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PRESENTATION

Operator

Welcome to the Xylem Fourth Quarter and Full Year 2017 Earnings Conference Call. (Operator Instructions)

I would now like to turn the call over to Matt Latino, Senior Director of Investor Relations.

Matthew Latino - *Xylem Inc. - Director of IR*

Thank you, Holly. Good morning, everyone, and welcome to Xylem's Fourth Quarter and Full Year 2018 Earnings Conference Call. With me today are Chief Executive Officer, Patrick Decker; and Chief Financial Officer, Mark Rajkowski. They will provide their perspective on Xylem's Fourth Quarter and Full Year 2017 Results and discuss the full year outlook for 2018. Following our prepared remarks, we will address questions related to the information covered on the call. (Operator Instructions)

As a reminder, this call and our webcast are accompanied by a slide presentation available in the Investors section of our website at www.xylem.com. A replay of today's call will be available until midnight on Friday, March 2. Please note, the replay number is (800) 585-8367, and the confirmation code is 41782548. Additionally, the call will be available for playback via the Investors section of our website under the heading Investor Events.

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 events or results could differ materially from those anticipated.

Please turn to Slide 3. We have provided you with a summary of our key performance metrics, including 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.

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

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Thanks, Matt, and good morning, everyone. Thanks for joining us today to discuss our strong 2017 results and our outlook for 2018.

As 2017 unfolded, we continued to strengthen our execution, which helped us accelerate our growth momentum throughout the second half of the year. We delivered on all of our financial commitments for the year, and are on track to meet our long-term objectives.

In both the fourth quarter and full year, we delivered solid top line growth in the U.S., Europe and emerging markets and across each of our key end markets. We made solid progress in each of our businesses with a number of standout achievements, including successful new product launches, strategic project wins and the continued deployment of capital, all of which will drive our long-term growth and value creation for shareholders.

Yesterday, we closed on our acquisition of Pure Technologies, and we couldn't be more excited about the prospects we see ahead. We also acquired a small company called EmNet, which operates in the water infrastructure analytics space as well. I'll come back to this in a few minutes. We have a lot to cover today, so I'm going to hit a few highlights, and then turn it over to Mark to walk through the numbers.

In addition to our broad-based revenue growth, we also continued to drive increases in orders and backlog. Orders grew 10% in the fourth quarter, up sequentially from the 6% growth we delivered in the third quarter. This sets up very well going into 2018. It is worth noting that a sizable portion of these orders is for longer lead time projects and won't translate into revenue until 2019. We also delivered solid and broad-based growth across our key end markets.

Our performance in public utilities particularly stood out with 10% growth in the quarter. We saw strong results in nearly every geography and across all applications, with our Sensus business delivering 15% growth versus the prior year period. Another notable result was in our residential business. While it is a relatively smaller part of our overall business, it's worth calling out the double-digit growth achieved in both the fourth quarter and the full year. We'll discuss the outlook for this and our other end markets later in the call.

While we continue to enhance our execution in the marketplace, we also continued to execute our "productivity for growth" strategy. The team delivered another year of record results, about $150 million in continuous improvement savings, a 10% increase over last year's performance. A portion of these savings are being reinvested in the business by way of R&D, innovation and commercial initiatives to drive growth. We ended the year with adjusted EBITDA of 18.7%, an increase of 80 basis points year-over-year. This reflects the strong operational performance I just discussed, as well as the Sensus contribution.

Our operating margin for the full year was 13.4%, up 30 basis points, excluding the impact of acquisitions. We delivered full year adjusted earnings per share of $2.40, an increase of 18% year-over-year. We also had another year of strong cash generation with free cash flow up 41% over the prior year. This is an area where historically we have underperformed, so I'm quite pleased with the progress we've made and our outlook for sustaining this performance. Free cash flow conversion was 147% for the year. So all in all, a year of strong results.

I want to recognize and thank our teams throughout the company who stayed focused on the task at hand, while also keeping an eye on the opportunities ahead of us and laying the foundation for our long-term success. None of this happens without their commitment and execution, and I am very proud of what we've achieved together.

Now let me shift gears to spend a few minutes on the progress we've continued to make on the strategic priorities. These are the highest order imperatives that will enable us to meet our long-term financial commitments and set the company on a path of sustainable growth and expansion for many years to come.

The priority of accelerating profitable growth encompasses our initiatives to drive commercial excellence, grow in emerging markets and strengthen innovation and technology. The moves we made in 2017 to bring together our various U.S. commercial teams and reorient our sales and marketing focus around vertical end markets is helping to increase our bank pipeline, leading to strong top line results.

Specifically in emerging markets, we delivered 6% revenue and 15% orders growth for the year, and momentum in our key markets of China, India and Middle East is building. Accelerating innovation is a core element of our long-term growth strategy. The creation of new centers of excellence, a streamlined approach to product development and smart acquisitions have fueled our new product pipeline, leading to a 500-basis point increase to 24% in our Vitality Index over the previous year.

