity improvements.

Finally, at the bottom line, we delivered adjusted earnings per share of $0.54 in the quarter, a 10% increase over last year's result. We also generated $121 million in free cash flow, resulting in a 166% conversion rate.

Now please turn to slide five, and I will update you on the status of our acquisition integration.

We are thrilled to now have Sensus as part of a larger Xylem. Sensus is a complementary partner that significantly broadens our offerings with the type of systems intelligence solutions that move our portfolio up the technology curve. This instantly increases the value we can bring to customers with solutions that target some of their most urgent challenges. The need to increase energy efficiency, improve lifecycle costs, and extract actionable insights from data to optimize their operations -- these are all high on the priority list of customer needs that we are now better equipped to meet.

Together, we will strengthen our industry leadership position, particularly as we expand into new markets, leveraging Xylem's global reach and the strong customer relationships cultivated by both companies. With the deal closed, we are focused on executing our integration smoothly and efficiently so we can realize the full value of the combinations. Our teams have already been collaborating for several weeks and now that work will accelerate.

Today, Sensus will operate as an independent business unit and will be reported as a new segment. Randy Bays, who has been serving as president of Sensus, will continue to leave the business, reporting to me. We will be thoughtful and deliberate as we enable greater collaboration across our sales teams, ensuring that we capture new opportunities while not disrupting the existing business.

On the R&D side, our teams will immediately collaborate to identify areas where work can be combined or aligned to accelerate progress and fuel the substantial revenue synergies we expect to deliver.

The Sensus business is increasing our exposure to more attractive in markets such as public utility through the fast-growing smart metering sector. In the last two quarters, Sensus delivered top-line growth of more than 10%. This gives us even greater confidence in the 6% to 7% compounded revenue growth rate that we projected through 2020 when we announced the deal back in August.

With two months remaining in the calendar year, we expect Sensus to add about $0.01 to our full-year adjusted EPS. In 2017, their contribution is expected to increase our earnings by at least 5%, or approximately $0.10 to $0.12 of earnings per share. We are still early in the process of evaluating the full range of possible synergies, but we remain confident in our ability to deliver cost savings of at least $50 million in revenue synergies in excess of $100 million by 2020, which we communicated when we announced the deal.

With Visenti, we have a business that is highly complementary to both Xylem's and Sensus' offerings. In fact, the Company was in Sensus' own acquisition pipeline. Visenti operates in the $2 billion market of asset management solutions, which is growing in the high single-digit rate. One of these specific challenges that Visenti's technical solutions address is what is known as nonrevenue water. This term refers to treated drinking water that is lost through leaks, theft or other causes.

Globally, roughly 30% of treated drinking water is lost every year. Said another way, for public utility, that is 30% of their product just dripping away. As utilities and communities focus their resources on improving the resiliency of their infrastructure, this is an urgent and solvable challenge that we are now well-positioned to help them address. Furthermore, the addition of Visenti's highly expert data scientists, along with Sensus' capabilities in this area, will further accelerate our overall R&D work across Xylem in the area of systems intelligence. This is yet another compelling demonstration of how M&A can serve as a proxy for R&D.

This was an attractive deal at $8 million plus earn-out opportunities. Given its relative size, we currently expect it to be neutral to both 2016 and 2017 results.

Now I will turn it over to Mark for more details on the quarter, and then I will come back to our final outlook for the year.

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

Thanks, Patrick. Organic revenues were flat in the quarter. We generated a point of growth from acquisitions which was offset by currency impacts. We had another quarter of strong growth in public utilities, which helped mitigate increasing softness in the industrial end-markets.

Looking at our end-markets in more detail, the outstanding growth we've seen in the public utility continued for the fifth consecutive quarter.

Globally, we correct 10% in the sector during the third quarter, reflecting our leadership position and ongoing strong execution in which we are capturing share and delivering value to our customers.

Revenues also grew 2% in both commercial and residential building services in the quarter. Offsetting the growth in these end-markets was a 7% decline in our industrial markets, including softer than expected revenues in our dewatering and analytics businesses. I will cover these challenges further in my overview of our segment performance.

Regionally, Western Europe grew 3% in the third quarter with modest growth across most of our businesses and end-markets. The US market was up 1%, as strong performance in public utilities was largely offset by weakness in the industrial markets. Our emerging markets results were mixed. Overall, we saw a 4% decline in the quarter, which included a tough prior-year comparison of 9% growth. Our Middle East business declined 28% during the quarter, reflecting both the timing of large prior-year project deliveries as well as a further slowdown in the region.

China was down 4% year over year and in line with our expectations. We are encouraged by the quarters sequential improvement in revenues and orders as well as positive year-over-year growth in our water infrastructure segment reflecting what we believe is a slow but steady recovery in this market.

India was a bright spot, delivering strong growth of 67%, driven primarily by our continued execution on the large custom pump project that Patrick mentioned. Shifting gears, our teams did an outstanding job expanding operating margin by 90 basis points to 14.6%. Our initiatives around continuous improvement and business simplification continued to create significant value for the Company. In the quarter, global procurement, lean six Sigma activities, and restructuring savings reduced our costs by $35 million resulting in 390 basis points of margin improvement.

