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PRESENTATION

Operator

Welcome to the Xylem's first-quarter 2015 earnings conference call. At this time, all participants have been placed in listen-only mode, and the floor will be open for your questions following the presentation. (Operator Instructions).

I would now like to turn the call over to Phil De Sousa, Vice President of Investor Relations. Please go ahead.

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

Thank you, Angie. Good morning, everyone, and welcome to Xylem's first-quarter earnings conference call.

With me today are Chief Executive Officer, Patrick Decker, and Chief Financial Officer, Michael Speetzen. They will provide their perspective on Xylem's quarterly results and discuss the full-year outlook for 2015. Following our prepared remarks, we will address questions related to the information covered on the call, at which time, I'll ask that you please keep to one question and a follow-up, and then return to the queue, so that we will have enough time to ensure everyone the opportunity to ask a question.

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.XylemInc.com.

All references today will be on an adjusted basis unless otherwise indicated. And non-GAAP financials are reconciled for you in the Appendix section of the presentation. A replay of today's call will be available until midnight on May 14th. Please note the replay number is 800-585-8367 and the conference ID is 5381163. Additionally, the call will be available for playback via the Investor section of our website under the heading Presentations.

With that said, please turn to slide 2. We will make some forward-looking statements on today's call, including references to future events or developments that we anticipate will or may occur in the future. These statements are subject to future risks and uncertainties, such as those factors described in Xylem's most recent Annual Report on Form 10-K, and in subsequent reports filed with the SEC. Please note that the Company undertakes no obligation to update any forward-looking statements publicly to reflect subsequent events or circumstances, and actual results and events 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 thank you all for joining us. Before we get started this morning, I want to acknowledge the earthquake in Nepal that occurred last weekend and the events that continue to unfold in the aftermath. The resulting devastation and suffering are profound. And we, along with so many other global citizens, are responding with immediate resources to assist with their most urgent needs.

We are also actively working to identify additional means and funds to help in this recovery. That spirit is core to our mission here at Xylem and we are keeping all those who have been impacted in our thoughts.

Now let me turn to our results. We started off the year on a sound footing, generating solid first-quarter results. This morning, I'll share some highlights with you. I will also provide a brief update on a few of our key priorities for the year, and discuss our 2015 outlook. I'll then turn the call over to Mike to share additional details, and we'll wrap up by addressing any questions you might have at the end.

We delivered another quarter of solid operational performance, as our teams steadily increased their focus and elevated their execution to deliver a seventh consecutive quarter of margin expansion. While growth rates in the immediate term are not particularly impressive, I am pleased with our execution, particularly as we face mixed economic conditions, including weak industrial markets.

And looking ahead, we see some encouraging signs in certain end markets we serve, as well as attractive investment opportunities that will position us well for stronger growth over the longer-term. As market conditions and macroeconomic variables fluctuate, we remain focused on the factors we can influence, mainly building stronger customer relationships to fuel sales and build backlog, driving better performance, and executing a disciplined capital deployment strategy. This is how we will create more value for our customers and our shareholders.

As I have discussed previously, we have rolled out our integrated commercial IT platforms in a couple of regions now. We are still in the early stages, but I am very encouraged by the results I have seen. These tools are enabling our sales teams to increase lead generation across the portfolio, reduce the time required to produce a quote, and simplify the administrative burden with a streamlined ERP system.

For example, our CRM system, salesforce.com, was implanted across our Americas region, and will be rolled out globally over the course of this year and next. This tool facilitates the immediate sharing of contact and business leads across our commercial teams and growth centers. This is speeding our pipeline of projects, which, over time, we expect will result in a higher growth rate.

A key component of our overall progress is our work in the area of continuous improvement. We are squarely focused on driving a continuous improvement mindset across the enterprise. In other words, broadening the deployment of lean beyond the four walls of the factory. Already we see pockets of success across certain geographies, as teams lean out various processes. But we know there's more that can be achieved, and we have high-priority projects to advance its agenda.

One example is an end-to-end supply project -- supply chain project on one of our largest product lines that should yield a 25% reduction in inventory. And by centralizing our global sourcing activities, we now have visibility to identify meaningful savings on indirect spend, such as contingent labor and freight. These initiatives drive performance and they generate measurable savings that can also be reinvested for growth.

Last month, we announced that Steve Long had joined Xylem as Senior Vice President and President of Emerging Markets. The emerging markets are particularly important to our growth strategy. They include some of the fastest-growing areas of our business, as development in these regions fuels the building of new infrastructure, which presents us with the opportunity to develop new install bases of our Water Technology Solutions.

Steve is well-positioned to lead our efforts to capture and maximize those growth opportunities. One of his immediate areas of focus is to advance our strategy of further localizing our supply chain and R&D in critical growth markets, beginning with China and the Middle East. Steve brings more than two decades of management and commercial expertise, as well as deep knowledge of the unique needs in these regions. I had the opportunity to work with Steve previously, and I know he will bring new ideas and perspective to the good work that's already underway.

I also expect to be able to announce a new Innovation and Technology Officer in the coming weeks. This leader will help us to coordinate and accelerate our R&D efforts, focusing on breakthrough technologies, and innovation in services and business models. As I've said before, we intend to invest some of the productivity savings we generate back into growth opportunities, including innovation.