As I already mentioned, our continuous improvement program continues to generate impactful results. This is an area where we will continue to develop, creating new opportunities to unlock savings by eliminating waste and increasing efficiencies. These efforts not only fuel margin expansion, but they are funding investments that are vital to our long-term growth and improving our speed to market.

Underpinning these efforts are the programs we are expanding to further deepen our talent pool. The additional capabilities we've brought into Xylem through acquisitions have also accelerated this work. As I have outlined in my first Investor Day back in 2015, we will continue to put capital to work in smart disciplined ways to develop and acquire the solutions we need to best address our customers' challenges. Our acquisitions to date fit squarely into our smart water technology strategy. Finally, we continue to return capital to shareholders, today announcing a 17% increase in the dividend.

Now let's turn to the next slide to talk about Pure Technologies and the role this new addition will play in our long-term growth plans. As I mentioned, we closed on the Pure transaction yesterday, and the team has been working on the integration planning for the past month, so we're ready to get started. Pure, which until yesterday, was a publicly-traded company, finished 2017 with strong results. In the fourth quarter and the full year, they delivered revenue growth of 15% and 11%, respectively. They also delivered strong adjusted EBITDA at 25% in the quarter and 18% for the full year. This is a fantastic business that will expand our opportunities, fuel our growth and accelerate value creation for our shareholders.

Pure will be the foundation of a broad platform we're building, bringing together a portfolio of analytics capabilities and technologies that will address our utility customers' infrastructure pain points and significantly improve the economics of their operations. Challenges, such as non-revenue water and aging infrastructure cannot be effectively addressed with a one-size-fits-all approach, particularly as you move around the globe.

Customers need a partner who can effectively assess and understand their unique challenges, and then bring together the right solutions to address them in ways that add value to their operations. Collectively, our advanced infrastructure analytics capabilities will increasingly position Xylem as that vital partner and solutions provider, in addition to being a supplier of unmatched products and services.

Joining Pure in this group will be our Visenti and HYPACK businesses, as well as a smaller acquisition we recently completed of a company called EmNet, and we'll continue to fill in other gaps as needed.

EmNet, which is based in South Bend Indiana, provides network modeling and optimization solutions that enable municipalities to manage the urban water cycle and wastewater and storm water systems. This is a pivotal addition to Xylem as it significantly increases our ability to help customers manage their wastewater network and storm water systems, areas of growing concern. Both Pure and EmNet are excellent examples of M&A serving as a proxy for R&D that will help accelerate our progress.

This Advanced Infrastructure Analytics business will be led by Al Cho, our Former Head of Global Strategy, who also led the acquisition team for most of these businesses. It will be part of our Measurement & Control Solutions segment under Colin Sabol's leadership, but it will be an enterprise operation, partnering and collaborating with all of our commercial teams and business units around the world. We're very excited to bring together these capabilities to tap new opportunities. We will leverage the deep knowledge each team has along with our trusted customer relationships and global scale to accelerate the growth of our business.

Now I'll turn it over to Mark for a more detailed review of our results.

E. Mark Rajkowski *- Xylem Inc. - Senior VP & CFO*

Thanks, Patrick. Please turn to Slide 6. Patrick's already covered some of the highlights of our 2017 results, so I'll quickly touch on a few of the details.

I'm very pleased with the team's performance this year, particularly our strong revenue growth in the fourth quarter, which enabled us to deliver at the high end of our revenue guidance for the year, with 3% organic growth and 4% on a pro forma organic basis. This reflects strength across all of our end markets and solid growth in each of our businesses. Geographically, we saw the largest increase in the emerging markets, up 6% with the U.S. and Western Europe up 3% and 1%, respectively.

Adjusted EBITDA margin was up 80 basis points to 18.7%, which largely reflects continued traction from our productivity initiatives, as we realized $148 million in savings, an increase of 10% year-over-year, as well as the benefit of volume leverage. Partially offsetting these improvements are inflation, higher investments for growth and unfavorable mix, driven by emerging markets project revenues.

Operating margin for the year was 13.4%, up 30 basis points from the prior year, excluding the purchase accounting impact from Sensus. Earnings per share this year of $2.40 increased 18%, a clear indication that we're on the right path to deliver financial returns in line with what we laid out at our Investor Day last April.

Another important indicator, and one that I'm fond of, is our free cash flow performance. This year, we generated $544 million of free cash flow, an increase of 41% year-over-year. We also delivered 147% cash conversion, which is well above our target of 110%. An important driver of our cash flow performance is the progress and focus from our teams globally on improving our working capital levels. We reduced working capital to 18.5% of sales, which is a 150 basis point improvement year-over-year.

I'm proud of the work of our teams. However, there's further room for improvement, and we have good confidence in our ability to achieve our long-term goal of reducing working capital to the mid-teens.