This included $4 million in savings from the restructuring actions we executed earlier this year. These savings more than offset 180 basis points of cost inflation and funded 90 basis points of strategic investments. Given the ongoing weak demand we are facing in the industrial end-market, we are accelerating actions to mitigate the near-term impact and position the business for further margin expansion as conditions improve. Acquisitions negatively impacted operating margins by 20 basis points in the quarter, reflecting in part non-cash amortization costs associated with purchase accounting.

Given the challenges we faced during the quarter in our industrial markets, very pleased with our team's performance in delivering adjusted earnings per share $0.54, an increase of 10% year-over-year.

Please turn to slide 7, and I will provide additional details on our reporting segments.

Water infrastructure recorded orders of $604 million, up 2% organically year over year. This growth was primarily driven by the $13 million treatment order which Patrick highlighted earlier. It also includes the $37 million custom pump order in India which offset a similar large project award last year.

We exited the quarter with total backlog of $598 million, down approximately 5% year over year, but improving quarter sequentially by 10%. It is worth noting that our treatment project final continues to grow, up 22% from this time last year. This trend gives us confidence that the municipal market will remain a source of growth for the foreseeable future.

Revenues of $554 million represent a 1% increase year over year on an organic basis. Acquisitions added an additional $8 million to the top line, while foreign exchange was up $14 million headwind. In the US, the segment grew 6% overall. Our public utility business grew 25%, surpassing a very strong first-half growth rate of 22%. This growth was partially offset by significant challenges in our dewatering business, including double-digit declines directly tied to the oil and gas market and a 15% reduction in equipment sales to distributors for reducing their investments in fleet inventory.

Western Europe grew 2% overall, driven by another solid quarter in the UK, where our teams drove 14% growth, capturing opportunities as we continued through the amp 6 cycle. This growth was partially offset by the lapping of project deliveries across Europe as well as lower public utility demand in France. Emerging markets declined by 6% overall, driven by substantial slowing in the Middle East and Latin American markets. These challenges were partially offset by a significant positive contribution from India, with revenues up more than 80%. And China returned to growth in the quarter, posting a 3% increase, a positive trend that we expect will continue.

The prolonged decline in oil and gas prices is significantly impacting the level of government and industrial spend in the Middle East, where revenues for the segment were down 42%. Revenues in Latin America were down 16% in the quarter, reflecting the lapping of prior-year projects in our dewatering and analytics businesses and, to a lesser extent, still-challenging market conditions in the mining sector.

Operating margin increased 50 basis points to 15.9% as productivity initiatives offset cost inflation and unfavorable mix as well as funding increased strategic growth investments.

Our productivity programs drove 380 basis points of margin expansion, reflecting a 100-basis-point quarter sequential acceleration in year-over-year savings from these actions. Inflation was 180-basis-point headwind, and we had 70 basis points of unfavorable mix, largely driven by the declines in our higher-margin dewatering and analytics products.

Acquisitions were also a 40-basis-point drag on margins in the quarter.

Applied Water booked orders of $342 million in the quarter, flat organically over the prior year. The segment entered the fourth quarter with total backlog of $177 million, most of which is expected to ship in the fourth quarter. Revenues were $343 million, down 1% organically versus the prior year. In Western Europe, revenue increased 4%, with strong growth in the commercial building services and residential markets. Here, we continue to benefit from energy-efficient product launches and our enhanced regional sales capabilities.

Segment revenue was up 1% in our emerging markets, primarily due to 7% growth in Latin America, which more than offset sales declines in the Middle East.

In the US, revenues were down 4% in the quarter. This was primarily driven by the segment's industrial revenues, which declined 9%. Primarily reflecting continued weakness in oil and gas and, to a lesser extent, light industrial attributable to lower OEM demand in food and beverage and decreased docking levels by marine distributors.

Delays in the release of projects in the US commercial building sector drove lower year-over-year revenues but were partially offset by growth in residential groundwater applications.

Segment operating margin decreased 180 basis points to 15.5% year over year. Cost reductions drove an impressive 410-basis-point margin improvement, representing a 30-basis-point quarter sequential acceleration in year-over-year cost savings. This more than offset 170 basis points of cost inflation and 90 basis points from strategic growth investments, which included the localization of product assembly in the Middle East.

Now let's turn to slide nine to cover the Company's cash flow and financial position. We closed the quarter with a cash balance of $659 million. Subsequent to the end of the quarter, and in connection with the Sensus and Visenti acquisitions, we utilized approximately $400 million of European cash to close these transactions.

We also issued $900 million of long-term US notes, which were split into two tranches. The first tranche was for $500 million with a 10-year maturity in a 3.25% interest rate. The second tranche was for $400 million, a 30-year maturity at a 4.375% interest rate. As Patrick indicated, we were 10 times oversubscribed, reflecting investor support for the deal and our Company's strong financial profile. To complete the deal financing, we placed $200 million of short-term European debt in $200 million of commercial paper, which we expect to repay over the next 12 to 18 months.

