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<<Jose Garza, Analyst, Gabelli & Company>>

Okay. So, as some of you may recall from this morning, I am Jose Garza, one of the industrials analysts at Gabelli & Company specifically focusing on the water side. We are very privileged to have Patrick Decker joining us from Xylem and doing a bit of a fireside chat here. Xylem, based in Rye Brook, New York, is a global leader in the design and manufacturing of technology-intensive pumps and services, filtration and disinfection applications, analytics applications and most recently meters when it acquired Sensus in 2016.

Xylem is the world's largest wastewater pump producer with water utilities accounting for roughly $2 billion of the Company's customer base. The Company has 180.4 million shares outstanding priced at $48.12, an $8.8 billion market cap, $2.1 billion of net debt for a $10.9 billion total enterprise value. So as I said, Patrick is joining us for the first time at our conference here, and we are very excited to have him. Also to my left is Justin Bergner, who is one of the industrials analysts at Gabelli & Company as well.

So, with that, we're going to do a fireside, and I guess I'll start off with a question, but please chime in with any questions that you may have, and we'll get the mics to you. So we want this to be interactive, so let's do that, unless you have any opening comments that you want to have.

<<Patrick K. Decker, President and Chief Executive Officer>>

No, I think I would probably start first by again thanking you all for your interest. Maybe I'll very briefly lay out, for those of you that may not know of Xylem, what the investment thesis was that we laid out about a year and a half ago actually in this room at my first Investor Day. I've been with the Company now almost three years. And there were really kind of three key elements of the investor thesis which I think we have been executing quite well against in the last year and a half. The first was based upon the end market exposure that we have with the heavy public utility element and a global exposure in emerging markets. We are poised to outpace the market in terms of growth organically, and spending a lot of money in technology to enable that.

Secondly, there is a multi-year self-help story here in terms of margin expansion. And we laid out a pathway to a 300 to 400 basis point op margin expansion over the course of the next few years, and we are well on track to outpace that. And then third, we've got a great balance sheet with cash deployment capabilities, and so we had laid out about a year and a half ago that we would have up to $3.5 billion plus after investing in the business to do a balance between M&A and share repurchase. We put about half of that to work late last year when we acquired Sensus for about $1.7 billion, and the cash profile of that business, as well as the legacy Xylem businesses.

We've got an Investor Day, I'll do a shameless plug here, we have an Investor Day coming up in Raleigh-Durham, North Carolina on April 4, which is our Sensus headquarters. And it's really to showcase the technology, the synergies we are going after, but also to lay out our new set of three and five-year targets. And what you'll hear there at that day is that, even though we spent $1.7 billion on this acquisition, we will have same or even more cash capacity over the next three to five years, another $3.5 billion plus along the way. So I feel good about the position we are in, so I just wanted to lay that kind of thesis out, Jose, before we get into Q&A.

<<Jose Garza, Analyst, Gabelli & Company>>

Yeah. And I was going to plug the Investor Day, but that's cool.

<<Patrick K. Decker, President and Chief Executive Officer>>

You can plug it again.

<<Jose Garza, Analyst, Gabelli & Company>>

April 4. So I mean obviously the key development in your tenure is the Sensus acquisition.

<<Patrick K. Decker, President and Chief Executive Officer>>

Yeah.

<<Jose Garza, Analyst, Gabelli & Company>>

So, completed that in late last year. So kind of I guess, number one, review kind of the strategic rationale, and then tell us about your expectations in terms of what that does to your business.

<<Patrick K. Decker, President and Chief Executive Officer>>

Sure, terrific. Yeah, so when I came on board about three years ago – first of all, Xylem is a business that – a set of businesses that were spun out of ITT Corporation back in late 2011. I joined the Company in early 2014. And at that point in time, I think both from the standpoint of investors but also Board, it wasn't clear what the overall strategy of the Company was other than a tagline of less salt water, which isn't really a strategy. So we did a lot of work in the first several months to identify where were the places in water that we wanted to play. And one of the areas that were identified there – we really identified two key areas for us to focus on, to move beyond being simply a pumps company.

The first was, in broadly speaking, smart infrastructure in the water space. I'll come back to that in a second. The second area was industrial treatment. We have a treatment business today. It is still rather small, and so that's an area we continue to look and explore. And so in the area of smart infrastructure, what we really identified as one of the greatest areas was what we call measurement analytics and control. And so whether you're talking about a water utility or a user of water, they've got different pain points that largely can be addressed through bringing smarter infrastructure into play.