Please turn to Slide 7, and I'll take you through our fourth quarter performance. We recorded orders of $1.3 billion in the fourth quarter, an increase of 10% organically year-over-year, with good growth across all 3 segments. Revenues were up 17% in the fourth quarter. Organic growth was 7%. Acquisitions contributed 6%, and we benefited 4% from foreign exchange.

From an end market perspective, public utilities were up 10% organically. While we had an easier comparison to the flat performance in the prior year period, as Patrick mentioned, this growth reflects strength across nearly all regions and applications globally, driven by continued momentum in our markets and some share gains. Industrial was up 3%, including mid-single-digit growth in the U.S. and Europe, as we continue to see recovery in those markets.

Rounding out our performance, we saw continued strength in residential and commercial markets, up 15% and 4%, respectively. I'll touch on these markets in more detail in the Applied Water segment discussion in just a few minutes. Regionally, the U.S. market drove most of the organic increase for the quarter and was up 9%. Emerging markets and Western Europe were up 6% and 3%, respectively.

EBITDA margins increased 40 basis points in the quarter to 20.2%. This margin expansion was primarily driven by ongoing savings from our productivity programs and volume leverage. This was partially offset by inflation, unfavorable revenue mix and higher investments for growth. Operating margin for the quarter was 15.2%, which is up 10 basis points versus the prior year, excluding purchase accounting amortization.

Overall, I'm encouraged by the continued momentum in our markets and the strong execution by our teams in delivering fourth quarter earnings per share of $0.76, an increase of 15% year-over-year.

Please turn to Slide 8, and I'll provide additional details on our segments. I'm just going to address our fourth quarter segment results, but the details of our full year segment performance are included.

Water Infrastructure recorded orders of $566 million in the quarter, up 11% organically year-over-year. This growth was primarily driven by Wastewater Transport orders, which increased more than 20%, reflecting strong demand across all regions. We exited the quarter with total backlog of $610 million, up approximately 17% organically over the prior year period, and providing us with confidence in delivering our first quarter revenue outlook. It's also worth noting that a higher percentage of our backlog entering 2018 is shippable beyond 1 year due to several large project wins during the quarter.

Water Infrastructure revenue of $583 million in the quarter represents a 6% year-over-year increase on an organic basis, with foreign exchange providing a $21 million headwind -- tailwind. In the U.S., segment revenues were up 8% overall, driven by strength in wastewater transport market and double-digit growth in our dewatering business, which has benefited from the continued recovery in the industrial energy and commodity sectors. These businesses were also strong in Canada, where we posted 22% growth.

Emerging markets revenue increased 5% with mid-single-digit growth in all regions. Of particular note, was the demand in China and the Middle East for wastewater transport pumps, as well as 60% growth in India from large custom pump projects? Western Europe was up 3% overall, primarily driven by treatment project deliveries in the Netherlands, Belgium and France.

Operating margin for this segment decreased 70 basis points to 18.4%. Benefits from cost reduction and volume leverage were more than offset by higher inflation, foreign exchange transactional losses and higher year-over-year strategic investments to accelerate growth and product localization in key emerging market countries.

Please turn to Slide 9. Applied Water booked orders of $373 million in the quarter, which was up 6% organically over the prior year period. Our book-to-bill ratio was 1 in the quarter, which is in line with our historical performance.

Overall, we exited the quarter with backlog of approximately $200 million, up 20% organically compared to last year. Our shippable backlog for the first quarter of 2018 increased 13% on an organic basis. This provides us with good confidence in our first quarter revenue outlook, but it's important to remember, this is a very short cycle business, and backlog represents less than 1/3 of our expected first quarter revenues.

Revenue was $373 million, up 5% organically versus the prior year quarter. In Europe, revenue increased 7%, driven by double-digit growth in both industrial and residential applications. Our investments in new products and sales capabilities have enabled us to take modest share in these markets.

In the U.S., segment revenue was up 6% year-over-year. This was primarily driven by the segment's commercial business, which benefited from cold weather in the Northeast, driving restocking of heating and circulator pumps. The industrial vertical was also strong in the quarter as the general industrial and oil and gas markets continue their recoveries.

Finally, emerging markets revenue grew 4%, reflecting strong growth in China and other Asia Pacific countries from demand for secondary clean water sources. We had double-digit growth in the Middle East from large project wins and some modest market share gains, as we continue to benefit from the investments we've made to localize our supply chain. This growth was partially offset by weakness in the commercial business in Asia Pacific, as well as softness in Latin America.

Segment operating margin in the quarter increased 150 basis points to 17.2% year-over-year, the highest of any quarter for the Applied Water segment. Margin expansion was driven by 340 basis points of productivity savings, as well as volume leverage. This was partially offset by 190 basis points of cost inflation and 70 basis points of growth investments.