Lastly, I would like to highlight that we continue to maintain our investment-grade credit rating, which will require that we focus our capital deployment on debt repayment over the next 12 to 18 months. Now back to a few more cash items for the quarter.

During the third quarter, we invested $28 million for capital expenditures and also returned $28 million to our shareholders through dividends. Free cash flow in the quarter was $121 million, a 4% increase from the prior year. Free cash flow conversion was 166% in the quarter, and we expect to deliver at least 100% cash conversion this year. We also improved working capital as a percentage of revenue by 40 basis points in the quarter, excluding the impact of acquisitions in foreign exchange.

Now please turn to slide 10, and Patrick will cover the update to our 2016 outlook.

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

Thanks, Mark. We are updating our full-year revenue guidance and now expect to generate revenue of approximately $3.8 billion for the full year. This reflects a few changes.

First, we are lowering our full-year organic growth expectation from what was previously a 2% to 3% range to 1.5% to reflect both our third-quarter performance and changes to certain end-market assumptions, which I will cover in more detail in the next slide. This reduction includes nearly a full-point decline due to weaker conditions in the Middle East.

Secondly, we are updating our top-line guidance to reflect greater-than-expected foreign exchange headwinds.

Lastly, we are incorporating the expected contribution from the Sensus acquisition. This includes $140 million revenue that we expect this business to generate in November and December.

Along with the transactions we announced early this year, we now expect acquisitions to add approximately 5% of revenue growth to our full-year 2016 performance. Following another quarter of strong execution and productivity delivered by our team, and anticipated contributions in the fourth quarter, we are forecasting full-year operating margin of 13.4%, including 50 basis points of dilution attributable to acquisitions. Excluding the acquisition dilution, our operating margin is expected to increase 100 basis points over the prior year.

As I mentioned earlier, we are maintaining our previous EPS midpoint of $2.03 while narrowing our EPS guidance range of $2.02 to $2.04. Our new guidance reflects the net impact of the Sensus acquisition offset by $0.01 of unfavorable foreign exchange translation in addition to other volume and cost savings adjustments. Mark will provide more color on these impacts in a few minutes.

Now please turn to slide 11, and I will walk you through the update to our end-market assumptions for 2016.

Beginning with public utility, at 33% total revenue before the impact of Sensus is added to the portfolio. Over the first three quarters, we generated very strong organic revenue growth, up 12% year over year. Looking ahead, we expect growth to moderate particularly as we lap our very strong fourth-quarter performance of last year, when we grew 8%. We expect continued momentum in this market to generate a mid- to high-single-digit increase in the fourth quarter of 2016.

As a result of our performance to date and fourth-quarter expectations, we now anticipate public utility growth in the high-single to low double-digit range, which is higher than our previous guidance. Our industrial end-market, which represents 44% of total revenues, full-year organic revenue is expected to be down mid-single digits, weaker than we previously anticipated. We now expect declines in the oil and gas sector to continue at least into next year.

Moving to commercial, after first-half growth of 3%, we delivered a 2% increase in the third quarter. Our teams continue to see relatively healthy levels of design and quoting activity, which could provide for some incremental growth in 2017. However, in the immediate term, based on actual order input rates, we believe that growth will remain in the flat to low single-digit range. Now, this global outlook includes some geographic differences.

For example, we expect a more stable growth environment in the US institutional market and continued growth across most European geographies. China should benefit from the lapping of lower prior-year comparisons. The Middle East, however, is expected to face more challenging market conditions.

In a residential, we now project full-year revenue to be down low single digits. Agriculture will likely be down mid-single digits. Now, while these sectors experienced challenging market conditions in the first half of the year, we did see some slight improvement in the third quarter.

Now please turn to slide 12, and Mark will walk you through more of the details on the outlook. Mark?

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

Thanks, Patrick. Before I cover the outlook, I would like to spend couple minutes highlighting the benefits of our continuous improvement in business simplification programs, including the improvements we are making to the experience our customers and channel partners have when doing business with Xylem. Our ability to operate our business in a more aligned fashion with improved processes and by leveraging our global scale is a significant opportunity for us at Xylem.

For example, our centralized global procurement organization was formed less than two years ago and today is delivering savings and improved supplier quality in terms at a significantly higher level of performance. After posting record savings of $64 million last year, the team is well on its way to delivering $80 million in 2016, representing a 25% year-over-year improvement.

Procurement savings have provided 200 basis points of operating margin expansion over the first three quarters and are expected to drive nearly 260 basis points in the fourth quarter of this year.

Lean and six Sigma are also gaining traction this year as we build more capability throughout the organization. This will be a significant value creation tool for years to come.

As for this year, we anticipate completing more than 100 Kaizen events which will provide approximately $35 million in full-year savings. We anticipate an acceleration in savings from these activities as we close out the year, given the increased velocity of our kaizen events as well as the leverage from higher fourth-quarter volume.