Now let me quickly review our first-quarter performance. Orders were flat organically, but they were up 4% in our Water Infrastructure segment. This growth reflects several key project wins, with notable progress in our treatment business, which delivered order growth of 13% in the quarter. And while Applied Water orders were down 4%, we did expect a deceleration in this segment, following the strong bookings generated during the fourth-quarter of last year.

One of our big wins in the quarter was a $16 million order for a major municipal project in Canada. The order for flight custom pumps, along with accessories and spare parts, is part of a multi-year project to upgrade this municipality's drinking water treatment plants and distribution systems. This win reflects both the superior quality of our products and the benefits accrued from a strong customer relationship.

In addition, our teams will be able to bring forth the applications expertise needed to craft a customized solution that met the unique requirements of this multifaceted project. This comprehensive approach also helped lay the foundation for potential collaboration on future phases of this endeavor in the years ahead. This order contributed to a 10% year-over-year increase in total backlog and constant currency.

Our teams are spending more time in the field; more time with customers understanding their needs. And the result is that we are building a richer pipeline of projects. Early this month, I had the opportunity to see some of that work in action on a visit to Southern California.

As all of you know, the state of California is now into its fourth year of record drought conditions. The Governor recently issued an Executive Order that, among other things, imposed mandatory potable urban water use restrictions, and accelerated funding for certain drought mitigation initiatives, including the development of water reuse projects.

Xylem is very well-positioned to help the state and its many (technical difficulty) municipalities viable water reuse projects. We have the leading technologies, the applications expertise, and the proven experience to develop solutions to create a sustainable source of water.

In San Diego, I visited the Advanced Water Purification facility at the North City Water Reclamation Center. This site is the focal point of the City's demonstration project, which is a pilot study to determine the feasibility of water reuse technologies to supplement local drinking water supplies, both indirectly and directly. Our technologies are integrated throughout this pilot, and our team has worked closely with the customer on all phases of this venture.

This, along with other pilots in California, is helping to feed our reuse pipeline. That said, even with accelerated state funding, these projects take time to develop to bring them to the point of an actual order. But our teams are working with the right people on the ground, to help influence and advance these initiatives.

Now getting back to our results. Organic revenue grew 1% in the quarter, which was in line with the guidance we provided in February. Operating margin expanded 40 basis points year-over-year or 60 basis points excluding the unfavorable impact of foreign exchange translation. This margin expansion was driven by productivity gains and cost reductions from our continuous improvement initiatives. It also reflects our disciplined approach to investments.

We delivered earnings-per-share of $0.33, up 9% year-over-year before the impact of foreign exchange translation. Considering the muted topline growth, we're pleased with our teams' ability to generate the strong bottom-line performance. We also improved free cash flow generation after funding an increase in growth enabling CapEx investments.

And finally, on the capital deployment front, we increased our quarterly dividend by 10% and opportunistically repurchased $50 million in common stock. In total, we returned $76 million in capital to our shareholders. As I mentioned previously, we do expect to execute on some bolt-on acquisition opportunities later in the year.

Now turning to slide 4. There is no change to the operational outlook in our guidance. Given the deterioration of the dollar since we last provided guidance, and the ongoing volatility in the currency markets, we believe it's prudent to update our 2015 full-year guidance only to reflect additional foreign exchange translation headwinds.

To recap, consistent with the guidance we provided in February, we anticipate 2015 organic revenue growth of 1% to 3%. Similarly, we continue to expect our adjusted operating margin to grow in the range of 50 to 90 basis points, reflecting the carryover benefit of our broad-based restructuring efforts last year, as well as additional efficiencies we expect to drive in 2015.

We are updating our adjusted earnings-per-share guidance to $1.80 to $1.90 for the full year, which includes $0.26 of negative foreign currency translation impact. This is a nickel more than we previously anticipated. Excluding this headwind, year-over-year EPS growth is still expected to be in the range of 5% to 10%. Finally, we will continue to execute a disciplined approach to capital deployment, which is expected to result in 100% free cash flow conversion.

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

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

Thanks, Patrick. Please turn to slide 5. We generated revenues of $837 million, down $69 million from the prior year. The year-over-year decline reflects the anticipated foreign exchange translation headwind, driven by a stronger US dollar, and the impact of our valves divestiture in the third-quarter of 2014. Excluding those items, organic revenue increased 1%, in line with our expectations and the outlook we provided during our last call.

From an end market perspective, commercial led the way, up 9%, with both public utility and residential up 2%. Partially offsetting these gains were declines in the industrial and agricultural markets of 1% and 13%, respectively.

From a regional perspective, we continue to see strong growth in emerging markets, up 9%, and modest growth in the US, up 2%. This was partially offset by declines in Canada and Australia, which were each down 12%. Lastly, Western Europe was flat for the quarter. Operating margin increased 40 basis points to 10.8%. Excluding the negative impact of foreign exchange translation, margins increased by 60 basis points, which demonstrates our improved cost base, as this is a strong performance, given the limited operating leverage on 1% organic growth.

Focus and strong execution on continuous improvement and business implication initiatives reduced cost by $23 million in the quarter, and resulted in 270 basis points of margin expansion. Partially offsetting these reductions were inflation of nearly 2%, higher pension expense, and the unfavorable impact from the divestiture of our valves business last year.

Earnings-per-share declined by $0.01 to $0.33. However, excluding the foreign exchange translation headwind of $0.04, we grew EPS 9%.