Now let's turn to Slide 10. Measurement & Control Solutions booked orders of $331 million in the quarter, which was up 12% organically over the prior year period. Revenue for the quarter was $321 million, up 10% on a pro forma organic basis over the prior year period. This includes 15% pro forma organic growth in our Sensus business and 1% growth in our Analytics business.

For Sensus, revenue in our water business increased 11% year-over-year in the quarter, which was in line with our expectations, as we lapped the challenging comparisons to the prior year from the restocking of our iPERL water meters, and we also delivered higher growth from AMI deployments in North America, as well as increased demand in Eastern Europe and the Middle East.

Our gas business was up 35%, mostly from the growth in large AMI project deployments in North America during the quarter. Electric was down modestly in the quarter due to the timing of large project deployments. We continue to see high demand for our solutions in this sector. In fact, during the quarter, we shipped our 1 millionth Stratus meter, a pretty impressive accomplishment for having been launched only a year ago.

Finally, the team delivered a 45% increase in revenues in our software and services business, which was largely driven by a couple major contract upgrades.

Shifting to our Analytics business, it delivered 1% growth in the quarter. Double-digit growth in emerging markets from strong demand in China and India for surface water monitoring applications was largely offset by softness in Europe.

Now moving to segment margins. Adjusted EBITDA margin for the quarter improved 170 basis points year-over-year to 19.9%. The increase was primarily due to 290 basis points from productivity savings as well as benefits from volume leverage, partially offset by cost inflation and higher investments for new product development and revenue synergy programs.

In the quarter, adjusted operating margin for the segment increased 130 basis points from 9.3% to 10.6% and was up 190 basis points, excluding the impact of purchase accounting.

Now please turn to Slide 11 for an overview of cash flows and the company's financial position. We closed the quarter with a cash balance of $414 million. Free cash flow in the quarter increased 58% from the prior year to $261 million and was driven largely by significant improvements in working capital across all of our businesses, as well as strong operating performance in Sensus. Free cash flow conversion was 147% for the year, the highest in our history as a public company.

We invested $51 million for capital expenditures in the quarter and returned $33 million to our shareholders through dividends. We also paid -- repaid $98 million of debt, which was the remainder of our outstanding short-term borrowings. We closed the year with debt at 3x EBITDA, which is below our original forecast for the year, and we remain committed to maintaining our investment-grade credit rating.

Now please turn to Slide 12 and Patrick will cover the update to our 2018 outlook.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Thanks, Mark. As we discussed, we entered 2018 with solid momentum. We have confidence this momentum and initiatives we continue to invest in are advancing us to our long-term growth and earnings targets.

At the top line, we expect to deliver full year revenue of approximately $5.1 billion to $5.2 billion, reflecting an organic growth rate of 4% to 6%.

Pure will add approximately 2% to our reported 2018 revenue. Our continuous improvement initiatives will continue to generate savings, which we expect to total about $160 million in cost savings to the full year. This is a 10% year-over-year increase and will keep us well on pace to meet our long-term target.

Our adjusted operating margin is forecasted to expand 60 to 100 basis points to between 14% to 14.4%. This excludes about 20 basis points of margin dilution from acquisitions. Adjusted EBITDA is expected to improve by 70 to 100 basis points, which will bring that to a range of 19.4% to 19.7%. At the bottom line, we expect to generate adjusted full year earnings per share in the range of $2.82 to $2.97. This excludes integration, restructuring and realignment costs of about $35 million. Adjusted EPS growth is projected to be in the range of 18% to 24% for the year.

Finally, as Mark discussed, we expect to continue to generate solid cash from operations. This will enable us to deliver free cash flow conversion of at least 115% in 2018. This contemplates anticipated capital expenditures of $190 million to $200 million.

Now please turn to Slide 13, and I'll walk you through our end market assumptions. Public utility constitutes about 47% of our revenue. We are entering 2018 with solid momentum in this end market, and we continue to see indicators of sustained growth, particularly in the U.S. and key emerging markets.

For 2018, we expect revenue in public utilities to grow in the mid-single digit range overall. The smart meter market is projected to generate slightly higher growth in the high-single digit range. Industrial end market revenues represent about 36% of revenue. Here, we continue to see a mixed environment. The light industrial market, specifically in the U.S. and Europe, are solid, and we see the oil and gas and mining sectors continuing to improve. That will be balanced by mixed conditions across the emerging markets, where strength in China and India, which are benefiting from increased government investments, will be somewhat offset by softness in parts of Latin America. As a result, we project industrials to be up low to mid-single digits.

Moving to the commercial end market, which makes up about 12% of our revenue. We expect 2018 organic growth to be in the low to mid-single digit range. Here, we see low but stable growth in the U.S. and some moderation in Europe, which is coming off more than 2 years of strong growth. We expect to see some strength in the emerging markets, where the Smart Cities initiative in India and solid growth in China continue to drive demand. We also anticipate greater success in winning larger projects in the Middle East, now that we are able to produce product locally.