Beyond cost savings, this program is meaningfully improving the speed and service performance with our customers. For example, year to date, our on-time delivery has approved by 400 basis points while also enabling us to reduce customer lead times.

We also expect to see an increase in cost savings attributable to our business simplification activities. During the third quarter, we realized $4 million in restructuring cost savings, bringing our year-to-date total to $9 million. As a result of recent actions, we now anticipate $7 million of cost savings in the fourth quarter, nearly double the benefit from the programs executed earlier this year.

These actions will help us mitigate some of the nearer-term demand weakness we are anticipating in our industrial markets and will provide additional run rate benefits in 2017.

In summary, our focus on continuous improvement and business simplification has provided substantial benefits to date. These actions will enable us to continue to deliver margin expansion while also positioning us more competitively with our customers. Please turn to slide 13.

As shown on this slide, we are maintaining the midpoint of our full-year EPS guidance at $2.03 per share while narrowing the range to $2.02 to $2.04 per share. While there was no change to the midpoint of our full-year guidance, there are a number of factors which will be impacting our fourth quarter. Relative to prior guidance, we are reflecting that impact of our revised revenue outlook, including $0.01 unfavorable impact from recent foreign exchange fluctuations.

At the operating margin level, we expect higher productivity gains and incremental cost savings to provide 30 basis points of margin expansion and $0.05 of EPS benefit. We expect Sensus revenues to be $140 million for the two months ending December 31. We also expect Sensus operating income to be $0.04 accretive to fourth-quarter earnings, including our preliminary estimate of $0.03 of non-cash amortization costs for intangibles, which has a dilutive impact on Xylem's overall operating margins. We will provide an update to the expected impact from non-cash intangible amortization on our next call after we complete the initial purchase price valuation for the opening balance sheet.

Finally, fourth-quarter interest expense will increase $8 million, or $0.03 per share, reflecting higher borrowings to fund the acquisition.

Please turn to slide 14, where I will briefly summarize our key fourth-quarter assumptions.

Organic revenue growth is expected to be flat to up 1% for the fourth quarter, with water infrastructure anticipated to grow in the range of 1% to 2% and applied water expected to be flat to down 1%. As I mentioned, Sensus is expected to add approximately $140 million of revenues in the quarter. Operating margin is expected to range between 14.6% and 14.9%, including 130 basis points of dilution from this year's acquisitions, which was primarily due to non-cash amortization of intangibles. And earnings are expected to range between $0.65 and $0.67 per share.

With that, I will hand the call back over to Patrick for some closing comments. Patrick?

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

Thanks, Mark. So, overall, we continue to deliver on the investment thesis we unveiled at our investor day last fall. We continue to benefit from differentiated end-market exposure and are delivering above-market growth in the public utility sector. Our strong and sustained commitment to continuous improvement and business simplification efforts is driving margin expansion. And we are accelerating capital deployment to create greater shareholder value.

Now, operator, we can open it up to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jim Giannakouros, Oppenheimer.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Let me start with the big one -- news yesterday that a large asset in your world is becoming available. You mentioned in your prepared remarks that debt repayments is the priority. Does that and integrating Sensus preclude doing anything big on the M&A front, and how big would you go?

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

Yes, well, thanks for the question, Jim. First of all, we clearly don't comment on speculation on transactions, et cetera. I will say that our number one focus right now is to deliver on our full-year commitments here in the fourth quarter, make sure that we are well-positioned to deliver another strong year in 2017. And all of that, of course, includes a very successful integration of Sensus, which we are very excited about. So I'd keep my comments to that.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Fair enough. If I can follow up on specifically what you're seeing in dewatering, I know that some reads are stabilizing in upstream. I think that's tied to recounts, et cetera. But you guys are saying that headwinds may persist into next year. Curious if there's anything specific to dewatering. And how should we be thinking about the margin (inaudible) as well as analytics. Thanks.

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

Sure, it's a great question. So I think that we are not seeing anything different, I would say, from our peers or others in this space that relates to a more dour view on the impact of oil and gas. I think we're just trying to be -- quite frankly, trying to be conservative here as best we can on what the outlooks could be. This is a fairly short-cycle business for us in dewatering. And so it's kind of hand-to-mouth in terms of what rental rates are, et cetera.

What we really saw in the quarter that was a bit more of a surprise for us was the pullback by our distributors in terms of them buying pumps from us. So, cutting back on their capital spend. In speaking to them, trying to get a feel for how much of that is a near-term blip versus a new baseline. And it's very difficult for them to get a read right now on the markets themselves.

So, we are saying it carries through 2017, but that's our best guess at this stage. But I would say there is nothing unique about our position in this space relative to others.

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

And certainly, those are higher-margin products sales. So, as I mentioned in my comments, we would expect that to have roughly 30-basis-point impact on operating margins.

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

Yes. And last I would say is the team in dewatering -- they are not exclusively tagged to oil and gas or mining. There is a very healthy muni market out there as well. And I know that Dave Quentin, who leads the business, and the team are driving aggressively to diversify our exposure in that business to capture some of those non-oil and gas opportunities. But those are not quick-turn things that happen within a month or two, and that's what we are really focused in on as we head into 2017.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Thank you. That's helpful. I will get back in queue.