And so that led to the rationale behind acquiring Sensus. Sensus has historically been known as a metering company, and certainly they are very proud, as they should be, of the quality and the performance of that core business. But over the course of the last three or four years, they've done a handful of acquisitions that have moved them beyond being simply a metering company and getting into some unique metrology, but also data analytics capabilities predominantly focused on the clean water side of the network as well as electric and gas utilities.

One of the – there are really three big revenue synergy opportunities that we are driving and I feel very good about. The first is that many of their existing customers are customers of the legacy Xylem business, but we were serving the wastewater side of the utility, whereas they'd been servicing the clean water side. And so we are going to be able to leverage the existing metrology that those customers have already invested in to be able to apply that technology across the wastewater network. And again, we'll showcase more of that at our Investor Day. The second area is we've got a number of large water utility customers around the world that are moving up the technology curve in terms of advanced meters, but also using telemetry to get access to big data to solve certain pain points.

Pain points can be non-revenue water where you have leaks, inaccurate measurement. Another pain points is energy consumption on the wastewater side where big data is going to be very helpful and we are already getting traction in that area in building out our software as a service capability. Those large utilities globally are customers that Xylem already had a relationship with, but Sensus did not. They are largely a North America focused company, so we think there are big revenue synergies there. But the deal itself was not justified by purely revenue synergy. We actually didn't even guide to that when we announced it. We paid for it through cost synergy. There's a lot of procurement overlap and some G&A overlap that we are going after quite aggressively as well.

So, when we announced the acquisition back in October, we made it clear that, while Sensus itself we expect to continue to grow somewhere in the 6% to 7% organic growth level, which is actually a little lower than what they have been growing the last couple of years, so I think we are conservative, but we did not build in any revenue synergies into our outlook for Sensus and Xylem at the time that we announced the deal. So it's all upside.

<<Jose Garza, Analyst, Gabelli & Company>>

Excellent. So, turning attention to 2017, then, adding on that Sensus growth, how should we look just – how do you think about your base business and then the Sensus business looking out this year, and then going forward?

<<Patrick K. Decker, President and Chief Executive Officer>>

Sure. So we had laid out at Investor Day a year and a half ago that we felt that over the – we laid out two different milestones. We had through 2018 and through 2020. And through 2018, we had said that this would be – that legacy Xylem would be a business that would grow somewhere between kind of 2% to 4% organically, kind of in line with where we had been, and that, in the out years to 2020, these were businesses that could grow 3% to 5%, which included about 1 point, extra point, from share gain. And so I would say our outlook for this coming year is a little softer than that. I can explain why, but we are looking on our legacy Xylem business of being between 1% to 3% organic growth. You add to that a 6% to 7% organic growth for Sensus, you blend that together and you have a pro forma organic growth of basically 4%. We guided 2% to 4% as the pro forma organic growth for 2017.

We will lay out a set of revised kind of targets for 2018 and 2021 in Investor Day, but I wouldn't expect anything meaningfully different from what we had talked about a year and a half ago in terms of what we see as the underlying growth rates in the market Jose as well as expected share gain.

<<Jose Garza, Analyst, Gabelli & Company>>

I guess, since you laid that out a year and a half ago, I mean what's that progress in the share gain that you kind of baked into those numbers longer-term?

<<Patrick K. Decker, President and Chief Executive Officer>>

Yes, so, we feel very good. We are coming off of a very, very hot year in terms of our public utility business. And before you layer on Sensus, public utility has historically been about 35% to 40%, depending upon the year, of our total revenue in Xylem. And this past year, we grew that business double-digit, and really, really strong year. We have some tough comps here in Q4 of last year and Q1 of this year, which is why we guided the way we did in terms of being flat to slightly down. It is simply very tough comps. We actually grew our public utility business in the U.S. last year 22% in the first quarter.

And so we still feel very good about share gains in that space, and we still feel very good about the outlook for public utility, both U.S., Europe, and emerging markets, over the foreseeable future. This year, we've guided that business to being low-single digit growth, and that's simply because we had a great year last year. And so if you blend those two years together, you're talking kind of mid to high-single digit growth over that time frame. We expect that to continue. The industrial space is about 44% of our total revenue, again, prior to Sensus. That business, for us, industrial for us is not so much heavy industry. It's really about 39% of that 44% is light industry. It is food and beverage, pharmaceuticals, chemical processing, car washes, all kinds of stuff. But as long as a site is up and running, they are going to burn through our pumps. And it's really a replacement business. That business has historically grown about 2%, and that's kind of we're calling the kind of flat to low-single digit this year in that area.