Finally, in residential, about 5% of our revenue, we anticipate full year 2018 revenue growth in the mid-single digit range, coming off particularly strong growth in 2017. We expect the competitive dynamics to continue in the U.S. where demand tends to be replacement driven. We do anticipate a continuation of the solid demand we've been seeing in China and other Asia Pacific countries, as residents seek a secondary clean water source.

Now please turn to Slide 14, and Mark will walk you through more details on the outlook.

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

As we've done in prior years, we're providing the seasonal profile of our business, as well as highlights of our 2018 planning assumptions. As Patrick just discussed, we're guiding to 4% to 6% organic growth for the company in 2018. This breaks down by segment as follows: 4% to 6% growth in Water Infrastructure; 3% to 5% growth in Applied Water; and 7% to 8% growth in Measurement & Control Solutions.

We're assuming an FX euro rate of 1.21, which was the average rate for January through the end of last week. For your reference, we've included our FX sensitivity table in the appendix. We're also updating our estimated tax rate to reflect our current view, following the passage of the new tax law in December. Overall, tax reform will be modestly beneficial to our business, lowering our long-term structural tax rate from 22% to 20%.

Also, during the fourth quarter, we recorded a $45 million non-cash charge in connection with the new tax law, which reflects the cost of repatriation of foreign earnings, partially offset by the benefit from remeasuring our U.S. deferred tax liabilities at the new rate. We estimate that the cash taxes to be paid related to repatriation will be approximately $60 million, payable over 8 years, and this will partially offset the benefit of lower cash taxes payable in the U.S. due to the rate reduction.

Now moving to our first quarter planning assumptions. We expect growth in the range of 5% to 6%, as we lap a relatively weak first quarter in the prior year and benefit from a strong backlog position exiting the year. We expect our first quarter adjusted operating margin to be in the range of 11.3% to 11.5%. This reflects 110 to 140 basis points of margin expansion, excluding the dilution of Pure purchase accounting amortization. Also, the first quarter is Pure's seasonally lowest revenue period and is expected to result in $0.01 of EPS dilution.

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

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Thanks, Mark. 2017 was a strong year for Xylem. We delivered on our financial commitments and made significant progress on each of our strategic priorities. Our teams are executing well, and that is manifesting in stronger results at both the top and bottom line.

I'm very pleased with the momentum that we've been building across the business. With a growing portfolio of smart solutions, we're forging deeper customer relationships, becoming a valued partner and not just a supplier.

We're in a very strong financial position, fueled by excellent cash generation. This will enable us to continue to deploy capital in smart ways. We understand what our customers' challenges are and where we can create the most value in their operations and for Xylem. That's where we'll continue to focus our innovation and M&A activities.

We look forward to continuing this progress in 2018, further strengthening our performance and advancing on our 2020 objectives.

Now operator, we can open up to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is coming from Nathan Jones, Stifel.

Nathan Hardie Jones - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

One of the things I noticed from the slide deck here is that the level of investments in the fourth quarter are higher than they were for the whole year. Can you talk about what the incremental level of investments is -- increase is in 2018? What kinds of things that you're investing in? Where you are in the development process for those kinds of things? I know there's transferring Sensus technology to the legacy portfolio and that kind of stuff. If you could just give us an update on what these investments are? Where they're going? What kind of level we should think of as a sustained level of investment in the businesses here?

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Sure. So Nate, I'll -- maybe I'll talk directionally as to where we are investing and so forth and the timing of that, and then I'll let Mark speak specifically to the rate of investment that we saw in Q4 and what we expect for '18. I think, directionally, what we're seeing here is we've made good progress. The teams have identified specific areas of investment to drive the synergies with respect to leveraging the Sensus technology and those new offerings to market.

Two, we've seen opportunities to increase our investments in emerging markets and accelerate those growth investments as we focus on localization. And I would also say that we have made some good investments in building out some of our marketing capabilities as well, especially around our vertical marketing efforts. So those are a few examples. Obviously, as we turn to 2018, we're not planning -- I mean, if you look at our long-term targets we put out last April at Investor Day, we're not looking at any kind of increases in investment levels above what we laid out there. A lot of this is timing within any given quarter, depending upon how we feel about the performance of the business. But Mark, do you want to comment on specific dollars?

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

Yes. And I think, Nate, one of -- if you just look at the year-over-year, one of the things you have to keep in mind is in 2016, we had fairly heavy investment in building out some of the capabilities in the Middle East and so that, to some extent, depressed, if you will, the year-over-year comparison. So we did ramp up a little bit more in the back half of the year, and some of that is just a function of being clear in terms of what and where we need to spend money relative to building out our Systems Intelligence centers of excellence. We are building out capability in emerging markets as well to take advantage of what we believe will be continued very strong growth rates in 2018 and beyond.