Operator

Deane Dray, RBC Capital Markets.

Deane Dray - *RBC Capital Markets - Analyst*

Would like to dig a little bit into the water infrastructure. It was nice to see continued strength in municipal. But one of the things that jumped out at me was some of the weakness in analytical. And a lot of people might think that's pretty resilient. So what's causing some of the softness there?

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

Yes, I would say first, Deane, it was the industrial side of the analytic exposure that we got hit the hardest with, and we saw that consistent with a couple of our bigger competitors -- the same kind of market downturn. And it was also very concentrated in North America here in the US. So, I would say it was US industrial was the primary impact.

And then we also had a reasonably large project that we shipped out to Brazil, a couple million dollars last year. So that was about a half of the decline that you saw with that tough compare on that large one-time Brazil project.

Deane Dray - *RBC Capital Markets - Analyst*

Great. And then I liked all the color on the productivity initiative that you've got going on. And could you remind us where the goal is in terms of operating margin upside?

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

Yes, so -- you know -- and, again, this is all separate from the impact Sensus has for us, which should be additive to what we're talking about here. And we will talk about the framework for Sensus further and the timing around when we will give new three- and five-year outlooks for the Company.

But our base business of Xylem, excluding Sensus, we believe that there is 300 to 400 basis points of operating margin expansion, and that is net potential increases in R&D investments. Now, those investments in R&D will not be a steep as they were before because of the acquisition of Sensus. And we will be leveraging their capabilities and investing a bit more in that area. But it was 300 to 400 basis points.

And I'm pleased to say, Deane, that where we are guiding to the full year, if you take out the impacts of the purchased accounting from acquisitions, we will have delivered right at 100 basis points of that margin expansion this year. So I feel we are well on our way here and still in the early stages of that productivity focus.

Deane Dray - *RBC Capital Markets - Analyst*

That's real helpful. And then just last question for me, a little more color on this acquisition of Visenti. There's been such focus on nonrevenue water -- and you cited that 30% of leakage globally, and all municipalities talk about that. And that's one of the sources of fresh water, if you will. It's just fixing those leaks.

So I'm intrigued about the technology because most people are either talking about outside the pipe -- ultrasonic pipe detection or inside-the-pipe detection. What is Visenti's edge? And does this Singapore project -- will that serve as a reference site for you?

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

Yes, it certainly does, Dan. And I know you are extremely knowledgeable of Singapore PUB. So you can imagine what the reference point is on a global scale when you got Singapore PUB as an incubator to drive this.

And so Visenti has already diversified away. They've got a number of other customers in other geographies and, quite frankly, have more requests for their services than they have the resources to do right now, which is really part of the backdrop for our partnership and acquisition of them.

But they are -- they've got a couple of different software development capabilities that are able to not only gather the data from inside the pipe using ultrasound techniques and other opportunities. But it's also their data science and data analytics capabilities as they model that data that is coming back. And their ability to do that 24-7 irrespective of what the weather is is another opportunity that they leverage.

They are unique, and we do believe that there is an opportunity here to take this well beyond some of the emerging markets. We're actually going to plan -- it's a good time for me to say, we are actually going to be planning to do an investor day, Deane, in very early Q2 down in Raleigh-Durham. And we will be sure to have the team from Visenti there as well to be able to showcase that technology along with what we're getting here with Sensus.

Deane Dray - *RBC Capital Markets - Analyst*

Terrific. Thank you.

Operator

Ryan Connors, Boenning and Scattergood.

Ryan Connors - *Boenning & Scattergood Inc. - Analyst*

I had a question -- wanted to push on the public utility space a little bit and get at some of the drivers there. I know that you seem to be outperforming peers there, and I want to kind of just dig on where that is coming from. I know you talk about a lot of the internal improvements, but you are also on a parallel journey to improve your channel footprint. And I'm wondering whether there's any impact coming from those efforts, whether it be new distributor alignments or any other channel issues that are helping to drive your really strong numbers in public utility.

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

Sure. Yes, we are obviously very pleased with what the team has continued to do there. And as we said earlier, the funnel -- the bidding pipeline continues to grow very nicely, up 22% versus same time a year ago. So I think one of the drivers is that we are getting better visibility into the market as to the project funnel and pipeline. And we are improving our win rates. And part of that is, I think, the impact of us being able to leverage this integration of our commercial teams, looking across the entire public utility offering. So a lot of that lead generation is helping us in a number of geographies across the board.

Secondly, I think, as we have mentioned before, given our substantial market share leadership position in that space, we stand to benefit disproportionately in a rising tide environment. And so we get a lot more looks, I think, than many of our competitors do, and that is really driven as much by our large installed base. And so as the munis are reinvesting in refurbishment of their existing infrastructure, it is highly unusual that they would swap out or switch out an entire pump network. And so we get the disproportionate benefit of that replacement work.