We've got a very small oil and gas mining exposure. It's only 5% in total. 3% is oil and gas and 2% is mining. And that's been a headwind for us over the course of the last I would say two years. We don't even talk about it except for the fact that the variable margins on that business are quite high for us. And so we had to withstand some of the headwind this past couple of years. When that business begins to turn, you're talking about a business that spins off about 60% plus in variable margins. So, we are not building that into our outlook for 2017. It is going to come back. When? We don't know. But when it does, it's certainly going to be very helpful in terms of margin expansion as part of the story as well.

Q&A

<A – Patrick K. Decker>: Of course. Any questions from the audience to keep the conversation going?

<Q – Justin Bergner>: I'll jump in with one question, Patrick. I know you alluded to the margin expansion targets at the beginning. Now that you have sort of more on your plate with integration of Sensus, how should we think about the new margin framework without getting ahead of what you're going to say at your Investor Day? And what culturally is happening within Xylem to sort of keep the momentum going on the margin improvement story?

<A – Patrick K. Decker>: Great question. So, what we laid out at Investor Day a year and a half ago was that we believe that, through 2018 and then onto 2020, we would be able to improve our operating margins by anywhere between 300 to 400 basis points over that time frame. And that was after adding an additional 100 basis points into R&D to drive our own organic efforts to build out smarter solutions on the infrastructure.

Looking ahead a year and a half, as we finish this year with the guidance we've laid out, we will be well beyond halfway in terms of delivering that 300 to 400 basis points. That's before we talk about Sensus and synergies. So, some highlights of what you'll hear at Investor Day are effectively that as, we look further out beyond 2020 into 2022, we see that story continuing in terms of further operating margin expansion. What has been driving that has been terrific work by the teams in procurement, as well as in deploying lean Six Sigma across the organization, as well as driving a fair amount of structural cost out in G&A in terms of business simplification. That only gets richer as we look at the cost synergies from Sensus, which are additive to the 300 to 400 basis points. So what we laid out in terms of net synergies of $50 million over the next few years from Sensus is on top of what we had talked about at Investor Day.

Culturally, what's been happening is these were five businesses that made up the legacy Xylem business that were managed very much independently within ITT. So, there was a lot of duplicate G&A and overhead structure that had already been worked on, but we really are managing this much more now like one company, and so there are still opportunities to take out duplicate overhead cost structure, both in the sales area but also in G&A, and we'll have more to update on that at Investor Day.

<Q – Jose Garza>: Excellent. So, kind of just drawing on your background, Patrick, prior to coming to Xylem, your focus, a lot of it, was internationally. And one of those areas in particular was Asia. As you look at the global landscape and where water assets are put in, how is Xylem set up for that and to succeed and how does that evolve over the next several years?

<A – Patrick K. Decker>: Terrific question. So I would say that, first of all, the facts are that more than 70% of water investment in infrastructure that's happening over the next 20 years is occurring in the emerging markets. And when I first got here, I would say, much like many companies, we weren't nearly as focused enough on, first of all, the emerging market play and what it takes to be successful there, but also we were probably a bit scattered in terms of the number of countries that we were trying to be successful in. And so, one of the first things we did was to really identify what are those four major markets that we wanted to double down in? We already had a really good platform position in China. We had a relatively weak position in India. We had really no presence to speak out in terms of local supply chain in the Middle East, and we had a fledgling platform in Brazil and Argentina.

So those are really the four key areas that we had identified as top priorities. I benefit, certainly humbly, from almost 11 years of experience living in emerging markets, and you really have to take a long view on these markets and you have to realize the importance of getting the best talent locally. You can't parachute in ex-pats and kind of live off of that for your eternity, and so talent is critical, but also localization of product and technology. You cannot live off of importing high-cost jurisdiction products and technologies that are not fit for purpose in those markets. And so we've done a lot of work on increasing the localization of our products, the technologies, building out our leadership team and, quite frankly, having an adequate amount of patience to realize that you are not going to get it all in the first year.

So we were off to a great start. We had a rough year this past year because of China being down the whole market, but we finished China with orders up 17%, so we got a really good platform and backlog coming into 2017. And we expect for emerging markets to be growing mid-single digits here in 2017, which, in this market environment, I'm pretty proud of based upon the momentum, and that only gets better as we look into 2018 and beyond.