So some of it is just the timing of what we'd spent in 2016 and how that ramp looked and really just some of the time it's taken us to really make sure that as we do ramp up our spending, we know what we're -- what and where we should be spending on.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

To close out on that one, Nate, I wouldn't read in -- I wouldn't read anything into the kind of spike there in investment levels in Q4 as to any change in view on our investment strategy or our margin targets of the company. It simply is timing from any one quarter, a year to the next.

Nathan Hardie Jones - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

Okay, that's fair. And then I know -- I mean, everybody's fascinated with the opportunities for marrying the Sensus technologies together with the legacy portfolio. I know you'd been doing some development and some pilot testing of that. Can you talk about where you are in that process? When we should start to see these things coming to market and what the commercial opportunities are?

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Sure, yes. So we've -- as I've said before, we've got pilots going in a number of locations around the world with customers, and obviously, will remain nameless here for competitive reasons. But -- and we really are looking at capability or opportunities to leverage the Sensus technology from a comms perspective and a data analytics perspective and to the wastewater sector of the market. We've talked about energy efficiency along the wastewater network, as well as now we have the opportunity also to marry our capabilities within Sensus on the AMI deployment piece, along with what we already have in Visenti, with Pure and EmNet, to build out an even stronger offering there, not just in non-revenue water, but also as we go after one of the big pain points that our utility customers face and cities face, and that is combined sewer overflows. The whole storm water overflow challenge is a big issue.

So now we see an opportunity to even augment some of the pilots that we were already doing by bringing in these other capabilities. So I think you should expect to begin to hear about some of those wins here, I'd say, in the early to middle part of '18, and that really begins to ramp at least in terms of project wins later this year into '19. Those projects may or may not turn to revenue in '18 because they are longer lead time, but I would certainly be expecting to be announcing some significant wins there this year.

Nathan Hardie Jones - *Stifel, Nicolaus & Company, Incorporated, Research Division - Analyst*

When do you think you'll be kind of at a run rate kind of level of production of these kind of products?

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Well, I mean, each one of these projects and offerings are going to be unique. There's not a one-size-fits-all, and so I wouldn't look at it -- I don't think the measurement, Nate, is going to be so much there's going to be a run rate of a product offering or technology offering. I think it's going to be when are we at a point where we've got a steady stream of contract wins and revenues coming through on that. And I would say, certainly, late this year is the expectation. It doesn't mean we're not going to get any before then. But I think in terms of being able to say we're there now, and we actually have an established offering that we're able to use reference account wins to win other projects. It's the age-old, the best thing about winning big projects is you win more big projects because of the reference, and so that's the aim here.

Operator

Our next question will come from the line of Deane Dray, RBC Capital Markets.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Maybe we can start with the record free cash flow, and I was glad to hear Mark say he was very fond of that metric because I think we are -- investors are, too. So -- and Patrick, you said that a couple years ago, you were underachieving, and I'll say, you were like below 90%, but you made it a priority. And so we're seeing it come through here. So for Mark, you touched on the improvements in working capital, 18.5 this year, mid-teens is your goal. Talk about the time frame to get there, incentives for the management team and the sustainability at these levels because that would put you at like the top 5 of the multi-industry sector in terms of conversion.

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

Yes. Sure, Deane. And yes, thanks for that question. We're -- we did make very good progress this year, but as we look at the opportunities across our supply chain and inventory, some of our processes in terms of the billing and collection of receivables and even in payables, there's still good room for opportunity to improve. That mid-teens target is certainly something that we think is achievable and out in 2020, but we're looking at making continued progress in 2017.

So we'd expect -- it probably won't be 150 basis points, but another good, good chunk of progress. So a lot of work to do. We've got opportunities around standardizing payment terms, cleaning up our processes, and also in terms of on the commercial front, just as we negotiate contracts, getting more cash upfront.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

I would say, Deane, a couple of things I would add. So you're right. You asked a question about incentives as well. When I made the comment a couple years back about us underperforming, one of the changes that we made at that point in time was to simplify our annual incentive plan and to broaden the scope of population of people that were in that. And one of the 3 metrics that we have, obviously, one is organic revenue growth, the other being our operating income targets, but the third was working capital as a percentage of revenue.

And I would say, it took -- and as is oftentimes the case, it took a good year or so for that to sink in, and for the organization to really understand the levers that they could pull to drive that and the impact. And I would say, where we really felt good this year was really in the second half of the year. There really seemed to be a pivot across the organization in terms of things coming together. And a part of that was driven by us bringing some talent over from the Sensus team. Sensus has done a terrific job historically because they had a crisis years ago in terms of having to deal with working capital and cash, and the transfer of those learnings has gone a long way.