Now let me cover each of our reporting segments. Please turn to slide 6. Water Infrastructure recorded orders of $562 million, up 4% organically, including a $16 million project win for transport custom pumps. Book-to-bill was 1.12, our strongest since the first quarter of 2010. As a result, we exited the quarter with total backlog of $585 million, up 12% on a constant currency basis. Of this amount, 75% is due to ship this year, with the balance of nearly $150 million expected to ship in 2016 and beyond.

Revenue of $500 million was flat year-over-year on an organic basis. From an application perspective, we saw 3% growth in treatment, while transport was flat and tests was down 3%, due to a tough compare. Regionally, we saw the most significant growth come from emerging markets, which were up 10%. The US was also positive, up 1%. Offsetting these gains were declines in Canada, Australia and Western Europe.

In summary, strength in emerging markets was driven by our ability to capitalize on the development of water and wastewater infrastructure in these regions. Treatment, for example, increased more than 40% in China, driven by the delivery of ozone and filtration projects.

Transport applications also grew, up 9% in emerging markets, and tests generated positive momentum, but not enough to overcome the comparison to a $3 million project delivery in Brazil last year. The great news is that we expect to deliver on another sizable project to the same key account later this year.

The US contributed organic growth of 1%, driven by strength in test applications. Offsetting this favorable performance was lower public utility spend and lapping of prior-year projects in Canada and Australia. Furthermore, we saw weakness in Canada, driven by the softening of the oil and gas market.

Operating margin increased 10 basis points, from 10.5% to 10.6%, due to cost reductions and positive price realization. Restructuring savings of $4 million, coupled with sourcing and lean initiatives, more than offset the negative effects of inflation, pension and foreign exchange transaction losses. Foreign exchange translation unfavorably impacted operating income by $6 million, but was neutral to margin.

Let me now turn to slide 7 and talk to our Applied Water segment. Applied Water recorded orders of $353 million, down 4% organically. We do not believe this is an indication of any significant changes in this segment's end markets, but rather due to timing, as Applied Water reported organic order growth of 9% in the fourth quarter of last year. As a result we enter the second quarter with total backlog of $208 million, up 4% on a constant currency basis, more than 60% of which is expected to ship within the quarter.

Revenue was $337 million, up 2% organically from the prior period. Building service applications were up 6%, irrigation was down 13%. And industrial water was down slightly at 1% year-over-year. Regionally, we generated growth in emerging markets in the US, which were up 7% and 2%, respectively. And Europe was flat overall for the quarter.

To further summarize our revenue performance, I would highlight growth in building services was driven by strength in US commercial, up 9%, where we have seen distributors restocking in advance of what we anticipate could be a recovery in the institutional building sector. Additionally, we continue to see growth in emerging market regions like the Middle East and Asia-Pacific.

Residential was up 2% globally, as our new energy-efficient ecocirc XL pump drove a 20% increase in Europe. US residential was down 4%, as cold weather negatively impacted construction and demand in well pumps. Both irrigation and industrial water applications were down from tough comparisons, due to project shipments combined with overall softening market conditions.

Operating margin expanded 60 basis points from 13.3% to 13.9% year-over-year. Excluding foreign exchange, margins were up 90 basis points. Margin improvement was driven by the favorable impact of cost reduction initiatives and volume leverage. These factors were partially offset by lower price, the unfavorable impact of last year's valves divestiture, and nearly 2% cost inflation.

Now let's turn to slide 8, and I'll cover the Company's financial position. Xylem maintains a strong cash position with a balance of $554 million at the end of Q1. Our net debt to net capital ratio is a healthy 27%, and our commercial paper and revolving credit facilities remain in place and continue to be unutilized. We remain committed to our balanced capital deployment strategy, which is to maintain and grow the business while enhancing shareholder returns through dividends and share repurchases.

During the first quarter, we invested $37 million into capital expenditures, and we returned $76 million to shareholders through dividends and share repurchases. The Q1 return of capital to shareholders includes a 10% increase in dividends per share and $50 million of share repurchases. This leaves us with approximately $50 million of additional potential repurchases under our authorized programs.

Free cash flow was $2 million, which marks an improvement of $5 million from the prior-year, and is driven by improved working capital performance. That said, please turn to slide 9, and I'll cover 2015 guidance.

At the segment level, we expect Water Infrastructure revenue in the range of $2.2 billion to $2.3 billion, reflecting organic growth of 1% to 3%. And for Applied Water, we expect revenue of $1.4 billion, with organic revenue flat to up 2%. Segment margins are anticipated to be in the range of 14.3% to 14.7%, and operating margins are projected to be in a range of 13% to 13.4%, reflecting margin expansion of 50 to 90 basis points, excluding the impact of foreign exchange translation.

At the bottom line, we anticipate earnings-per-share of $1.80 to $1.90, excluding restructuring and realignment costs of $20 million. As Patrick noted earlier, we are reducing our full-year outlook to reflect the potential for incremental foreign exchange translation headwind. As noted on the slide, we continue to expect EPS growth of 5% to 10%, excluding the negative impact of foreign exchange translation.

As mentioned earlier, we are driving to 100% free cash flow conversion in net income. And this takes into consideration expected capital expenditure outlays in the range of $120 million to $130 million. We expect our return on invested capital to remain at approximately 11%, given the unfavorable impact of foreign exchange translation on operating income and an assumed higher tax rate. Excluding the anticipated impact of foreign exchange translation, we would expect approximately 50 basis points of improvement in 2015.