And the same on the aftermarket service repair side -- we have seen continued record levels of break-and-fix business, especially here in North America, that continues to benefit us.

And then lastly, we are in the early stages of some really exciting new product rollouts. We launched a new product called [Conservor], which is really not in these numbers but gives us great confidence about market share capture as we head into 2017 as well.

Ryan Connors - *Boenning & Scattergood Inc. - Analyst*

Okay. Okay, that's helpful. And I wanted to build upon Deane's question in regards to Visenti. I know you mentioned earlier -- obviously, you can't comment on M&A specifically. But conceptually, as you look at that leak detection non-revenue water space as a huge opportunity -- but obviously Visenti, a pretty small asset without a lot of materiality near-term in the numbers. Do you believe that that is a sufficient platform for you to grow the business you think you can grow in that sector? Or do you think you will need at some point to go out and build on that with further M&A in that sector?

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

Yes, it's a great question. I do think that over time we would not limit our efforts here to purely organic R&D. And so we continue to cultivate M&A pipeline. But having said that, our focus right now is squarely on integrating Sensus. What is encouraging to me also is that Visenti was actually in Sensus' M&A pipelines, so there is already a complementary benefit there that we believe we can leverage. And we're going to learn more about that over the coming months.

So, I wouldn't be foreshadowing any meaningful M&A here in the near-term as we focus on integrating Sensus, but I certainly would not rule out M&A over time here in this space.

Ryan Connors - *Boenning & Scattergood Inc. - Analyst*

Got it. Thanks for your time.

Operator

Nathan Jones, Stifel.

Nathan Jones - *Stifel Nicolaus - Analyst*

If I could just follow up on the industrial business, firstly on the oil and gas side there. As you said, it's a pretty short-cycle business. The rig count has improved. They need water. Is that implied that there is idle assets out there that your customers are utilizing rather than buying or renting new assets from you? Just any color you have into that market and why you didn't see that improvement in the quarter.

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

Sure, yes. If that was clearly the -- that was clearly the surprise for -- one of the two surprises was that and of course what happened in the Middle East. So, suddenly in Saudi was the second surprise for us. And those two together cost us well more than a point of organic revenue growth in the quarter, which is where we missed.

So, yes, there certainly are idle assets that are out there that oil and gas customers are using as well as mining. But it's also the impact Nathan of, again, just a mothballing and idling of either mines and/or fracking sites. And so those two things together were the impact.

But where we really saw it in the quarter was our indirect channel -- the distributors pulling back on their CapEx spend so dramatically, down 15% in the quarter. That caught us a bit by surprise as well. And we're trying to model that into our Q4 outlook and just trying to get a feel for what that might look like for 2017.

This might be a good opportunity to that point, Nathan, for me to perhaps share a little bit of the framework of how we're thinking about 2017. And if I start with the end-markets, based on what we see today, we expect these mixed market conditions to continue into 2017. Again, that includes a really robust public utility sector, but it will be against some tougher comparisons given what our full-year growth is this year. But we would still consider that to be very, very attractive.

We would also expect a sluggish environment to continue in industrial for the reasons that I just articulated here. Perhaps that's conservative, but we're trying to be conservative here.

I would say at this point, it would be hard to see organic growth for our historical Xylem businesses i.e. ex Sensus, beyond low single digits. But we are obviously going to learn a lot more as we get through Q4. We're going to be watching order trends closely, particularly in the Middle East and industrial. We are clearly taking actions to manage costs as we've done throughout this year.

But I would probably wrap up into 2017 with what we do know. We know that we're going to get significant contribution to revenue from Sensus, which, given its recent performance, should itself grow at least 6% to 7%, which is in line with the long-term CAGR that we laid out back in August when we announced the deal. What we also know is, at the bottom line we expect to get $0.10 to $0.12 of EPS accretion from Sensus. Now, that's net of purchased accounting impacts.

And then lastly, we expect our margin expansion pace to continue. ,Again, if you exclude the non-cash acquisition impacts from purchased accounting and you think about procurement, lean six Sigma and business simplification benefits. So we expect that margin expansion right in pace to continue. And we also know that we're going to get $0.07 to $0.08 of carryover savings from restructuring that we've already taken this year that will flow into next year.

So hopefully, to those listening, that gives you a little bit of a framework for how we are at least thinking initially about 2017.

Nathan Jones - *Stifel Nicolaus - Analyst*

That's helpful. Maybe if we could just talk a little bit more about the Middle East, was it -- I think you said 29% down in the third quarter. Do you have the comps handy for the first half of the year in Middle East? I can't imagine with oil priced at $50, that is likely to get any better in that geography in the near-term. I'm just --

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

Yes, so, through the three quarters, we are down 4% year over year. So it was up, and then it took a nosedive in the third quarter. Now, part of that year-over-year decline was not a surprise to us because we had a couple of large projects last year -- large on a relative basis for our revenue there -- that we knew was going to be a tough comp. And that was roughly about half of what that year-over-year decline in the third quarter was. So we expected some of that.