And I think the new frontier for us beyond what Mark laid out is, as we bring more and more of this longer-term contract mix into our portfolio on these smart water solutions, customers are usually willing to give you some payment upfront to really finance that. And so I would expect the mix of our revenue to be favorable there in terms of working capital.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

That's all good to hear. And for my follow-up, I just wanted to follow up on Nathan's last question there on these new smart infrastructure platforms. So we've all heard about non-revenue water. We understand how Pure fits in with Visenti and what's been done in Singapore and what the opportunities are. We've heard a bit. You've been cagey, Patrick, about the watershed opportunities, but I have heard from customers. I know which customers are doing the pilot programs. The feedback has been very good, so we're excited about that.

So maybe a bit more on the combined sewer overflow, I know it's a pain point, and coincidence or not, I was in South Bend -- or excuse me, I was in Austin for the big water conference and I sat in the presentation from the South Bend municipality. And they talked about EmNet and they gave -- they showed the dashboard. It was pretty compelling, and now it turns out it's part of Xylem. So take us through what that opportunity is.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Sure, yes. So I would -- and this is a big compliment to the EmNet team in terms of what you've shared there and we love the team. We love what we've seen there. I would almost view them as an equivalent of the Visenti wastewater and storm water overflow. They've got a terrific distributed sensing capability and data analytics capability to really help cities and municipalities both predict and deal with surges around storm water overflow.

So as you're well aware, and you would have heard there, Deane, heavy rainfall, snowmelt, a variety of things cause sewer systems to overflow and exceed the capacity of the wastewater treatment plant or they run off and they directly pollute rivers and streams and so forth. So again, EmNet provides this predictive analysis capability that helps the, again, the wastewater part of the utility better design and prepare for those kind of events.

We see that -- as you well know, they have a number of these contracts underway across the U.S., but they are really just getting started. South Bend was their origin. These guys came out of Notre Dame to address that. And we really think that this is a great opportunity for us to leverage our channel to utilities, not just here in the U.S. This is an issue that we deal with around the world, and it really is a new market.

Deane Michael Dray - *RBC Capital Markets, LLC, Research Division - Analyst*

Yes, absolutely, and it's great seeing you make an acquisition in this space. Just last point, just -- and related to this, the whole premise of using M&A as a proxy for R&D, and it seems like EmNet fits that exactly, and just talk about the funnel of other EmNet type of acquisitions out there.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Yes. So we've -- one of the things we're really excited about here is the opportunity to have Al Cho, who many of you have had a chance to meet and work with before, Al, really, as I said in my prepared remarks, has been instrumental with myself and the team here and Colin and others to really kind of architect what this platform needed to look like based upon our value mapping of our customers a few years back.

And so I would say we already knew going into the acquisition of Pure and EmNet. We had a pretty good idea of what those pain points and our gaps were. So we already had a growing pipeline of things like EmNet, and we've got a number of others that are out there that we are courting right now. I would say, though, what I'm even more excited about is Jack Elliott, the CEO of Pure, has agreed to stay on with me as a senior adviser to myself, to Al, to Colin to really help us architect even further what this broader universe of opportunities could look like, as we drive even more of a consultative approach towards the utility.

So while we think we've got a pretty good view on that, obviously, the ability to get in there with these customers and further explore what their pain points are is really just going to inform further what that pipeline looks like. So there's more to come, Deane.

Operator

Our next question comes from the line of Mike Halloran, Baird.

Michael Patrick Halloran - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

So first, on the demand side, obviously, really dynamic orders, and good to see the acceleration of orders through the year here. The prepared remarks commented on a lot of those orders, provided a nice runway through '18 but more into '19. So could you parse out what you're seeing both in terms of, call it, the repair/replace, the shorter cycle stuff, how the momentum carried in the fourth quarter and how you're thinking about that into next year, and then also large project funnel, customer willingness to put capital dollars forward and kind of compare and contrast those 2 dynamics.

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

Yes. Mike, let me take that one. And I would say that the order strength was fairly broad-based in terms of what we saw in bookings, both -- there was quite a bit of short cycle business. I mentioned transport was up 20% year-over-year. And that's generally shorter cycle, however, one of the things that we did see over the past quarter, we were very successful in winning a number of larger projects. And as a result, as we decompose that backlog, we had a much higher percentage than normally that will be shippable beyond 2018.

So it wasn't -- I would say, it wasn't that we saw a decline in the shorter cycle business. That was still there, but what's really encouraging was we're really starting to get traction on some of these larger projects, treatment, as well as industrial and a number of those certainly in our emerging market countries, where we have made investments to be able to be responsive to those types of opportunities.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

I would just add, Mike, that if you -- and maybe to tie that back to what we're guiding to for 2018 and kind of what the cadence looks like over the course of the year. Bear in mind that, certainly, Q3 and Q4 were a little bit easier compares to the previous year, but they were strong in terms of order growth overall.