Our operating tax rate is expected to be 21%, approximately 1 percentage point higher than 2014, given the expected mix in regional revenue, specifically higher growth in the US, where we have our highest effective tax rates. Lastly, fully diluted share count is expected to be 183 million.

Turning to slide 10. We have provided a summary of our first-quarter performance by end market, along with our current full-year outlook, which, as you can see, remains consistent with our original guidance.

In summary, Industrial, which represents 44% of total revenue, is expected to grow at low-single digits. Our projection assumes growth in emerging markets, but moderately lower than performance last year. And with the exception of oil and gas, we expect growth in the US. While oil and gas represents less than 5% of total revenue, it does have a higher profit margin. This end market is expected to decline approximately 40% year-over-year.

The public utilities sector, which constitutes 33% of our total revenue, is anticipated to grow at a low-single digit rate. Here, we expect continued growth in emerging markets as well as the US, where we see encouraging signs in terms of municipal funding strengthening in the second half of the year. We anticipate Europe to be stable.

For the commercial market, we see growth in the low to mid-single digit range. Again, the US market appears to be improving, and we continue to anticipate strength in the emerging markets. We do expect growth to moderate over the balance of the year, given the restocking activity we saw over the last two quarters. We expect Europe to remain soft.

Despite the positive start to the year, the residential market remains challenged, particularly in the US and Europe. New product launch in the third quarter of 2014 will provide a boost and partially offset the market headwinds in Europe during the first half of the year, but ultimately, we expect global residential to be flat to down low-single digits for the year. Finally, our smallest end market, agriculture, is anticipated to be flat for the year.

Turning to slide 11. Given the continued focus on foreign exchange and expected incremental headwinds, we thought it would be appropriate to revisit the information we covered last quarter. So, first, let's begin by discussing Xylem's foreign exchange transaction exposure.

This is true economic exposure, and as such, we have in place a comprehensive hedging program that substantially mitigates our overall transaction exposure. Our strategy is to proactively hedge and mitigate up to 75% of net cash flows for our seven largest currency pair exposures. We do this on a rolling 12-month basis. Furthermore, we hedged a monthly mark-to-market exposure on our balance sheet, and all of our hedging activity utilizes forward instruments.

Finally, as it relates to foreign currency transaction exposure, I would highlight that any residual impact not offset by our hedging program is reflected in our underlying operational performance.

Now let me address foreign currency translation exposure, which is the impact resulting from translating our financial statements of foreign entities back into US dollars for financial reporting purposes. Given the nature of this exposure and the anticipated impact on our financial results in 2015, we will continue to isolate the impact, so that you will be able to better judge the operational performance of our Company and progress against strategic initiatives.

The table illustrates our top five currency exposures. It provides you with the average exchange rate for each currency last year and the rate assumed in our previous guidance, as well as the average rate during the first quarter. Perhaps more importantly, because foreign exchange rates have continued to significantly fluctuate, we have also included the rates we assumed in our guidance update, taking into consideration the average euro to dollar rate in April of $1.07. Similar to last quarter, the table includes the full-year expected impacts on revenue and operating income.

To summarize, based on the rate assumption used for our guidance update, full-year revenue will be negatively impacted by approximately $320 million, and operating income by $59 million, which will result in $0.26 of EPS headwind. As you can see from this slide, we already saw revenue negatively impacted by $73 million, and operating income by $10 million in the first quarter. And we expect second-quarter results to be negatively impacted by $100 million on the top line and $18 million for operating income.

Turning to slide 12, I will further illustrate this impact. As you can see here, we expect organic revenue growth of 1% to 3% before approximately 8 percentage points of negative foreign exchange translation impact. This is 1 percentage point or $40 million higher than we previously anticipated. Operating income is expected to be in the range of $528 million to $553 million, resulting in margin expansion of 50 to 90 basis points, excluding the $59 million negative impact of foreign exchange translation noted on the slide. Again, this includes an incremental headwind of $11 million relative to our prior guidance.

Turning to slide 13, let me cover our second-quarter outlook. As we have done in prior years, I'd like to highlight the seasonal profile of our business, which you can see on the left-hand side of the slide. For the second quarter of 2015, we expect organic growth of approximately 2%. We anticipate foreign exchange translation headwind of approximately $100 million to revenue. On a sequential basis, total revenue should grow approximately 10%, which will result in a first-half/second-half profile of 48% and 52% for revenue, respectively.

Overall, we anticipate operating income to be down year-over-year, primarily due to $18 million of expected foreign exchange translation headwind. Unfavorable mix and normalized corporate run rate costs will dampen profitability. And as a result, we anticipate incremental margins of approximately 25% on a sequential increase in revenue. Lastly, we anticipate the continuous improvement activities and restructuring savings will fund strategic initiatives, as well as cover year-over-year inflation.

With that, let me turn the call back over to Patrick for closing comments. Patrick?

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

Thanks, Mike. As I said, we're off to a solid start to the year. We are excited about the direction Xylem is headed, and look forward to sharing more details about our future plans at an Investor Day meeting later this year.

For now, let me reiterate that we remain focused on driving stronger operating performance even as we face some uncertainty in the marketplace. I am pleased with the progress the team has made in that regard and the continued momentum of that work. We do see some positive signs ahead, and we will continue to invest to ensure that we are well-positioned to capture new growth opportunities later this year and into 2016.