The real impact for us in the quarter -- and I was just over there for our grand opening of our manufacturing facility and met with a number of our channel partners as well as with some customers from Saudi. And for those of you that are following the news there, you know that they are going through some serious budget constraints right now. And the common theme across pretty much all sectors is the common down 20%, 30% in the quarter. I'm not sure what the symmetry is there between that and what we saw.

But, for example, the Saudi government just about a month ago announced that they are doing an across-the-board 20% reduction in all government employees' salary immediately. And that is being driven by some of their funding constraints.

And so we saw that pull back in the quarter. We are being told that it will come back and that it is temporary. But right now, until we see an improvement in our order book there over the course of fourth quarter, we're trying to take a prudent view here on what kind of a drag that might have on our overall industrial growth.

Nathan Jones - *Stifel Nicolaus - Analyst*

That's great color, Patrick. Thanks very much.

Operator

Joe Giordano, Cowen.

Joe Giordano - *Cowen and Company - Analyst*

When I look at muni, the above-normal trend growth that you've been seeing there, last year was good, this year even better. You talk about the quoting funnel up 22%. But given where comps are, given what's in backlog in the actual orders right now in that from muni, are they supportive of incremental growth on current rates?

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

You mean faster growth rates than what we are currently seeing?

Joe Giordano - *Cowen and Company - Analyst*

Well, even -- it's going to be strong next year on a gross basis. We know that. But are backlog and current orders suggestive of incremental growth -- like, acceleration from here -- or staying at a really solid level?

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

I think it stays at a solid level. What we would say right now, based on what we've seen -- again, this is not in any way guidance, but we would say as we lap this year's comparison, we would expect it to be somewhere around mid-single-digit growth organically through 2017. Again, we will have a better feel for that as we wrap up our backlog at the end of Q4. But based on what we see right now, that's where we would spot it.

Joe Giordano - *Cowen and Company - Analyst*

Okay. That makes more sense. And in the Middle East, across your portfolio, if current order rates, let's just say, hold from where they are today through 2017, what kind of headwind is that into next year?

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

Yes, I -- it would probably be premature for me to give you a specific number on one region just yet given how quickly things moved. I wouldn't suggest that we're talking about the type of drop that we saw in Q3 by any means. It's probably looking more like where we year to date. But, again, we have a lot more work to do to make sure we have a good handle on what's happening. Specifically, in Saudi is the big driver that we are focused on.

Joe Giordano - *Cowen and Company - Analyst*

And how big is Middle East right now in terms of total sales?

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

It's a little less than 4% of our historical Xylem revenue.

Joe Giordano - *Cowen and Company - Analyst*

Okay. Last question on Sensus, what about the parts that are non-water? What is your view on those pieces of business?

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

We like them very much. So, as I've said -- and I know Deane is somewhere smiling right now when he hears me get ready to say we're not going to be dogmatic about water. This is a perfect example of that. So, on a combined basis, we will still have less than 10% of our total revenue that is somewhere other than water. But the electric, gas and lighting businesses -- really all the businesses of Sensus are participating in very attractive end-markets. They are growing very nicely. They are very attractive from a profit standpoint. And, quite frankly, in many cases, these are common utilities that provide both water, electric and gas. And so there would be a dissynergy there that wouldn't make any sense at all for us to think about any different of approach. And these are also market-leading positions they've got. So we are very attracted to the entire portfolio.

Joe Giordano - *Cowen and Company - Analyst*

Great. Thanks, guys.

Operator

(Operator Instructions) Robert Barry, Susquehanna.

Robert Barry - *Susquehanna Financial Group - Analyst*

I just wanted to clarify a comment earlier -- and appreciate the initial 2017 framework. I think you said on the margin side expecting kind of the pace to continue. So I think you're looking for about up 50 BPs this year. Is that kind of what the base case should be right now for next year, too?

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

Well, I would -- again, stopping short of giving a specific number here because we still -- we are very early in our planning process here. But I would certainly be pushing us to keep the pace that we are right now. And, again, I'm talking about that excluding acquisition impacts of purchased accounting, so that would be closer to 100 basis points this year if you separate the acquisition impacts.

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

We've got a lot of momentum on the global procurement -- lean six Sigma. Those events are ramping up in -- the same on the business simplification side. There is -- we've taken a number of actions that will carry over into next year as well. So, good momentum on just the cost part.

Robert Barry - *Susquehanna Financial Group - Analyst*

Right, right. It sounds like the real challenge is just Sensus, I think with the amortization, comes in at, what, like a mid-single-digit op margin.

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

It is higher single digits.

Robert Barry - *Susquehanna Financial Group - Analyst*

Yes, okay. And then I was just wondering if you could give a little more color on industrial. It sounds like the pressures are getting worse in oil and gas and mining, where they have been. But I think some comments in the prepared remarks suggest they are also spreading. I think you mentioned process for food and bev and marine. I guess a lot of that is in the applied water side. Maybe a little color there.