<Q – Jose Garza>: Excellent color. When you first set those emerging markets, I mean how do you think about your product offerings. Your core is on the pumping side. So what kind of differences do you need to approach it, and maybe where you are in the market in terms of premiums and how to think about that?

<A – Patrick K. Decker>: One of the things that we benefited from this past year to year and a half in China as well as in India, I'll take those two first, is, as you all probably know, whether it be the central government in Beijing or whether it be Prime Minister Modi in India, amongst a few other things, water and environment are top policy mandates. And so that's where we are benefiting, certainly not only from the money flowing, but also many of the companies that are now dealing with different regulations. I mean there's this perception that China doesn't have these kind of regulations in place, which is nonsense. It's an increasingly regulatory environment there on the water piece of things.

And so what we see happening is that customers are valuing the breadth of our portfolio, so the fact that we are able to talk not only about energy efficiency and consumption on the pump side in wastewater but we are also able to talk about our treatment offerings and our test and analytical capabilities and now add on top of that the telemetry and the metering piece that Sensus brings into the fold, we feel very well positioned in both China and India to really be able to take significant share. We've been taking share in China and India the last couple of years. We've had a couple of very large contracts that you will recall that we've won in India, large pumping stations that are irrigation lift stations that are all benefiting from some of the cleanup activity there in India as well as some of the expansion in infrastructure.

<Q – Jose Garza>: Excellent. Anything from the audience?

<Q – Justin Bergner>: Maybe we could shift and talk about sort of the M&A world. I'll start with a deal that is being shopped, no secret, GE Water, and just realizing that may not be something you're looking too closely at, but it would still be very interesting to understand what effect on the industry you think that asset sale will have. And I guess, this morning, it was rumored that Suez might be looking at that business or a large piece of that business. How do you see that, the outcome of that sale process, changing the competitive landscape for your relevant businesses?

<A – Patrick K. Decker>: Sure. Yes, so to put it in perspective, you can imagine, as a leader in the water industry, there aren't many of these processes that go on without us being pretty darn close to what's happening and a view on that. So while I can't comment on the speculation around that particular transaction, I would say that, to put it in perspective, the relevant piece of our business is the treatment business, which is less than 10% of our total revenue. It's an important piece of our business, but it's not a large share.

We don't see the disposition of GE Water really having any meaningful, direct impact on our business. We are largely selling into the municipal wastewater sector of treatment, whereas the GE businesses are much more largely into the industrial side of things, which is an attractive spot and an area that we certainly have looked at and will continue to look at. I just felt like this was not the right fit for us. It was not the right time for us to be serious about that.

We all speculate about who will win and what they will do with the portfolio, because it is a mixed element of businesses that are in there, and they each have different economics and value chains around them. So, we will stay close to it. We'll be curious as to who ends up being victorious, but I don't see it being a big disruptor to certainly our businesses in the water sector, if any at all for that matter.

<Q – Jose Garza>: What about the kind of notion if they were thought of years ago as a consolidator in the industry, and then obviously getting out of that business as well as Siemens some years back. Where does kind of the industry go at this point? You obviously made an acquisition. But generally, how does that kind of tie into what's going on there as you see it?

<A – Patrick K. Decker>: Yes, for those of you that follow the water sector at all, it is unbelievably fragmented, so both in terms of the number of technologies that are out there as well as just the number of companies that are out there. So that's why it was so important, I felt, when I came on board, that we really do some disciplined value mapping strategy work to really understand the roadmap. And so we've laid that out. As we mentioned at our last Investor Day, again, the two big areas for us were focusing on building out kind of systems intelligence, smart infrastructure space.

Sensus is a first move. It's not a final move. There are a number of things they had in their pipeline that overlap with what we were looking at in our pipeline. And so I think that's an area that we will prioritize as top-shelf move for us. Secondly, I would say is in the advanced industrial treatment space, and there certainly are more than just GE Water assets that are out there that I think will come to market at some point in time. People ask me about the pump side. I think we have some of the best pumps in the world, so I don't feel the need to go acquire any more. I think we've really got a good core base there. But at the same time, we certainly will defend our territory there and probably be a bit more opportunistic or defensive in that space depending upon what would ever happen there.

I think, broadly speaking, while there is going to be some level of consolidation in the water space, it's so fragmented that I don't see any kind of one or two big step moves that all of a sudden the whole industry has consolidated. It's going to be – there's going to be a series over probably a decade or more of opportunity to just make smart, disciplined acquisitions at good multiples. We got the Sensus business, which we think is terrific, at a little less than 10.5 times EBITDA. And now that we've got that tremendous synergistic platform with M&A opportunities that we can integrate into that, we think that was a great first move for us in building out this smart infrastructure play.