We remain committed to delivering on our financial commitments and executing a broad-based capital deployment strategy. Our operational outlook remains unchanged. And we are on the right path to realizing the full potential this Company is capable of delivering.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Deane Dray, RBC Capital Markets.

Deane Dray - *RBC Capital Markets - Analyst*

Hey, given all the macro anxiety, that's an awfully nice clean quarter from you guys. First question is -- help me understand the order cadence for the past two quarters. So, it looked like Applied was up nicely in the fourth quarter, but now I'm looking at flat organic orders starting off the year. And does that in any way challenge you to hit this 1% to 3% organic revenue growth for 2015?

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

Yes, Deane. This is Mike. I think, from an Applied Water standpoint, and I made a couple comments in my prepared remarks, we had order growth in the fourth quarter of about 9%. And we think that the performance in the first quarter is just indicative that a lot of folks, given some of the promotional programs and things that are underway, probably did quite a bit of restocking ordering back in the fourth quarter.

And so as we look at what the projection for the balance of the year is as it relates to Applied Water, we don't see anything from an end market standpoint that says we are going to see anything play out any different. It looks like the commercial market is in a recovery mode. The Architectural Billing Index, specifically around Institutional, has remained above [50] now for some time. And so -- and we think that's driving some of the advance ordering that we saw in the latter part of last year.

Deane Dray - *RBC Capital Markets - Analyst*

And on the -- your comments on oil and gas, now I'm not surprised you said before your exposure is less than 5%. But the expectation that that business is -- could be down 40%, that's much higher than our sensitivity model suggests. And maybe expand on the comment on this is one of your higher-margin businesses.

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

Yes. So, Deane, it's -- we have, obviously, some oil and gas exposure in our Applied Water business, but the predominant exposure really comes out of our dewatering business, where we are working on the frac pads for -- whether it's oil or gas, which is a pretty even blend between the two.

That business was down about 25% in the first quarter. And, based on our current projections, we anticipate it being down around 40% for the balance of the year. We had taken some of that into consideration as we had worked through guidance. But we've obviously made sure that the teams are working, the actions that they need to, to try and offset that risk.

I think the good news is our dewatering business has such a broad portfolio in terms of exposure to construction, muni-bypass, disaster recovery, that we've got the ability to mobilize and redeploy assets. And that's a lot of what the team is really focused on right now.

Deane Dray - *RBC Capital Markets - Analyst*

Thanks. Just -- if I could hit one last question. Just to clarify -- your comments on the increased business in China on the treatment side, you cited ozone and filtration. And is the filtration piece, is that part of your licensing agreement with GE?

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

No, this would not be related to the xenon membrane. This is around our Leopold gravity filtration business.

Deane Dray - *RBC Capital Markets - Analyst*

Great. So that's for your core legacy filtration side of (multiple speakers) --?

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

Exactly. Exactly.

Deane Dray - *RBC Capital Markets - Analyst*

Great. That's great to hear. Thank you.

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

Thanks. Thanks, Deane.

Operator

Ryan Connors, Boenning & Scattergood.

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

Thanks for taking my call. I wanted to -- Patrick, you mentioned this effort of -- that you will be announcing a new Chief Innovation Officer. I thought that was an interesting comment. And our understanding was that the product development pipeline had actually begun to regain some momentum, and that that was kind of a positive part of the story.

So can you give us a little more color about what drove the decision to sort of more institutionalize that? And what exactly that person's mandate will be? And what the kind of goals are in terms of metrics to drive any kind of material improvement on that front?

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

Sure. No, I'd be happy to, Ryan. So, certainly, I mean, I'm very pleased with the progress that each one of our five growth centers have done over the last few years in revitalizing the pipeline. And you have heard more and more of our new products coming to market.

This really is less about a leader coming in and kind of dipping into what each of our business units are doing. There are still some efficiency gains to be achieved there by way of localizing more of our product design and our innovation technology in some of our fast growth emerging markets. Whereas right now, that's still -- a large part of that is happening in the heritage markets in which those brands originated.

So, certainly driving a towards emerging markets is going to be part of that person's role and responsibility. But this is as much about some of the value mapping work that we've done over the course of the last few months, where we have engaged in a fact-based effort to really map out what the full array of water -- kind of water value chain needs are, that our customers are managing each day in different end markets, whether that be in the muni market, whether that be in oil and gas, power, mining, food and beverage -- you know, there's a whole list of markets that we have focused in on.

And what this person is really going to be doing is working with our marketing teams and others to identify where are some of the white spaces that we want to be driving both organic innovation and technology, but also helping inform some of our M&A activity. As you know, M&A is oftentimes a proxy for R&D in an industry where the IP is so fragmented. So those are probably the two primary areas that I have the innovation technology lead focus on.

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

Okay. And then I guess my related follow-up would be related to your last point there, which is, as you look at the M&A environment, I mean, you mentioned that the Company will likely become more active there over the balance of the year. What is the core -- obviously, you can't share with us any specifics, but are you more looking at acquisitions that add to your distribution or product portfolio in developed markets? Or is it more of a technology M&A, is that really the focus?

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

I think it will be a combination of the two. I would say our predominant interest will be in adding new technology and capabilities to the portfolio. But certainly, where there are opportunities for us to strengthen the core, we will certainly take advantage of that.

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

Okay, great. Well, thanks for your time.