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

Yes, Robert, I wouldn't read too much into a spreading into the general industrial sector, kind of what we call light industrial. We saw a little bit of weakness there in the quarter. But it was a rounding error relative to the impact that we saw from really two specific areas. And that was the impact of our distributors on the dewatering side heavily tied to oil and gas; and, secondly, what happened in Saudi and the Middle East. Those were really the two new things for us in the quarter that have us thinking a little differently about our guide for this year. And so in terms of our revenue number, I wouldn't read anything into the rest of the light industrial sector.

Robert Barry - *Susquehanna Financial Group - Analyst*

Got you, got you. And maybe just finally on commercial, there has been growing concern about what's happening in the non-res market. Sounded like maybe you saw some incremental slowing there. Can you just clarify what you are seeing in US non-res?

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

Yes, we still continue to see very attractive bidding and quoting activity both on our direct channel as well as indirect. And, again, I've had an opportunity to spend some time with those folks as well. And I think they are all feeling fine around the US sector. It really is some timing of products being awarded. The funnel looks attractive. But we -- and after two years of pretty constant growth, we saw some slowing there in the quarter. Keeping a close eye on it as we get through Q4. But it was still up a couple percent in the quarter, which is down from where you have been tracking through the first half of the year. So, again, keeping a close eye, but nothing there.

The other piece obviously was the weakness that we've seen in China. There continues to be a slowdown in China. We wouldn't say it's getting any worse. It has really just flatlined. And as we get through the end of this year, we will lap that comparison and we will be talking about net positive growth for China all-in.

Robert Barry - *Susquehanna Financial Group - Analyst*

Got you. Any particular verticals in the non-res US where you saw the slowing?

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

Yes, we saw a little bit of slowing in institutional in the quarter. And, again, that's why we -- those typically are larger projects, at least on a relative basis, and we saw some movement and timing around that in the quarter.

Robert Barry - *Susquehanna Financial Group - Analyst*

Okay. Thank you.

Operator

Chip Moore, Canaccord.

Chip Moore - *Canaccord Genuity - Analyst*

Good morning, folks, and congrats on getting the Sensus deal done. Very early here. Maybe we need to wait to get out to Raleigh as well, but any updated thoughts on synergies there? Obviously, a little bit of a different channel for water meters. Just what are your thoughts broadly?

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

Appreciate the question. And we will be sharing in our investor day down in Raleigh-Durham, which, again, I will say is going to be early Q2. That will be an opportunity for us to really showcase the progress we have on integration, how we're thinking about synergy, specific targets that we will be committing to in our three- and five-year outlook for both cost and revenue.

But I would say, as we mentioned back in the call in August, we are very confident that we're going to get at least $50 million in cost synergies. And, as I said in the last call, I would be disappointed if we didn't have more than $100 million of revenue synergies over that time frame as well through 2020.

The areas that are really the biggest opportunity for us on the cost side -- big opportunities in the areas of procurement. And so whether it be overlapping and supplier base, but also just using some of the tools that we put to use here at Xylem the last couple of years, we expect the same kind of progress and momentum to be there on a combined spend basis with Sensus. There are also areas of opportunity in some of our back-office functions and G&A support functions on a global scale.

On the revenue side, it really is going to be focused -- I would say, if anything -- in our synergy planning teams. I don't want to sound like the happy talking CEO here, but there were more revenue synergy opportunities than you can shake a stick at. The key was that they are longer lead time, some of them. They are going to require R&D and engineering support from Sensus. And so we're going to make sure that we are disciplined and balanced on how we think about those things.

But they are really predominantly in areas such as -- one, we've got a number of customers today in common where they already own Sensus' FlexNet and data analytics solutions. But they are only applied today to the clean water side of the network. And we have opportunities to now connect our devices on the waste water side to be able to provide similar solution to the customer for their challenges on waste water.

Second is they've got a number of big international projects that are out that they are bidding on that, in some cases, are with customers that are already customers of ours today that we hopefully are going to be able to help them leverage in some way.

And third, we think there's opportunities to also leverage their data analytics capabilities across multiple parts of the Xylem portfolio to bring in some of that software-as-a-service opportunity across our existing business.

So, these are longer lead times, but we are very excited, both Xylem and Sensus, about the opportunity here.

Chip Moore - *Canaccord Genuity - Analyst*

That is very helpful. Thanks. I think we will look forward to Raleigh. And just lastly on leverage at 3.7 times, do you have a target there you would like to get that to? Thanks.

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

Yes, we're going to get back to the mid-2s, back to our target leverage. And we've been pretty clear stating that intention publicly, certainly with the rating agencies.

Chip Moore - *Canaccord Genuity - Analyst*

Thanks, folks.

Operator

We have reached our allotted time for questions and answers. I will now turn the floor back over to Patrick Decker for additional or closing remarks.

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

Sure. Thanks. Thank you, everybody, for your interest and joining the call today. I know we have covered a lot of territory here, and you will have your follow-up calls with Phil for any clarification. Look forward to meeting with many of you between now and our next earnings call early next year. And, again, looking very much forward to the investor day down in Raleigh-Durham in early Q2.

So between now and then, safe travels, have great holidays and we will talk to you soon. Thanks.

Operator

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