<Q – Jose Garza>:

Excellent.

<A – Patrick K. Decker>:

Yeah, right here.

<Q – Jose Garza>:

That seemed to provoke a question.

<Q>: Patrick, thank you for your time.

<A – Patrick K. Decker>: Thank you.

<Q>: Two questions. So Sensus also came with some non-water assets. Do you have any interest in changing the ownership there or adding on to them? And then in the analytics space in particular, maybe I will include filtration. So, your capabilities there relative to the other companies like, say, Danaher for example and whether I'll say moving up the food chain, increasing your analytic capability in the technology, how important that would be in your M&A?

<A – Patrick K. Decker>: Sure. Yeah, two great questions. So, the first one is an easy one to answer. I get the question a lot, both you can imagine within the Company but also from investors. I am completely committed to the electric and gas element of utilities in the Sensus business. First of all, they are quite attractive businesses. Second of all, there's a fair amount of synergy between the different offerings to those different customers and, in many cases, they are the same customer.

So they have a lot of single-point utility operators that handle both water, electric and gas. So there would be a fair amount of dyssynergy even if I wasn't committed strategically to those businesses. And so we will feed those children like we do the others. There are some neat little interesting tuck-in opportunities from an M&A standpoint that we will certainly look at and explore. And I think it opens up the whole area of just smart infrastructure, broadly speaking, in the public utility arena.

Having said that, the lifeblood and the soul of the Company will continue to be very much focused on the water sector, and I think the premium that comes with that, which feeds into your second question, and that is it is absolutely paramount us that we continue to move up the food chain and technology curve in bringing more of the analytics capability into our offerings. Whether it be augmenting the rotary equipment side of things or whether it be our treatment offering along the way, that will continue to be very important. And if you look back at the last – we were on an MA pause for the first year and a half that I came here. And anything we've done over the last year and a half, small or large, have all been adding new, complementary technologies and analytics to the portfolio, and that will very much continue to be the theme.

<Q>: Okay.

<Q – Jose Garza>: Excellent. Anyone else? I guess, now, just giving us a broad overview of the municipal market, and you obviously said the U.S. should continue on this kind of trajectory. What about your other markets, which obviously do account for quite a bit, and in particular Europe, and how are you thinking about those?

<A – Patrick K. Decker>: Sure. So, we feel that – so what happened for us, for those of you that follow the stock and listened to our earnings call just a little while ago, we had a little bit of an air pocket, kind of speedbump, pothole, whatever you want to call it, in Q4, in terms of really two areas. And one was the normal spend out of operating CapEx budgets that we would normally see across Europe didn't happen in a few markets. That caught us by surprise. And that was mainly France, Italy and Spain. And that really was largely to do with some uncertainty, some political uncertainty there around elections near the end of the year. And we expected that to continue through Q1, but we still see good order strength.

We see good backlog. And so we are not concerned about the ongoing momentum of those markets across Europe. Europe historically has been much more disciplined and steady in their investments behind water infrastructure, much more so than the U.S. And so it typically has been more of a steady path. Emerging markets are also beginning to show good signs of strength. I talked about the order book in China. We've got really good pipeline and contract wins in India. I'd say the one big headwind out there for us is Middle East. It's not a large existing revenue for us, but we just finished our investment there in a new factory, an R&D facility, and we've been hurt by Saudi, which I'm sure you all heard many companies comment on.

We don't see that coming back this year. It could. We've built that into our guidance for this year. But I still have a long-term positive view on the Middle East as it relates to their water needs. I would say the other key market that we kind of talk about is industrial, mainly in the U.S. sector. As I mentioned before, we would call that business as kind of low-single digits here, flat to low single digits here, in 2017. I know that you've had questions before, Jose, around our watering business, which sells into oil and gas and mining. That business was down 4% last year. It's about $600 million of revenue for us. We are calling that business to be basically flattish to down slightly in 2017. But it's a tale of two halves. Our oil and gas and mining business was off 10% last year, but our public utility piece of dewatering was up 20% last year. And so that gives you a little bit of color around the ongoing strength behind the public utility sector.

<<Jose Garza, Analyst, Gabelli & Company>>

Excellent. Terrific color. With that, we'll wrap it up. Thanks very much, Patrick, for coming.

<<Patrick K. Decker, President and Chief Executive Officer>>

Thank you. Thank you.