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

Thank you.

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

Thanks, Ryan.

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

Thanks, Ryan.

Operator

Joe Giordano, Cowen.

Joe Giordano - *Cowen and Company - Analyst*

A couple questions from me. I wanted to talk about pricing. How would you gauge that in 1Q, maybe across the different segments, or maybe it's better to talk across geographies? And how do you view that going forward? I think there's some concern in the industry in general about how much of revenue declines are price-generated and when that -- decrementals associated with that, things like that.

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

Yes. So, we -- for the quarter, pricing was essentially flat for us overall, but it's a tale of both segments. So the reality is in our Water Infrastructure segment -- and we talked about this last year, we were undertaking quite a bit of activity to really boost our ability to get price in that segment. And we've started see traction -- we started to see that in the fourth quarter; we've seen it again in the first quarter -- where we got about 40 basis points.

So it's not earth-shattering, but it's good progress. I think the area where we are seeing certainly a lot more pressure -- and I don't think we are alone in this, in terms of the commentary we've heard from many of our peers and competitors -- we had close to 90 basis points worth of headwind in the Applied Water segment.

That market is very competitive. Given some of the dynamics around the end markets and the weather conditions, we've seen that amplified. I would say that it's remaining at this point disciplined, but it is an area that we are keeping a close eye on. And, obviously, the teams are very actively working countermeasures.

As you think about the full-year guidance, we talked about expecting price that would be somewhere less than 50 basis points. There's a chance that could be pressured, but it's early in the year, and we are going to be pushing the teams to do what they can to offset it. And quite frankly, making sure that we're hitting the right value proposition out there to get the price that we think we are entitled to, given the products that we have.

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

I would just add that two other areas that I think we are very much focusing on in helping mitigate this is, again, you heard us talk about ramping up our global procurement and sourcing efforts. So, taking advantage of this low growth and kind of deflationary environment to put that pressure back on our suppliers.

Secondly, this is an area where, again, rolling out new products is very helpful to us in terms of arresting the price declines, if not even driving some level of increase. So, all the more reason for us to be bringing new products to market.

Joe Giordano - *Cowen and Company - Analyst*

Yes, that's fair. On the emerging market side, that's been up double-digits/high-singles for quite a bit now. When do we start rolling into comps that become a little bit more challenging and keep that kind of pace?

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

Yes. We actually had our most difficult comp in the first quarter, where we had 18% growth last year. And as we indicated in our initial guidance and, obviously, what we've reiterated today, we expect strong growth in the emerging markets, high-single digits. We just don't anticipate it being at the levels that we recognized last year, where we were up about 13%.

So, we've kind of lapped the most difficult compare, but obviously, there's dynamics going on in China around the commercial markets. And so we think the guidance level that we've put out there is pretty consistent with what we experienced in the first quarter and is driving quite a bit of growth for the Company.

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

I would just add that I do want to just remind everyone that we are still very much in the building install base mode. And so it's heavy project activity; it will be choppy and lumpy from quarter-to-quarter, but we do see a steady stream of new products coming.

Joe Giordano - *Cowen and Company - Analyst*

Yes, that's good to hear. Maybe last for me, on the industrial outlook, you're minus 1% for the quarter. That includes big declines in oil and gas, and you're still looking for up for the full year. And there's been a wide variance across earnings so far this season, I feel, on Industrial segment guidance.

So why do you feel that your products are kind of more resilient in this environment? And what makes you -- what gives you comfort that you can still see growth despite the 40% decline in oil and gas there?

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

Yes. So I'd say it's a couple things. One, within the segment that's challenged by oil and gas dewatering, as I mentioned earlier, even though we are facing significant headwind from that particular vertical, that business serves a variety of other end markets that we do see continued strength in. So I think from a dewatering standpoint, we certainly have the diversity of the portfolio.

From a more broad-based Industrial perspective, I would say the geographic and ultimate end market breadth that we have. So if you remember some of the charts we've displayed in the past, our Industrial segment is very diverse in terms of general industrial, food and beverage, construction, et cetera. And so we think by that diversity, that's given us a little bit of insulation relative to the low single-digit growth rate that we are expecting for the year.

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

And this is also where we, I think, are very well-positioned from an emerging market standpoint, especially with the install build in the Middle East and China. And so while we are doubling down our efforts in those areas, I certainly don't want to diminish the great work the teams have already done historically to build our base there.

Joe Giordano - *Cowen and Company - Analyst*

Great. That does it for me. Thank you, guys.

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

Thank you.

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

Thanks, Joe.

Operator

David Rose, Wedbush Securities.

David Rose - *Wedbush Securities - Analyst*

Thank you for taking my call. I had a couple questions on the margin profile, both from kind of above the unit level. So, first of all, the R&D reduction that you had year-over-year, is that something that you see as structural what you've done to improve the productivity in return on investment R&D? Or was this more discretionary?

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

Yes, I'll take that one. I would say it's largely timing of spend within the quarter certainly is not a trend line that we are focusing to continue. If anything, over time, we'll be marginally increasing the amount of investment we spend in R&D.

There is also the opportunity we've been driving here to be more efficient and effective in our R&D spend. So, as we, again, further move to localize more and more of our R&D investment in some of the emerging markets, that's a more efficient spend that we are going to get. Because that will give the support not only to those local markets but also some of our global activity. So, it will be a mixed bag going forward, but I wouldn't read anything into the modest decline in the quarter.

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

And David, there is also some foreign exchange translation tied up in this. If you remember, we have overweight in terms of our engineering that's outside of the US in areas like Stockholm, where we are benefiting from, from a translation standpoint. Even when you pull that out, we are down. So the comments that Patrick highlighted absolutely apply, but it's being amplified by foreign exchange right now.

David Rose - *Wedbush Securities - Analyst*

Okay. So in Q2, that will be stepped up to a normalized level?

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

That's the plan, yes.

David Rose - *Wedbush Securities - Analyst*

Okay. And then lastly, within the -- in a margin context, on the Water Infrastructure side, you seem to make some pretty good progress despite the FX headwinds and some of the sluggish commentary you made about the overall markets. Where did you see most of the traction? Front end or within the four walls? Maybe you could provide just a little bit more perspective on that?

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

Yes, you know, I think, David, I --

David Rose - *Wedbush Securities - Analyst*

I'm sorry -- and then lastly, within that context, if you can also give us some color on how the pipeline looks within the backlog going forward.

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

Sure. I think from a margin standpoint, certainly the continued effort and focus that we have across the business on making sure that we are driving the lean in the global sourcing productivity, and I would say for Water Infrastructure, you don't see all of the margin leverage come through. Because, as we indicated, as we are growing in emerging markets -- which, for that segment, were up 10% -- while there are attractive margins, they're obviously at a lower rate, because it's primarily OEM business versus having the aftermarket content.

We are getting that volume leverage off of the growth within the platform. And so that's obviously aiding to the margin profile. And then (multiple speakers) --

THOMSON REUTERS

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

Yes. So the backlog for Water Infrastructure, so orders were up 4%. The backlog's at one of the strongest levels we've had, as I indicated in some of my remarks. When you look at our shipments for 2016 and beyond, we are up over 50%. And so, we are continuing to see the strength.

Our treatment business was up about 13% from an order standpoint. And that was pretty evenly spread across the globe. So, at this point, we are not calling a full-on municipal recovery, but we are certainly seeing the continued growth in orders trends for that business, not only in treatment but also in our large transport business.

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

I think we've also been pleased we've seen our win rate improve in the treatment business as well, which is a leading indicator for the rest of the business. It's gone now from 40% up to 45%, driven by a number of factors. But it's a pretty encouraging sign for us.

David Rose - *Wedbush Securities - Analyst*

That's helpful. And I guess really what I was getting at was that the margin profile of that backlog, as you start to sell -- the continuing emerging markets, as you pointed out, is there margin pressure there? Or do you see some margin improvement because of the product mix that's changing?

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

Yes. So we actually took a snapshot of that and continue to look at it. And it supports the gross margin level that we have that's just shy of 40%. Because at the same time that we are obviously winning in the emerging markets with margin that may be a little bit lower than the average, we also have some of our higher-margin business coming through in that backlog as well. So, overall, the blend is supportive of the outlook we have for the year.

David Rose - *Wedbush Securities - Analyst*

Okay. Great. Thank you very much.

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

Thank you.

Operator

Chip Moore, Canaccord.

Chip Moore - *Canaccord Genuity - Analyst*

As you get ready to roll out the new sales tools globally here, can you talk a little bit about what you've seen so far in the US? And then when you couple that with some of the newer energy efficiency products, et cetera, how you're thinking about potential share gains?

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

Sure, I'll take the first part of that and maybe let Mike comment on the second piece. I mean, we are very pleased with what we've seen in terms of the collaboration that our new sales tools drive. I think the benefits are in a few areas.

One is, it does make it easier for our commercial teams to get visibility as to sharing leads across the portfolio. As you've known for a while, we -- oftentimes our businesses have served the same customers, but we haven't always gone into those customers in a coordinated fashion. So, the salesforce.com tool is certainly helping in that regard.

I think it's also getting us more visibility to projects that are out there. So the combination of better visibility and improving our win rate is obviously a powerful combination.

I think, ultimately, over time, this is also about simplifying the wide diverse sales teams, and taking a lot of the administrative burden off of them. We are in the very, very early innings of that, so that's all opportunity in front of us, to allow them to be able to spend even more time out in the field in front of customers.

In terms of, again, rolling out new products, our vitality index is roughly around 20%. And that dipped down a little bit in the first quarter just by way of mix, but we do feel good about a number of the new products that we have that we've already rolled out, and some others that we are going to be announcing here over the coming few months.

If you want to add anything, Mike, on that?

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

Yes. Hey, Chip, I assume your question was in relation to the deployment of salesforce.com in terms of the share gains?

Chip Moore - *Canaccord Genuity - Analyst*

That's right.

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

Yes. So I think when we look at things like the ecocirc that I talked about in my prepared remarks, we obviously are taking share in the European markets.

And as we look at having a tool that enables, as Patrick said, our salesforce to be able to communicate opportunities and execute on those, we think that, coupled with the energy-efficient proposition that we have in our products, or that we are developing for our products, and given the climate we are dealing with, with our customers, in terms of trying to reduce costs, we think that's going to give us a very strong platform. As we've talked in the past, being able to outperform the market by a point or two, that's going to be a key part of that equation.

Chip Moore - *Canaccord Genuity - Analyst*

Yes, okay. That's helpful. Thanks.

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

Thank you.

Operator

Brent Thielman, D.A. Davidson.

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

You've got a few quarters now of strength in the commercial nonresidential product area, and there seems to be some momentum in that market. Is this a group that can be as meaningful as 20% or more of your sales mix if the market gives you enough tailwind, all else kind of generally equal on the other applications?

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

You know, I don't think so. I mean, it's 13% of our revenue today. And when I think about the growth potential that we have seen in industrial, and even public utility growing at a moderate rate, it's going to be tough for it to surpass that. I mean, we had 9% growth in the first quarter. But as I indicated in my comments, we think that's going to moderate to kind of low to mid-single digits.

Some of that has been driven by advanced stocking. But it is going to be a great part of the portfolio for sustained growth, as that market continues to improve over the next several years.

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

Okay. And then in terms of your guidance, are you expecting cost inflation to kind of stay a headwind throughout this year? It seems some of the movement in commodities the last several months would help in that regard.

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

Yes, I mean, at this stage, we are calling it less than 2%. So, relative to last year, we actually saw this starting to creep in towards the end of last year. But relative to last year, it's actually a net benefit for us.

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

There's also a sizable component of wage inflation there as well that needs to be addressed.

And I think Patrick's comments earlier around the strategic sourcing organization, I mean, we are really driving hard to continue what we've already had a strong performance to more than offset that. So back to the earlier point -- even if we do start to see some of the price downward pressure coupled with inflation, we are still confident that we can drive margin expansion in that environment.

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

Great. Thank you.

Operator

Brian Konigsberg, Vertical Research.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Question on restructuring. So you kept at $20 million -- correct me if I'm wrong -- I think there was maybe what -- [$17 million, $18 million] that wasn't done in 2014 that actually you're just doing in 2015, and you added a couple-million more when you provide your initial outlook.

I guess I was under the impression there that that could become more aggressive. Can you just maybe talk about where that stands? Is there an opportunity to maybe kind of hit the gas pedal on that this year, and where those opportunities might be, if you could?

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

Sure, Brian. I mean, again, we certainly acknowledge that there remains a couple-hundred points of opportunity as a percent of revenue to reduce cost. You see that most notably in our G&A line, but there's also costs that are hidden within our gross margin and other structure.

I would say we are taking a very strategic approach, rather -- it's far more proactive rather than reactive. And it's actually tied into our overall broader strategy. We will be sharing more details on what that plan would be as part of a multiyear, multifaceted approach later this year at our Investor Day.

Brian Konigsberg - *Vertical Research Partners - Analyst*

So, not likely much more this year; is that the takeaway?

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

Still remains open. We will have more to share. We are in the late stages of developing those plans. As you saw we announced a few months ago, we appointed Tony Milando as our Head of CI and Business Transformation. So, Tony is working very closely with Mike, myself and the leadership team to finalize those plans.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Got it. And maybe secondly, just on the guidance, maybe you could help a little bit with the bridge. So, the performance in Q1, you gave a pretty fairly detailed guidance for Q2 on the full-year operating profit. Just kind of looking at the revenue trends for the second half of the year, you're looking down maybe about $100 million or so at the midpoint, but you're looking for flat operating profit. Can you talk about what is layering-in in the second half that's going to help buffer still a decent sizable revenue headwind?

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

Yes. So one of the items is actually where you started, which is the restructuring. So we ended up picking up about $6 million in the first quarter. We'll probably get another $5 million in the second quarter. And then the balance of the $20 million is going to end up showing in the second half. So you're going to have elements of that, as well as just the mix of the portfolio in the second half, and our continued focus around making sure that we've got the discipline around sourcing and the lean deployment within the business.

Brian Konigsberg - *Vertical Research Partners - Analyst*

That's helpful. Thank you.

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

Thank you.

Operator

(Operator Instructions). Robert Barry, Susquehanna Financial.

Unidentified Participant

This is (inaudible) on the call for Rob today. So my first question goes back to dewatering. So you mentioned oil and gas, I was wondering what was the performance in the other verticals, in particular mining, utility and construction?

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

Yes. So our dewatering business overall for the quarter was flat. And it was primarily, obviously, driven down by the performance in the oil and gas. So the balance of the portfolio was probably up around 4% or 5%.

Unidentified Participant

Okay, great. Thank you. So -- and the second question regards more a geographical basis. In Canada, the weakness that you saw in 1Q, how much of that would you say is related to directing, directing both oil and gas? And then in Europe, Europe was flat. Have you seen any improvement in Europe, or is it too early to say?

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

Yes, I'd say on the Canada side, it is driven by oil and gas. We had a big distribution order last year that went into that particular segment. So we do anticipate having headwinds through the rest of the year, but it was overly pronounced in the first quarter. And as it relates to Europe, I mean, at this stage, I would say things are progressing. I don't know that we are in a position right now to make a call other than what we've talked about, the year being flat.

Unidentified Participant

Okay. Great. Thanks, guys.

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

Thank you.

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

Thank you.

Operator

At this time, there are no further questions. I will now turn the floor back to Patrick Decker for any additional or closing remarks.

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

Great. Well, thanks, again, everyone. Once again, as I said earlier, it's very early in the year, but I do feel that we are off to a very solid start. And I look forward to our next call in late July, where we will be updating you on our progress. So, in the meantime, thank you again, and safe travels, everyone.

Operator

Thank you. This does conclude today's Xylem's first-quarter 2015 earnings conference call. Please disconnect your lines and have a wonderful day.