As we look at '18, I would say, the way it shapes up is kind of 5% to 6% in both Q1 and Q2, and then probably moderates to 4% to 5% in Q3 and Q4 just because you get a little bit tougher compare at that point. But I think what we felt good about with those orders that go out to 2019, as well as the fact that when you look at our bidding pipeline in our treatment business, which we've always used as a proxy for the health of the [media] market. That continued to grow year-over-year, and is up north of $2.6 billion now in terms of bidding pipeline. So all indicators are that we're still well in -- we're still kind of in the early to mid-stages of this cycle of recovery and don't really yet see any signs there of any softening or weakness.

Michael Patrick Halloran - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Then just summing that up, I mean, essentially, continued short cycle weakness -- strength, excuse me, and momentum on that side, while you're building the project backlog at a pace that is better than you've seen over the last few years, with a still nice pipeline in front of you, that's fair?

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

Yes, well said.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Yes.

Michael Patrick Halloran - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

All right. And then on the margin side, obviously really nice margins in Applied and in the Sensus businesses. Maybe just talk a little bit about infrastructure. I understand a lot of the puts and takes there, particularly, on the growth side. The one that I was trying to get a little color on was the -- really the lack of volume, price mix, other leverage. I'm guessing the volume leverage is still there, but maybe the price mix, other components were a little less so, so maybe what happened in the fourth quarter, and just how do you think about incrementals into next year on a core basis there?

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

Yes. Sure, Mike. And you're right, I mean, there was solid volume leverage. We -- price was flattish. It wasn't a big factor. Where we took a little bit of a hit there was I mentioned in my prepared remarks, we did have some FX transactional losses. We do sell a lot of product out of Europe in U.S. dollars. And as the -- we try and hedge as much of that as we can, but when the euro really moves, it has an impact. So that was one factor.

And we just talked a little bit earlier about the great success that we had in some of our emerging markets in terms of those growth rates, particularly, I mean, India was up 60%. We had good growth in China, and those do carry lower margins. And so that -- there was a bit of unfavorable mix as well. As we look forward, we expect continued margin expansion in that segment, and would expect the drops on revenue growth to be more in line with what you'd typically see in that 25% to 30% drop.

Operator

Our next question will come from the line of Jim Giannakouros, Oppenheimer.

James Giannakouros - *Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst*

When looking at your margin progression goal of, I think, it's 17% to 18% by 2020, does that adjust for acquisitions? I just want to get that clarification question out of the way.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

It's reflective of the amortization that comes with Sensus. But I think the important point here, Jim, is that we do have good confidence in getting to that 17% to 18% target. We're going to continue to generate solid volume growth. Productivity savings are going to be -- we continue to deliver strong productivity savings. And in fact, we've got significant opportunities around our back office that we're ramping up this year and will really be a big lift in 2019 and '20.

We really haven't seen any of the benefit from some of the volume leverage and revenue synergies that we'll certainly expect to be getting with Sensus, and so we've got very good confidence in terms of our ability to deliver that 17% to 18% by 2020.

James Giannakouros - *Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst*

Got it, and since you touched on it, that Sensus legacy [sound] revenue synergy opportunity, that's $150 million to $200 million or so, are you tracking on plan there, or are you -- I'm sorry if I misunderstood you anticipating (inaudible) there.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

No, Jim, I think, that's right. I mean, I think the -- what I was alluding to earlier was, I think, the good indicator for us this year is we're definitely going to have revenue synergies that come from Sensus, a lot of revenue synergies that are coming also from the Pure transaction and the new platform we're building here. But I think the real strong indicator is going to be what are some of the big project wins and order momentum that we have that we can talk to later this year and as we exit '18 going into '19. So not that we're not counting on revenue there, but that's not really reflected in our guide for this year. I'm really focused more on what the order rate momentum and the contract wins are as we get later in the year.

James Giannakouros - *Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst*

Understood. And one follow on, if I may. Residential exposure within Applied Water is subject to specific regional influences, if I recall. But in your slides, and Patrick, you reiterated that you're calling for mid-single-digit growth off of 12% comp in '17. That's stellar. Can you frame that for us a bit more granularly? Appreciate it.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Yes. So I'll certainly give you my thoughts on that. I mean, if you look at what happened in, certainly, 2017 in the fourth quarter, we had a lot of strength in China and across Asia Pac. We also had some share gains in Europe from some of the new products that we've rolled out there. I would say growth in the U.S. was flattish in the fourth quarter, but it was strong for the full year.

What happened, I think, for the full year was you got the Asia Pac, Europe growth that's being driven there by domestic expansion. But it was also, we've had some disruption, as you all know, in the competitive dynamic here in the U.S. in terms of one of our competitors buying out a distributor. That created some disruption in the marketplace that our teams were successful in taking advantage of, quite frankly, and that got us a nice pop for 2017. We do see all that moderating as we go into 2018, but we expect there to be at least solid market growth in '18. I wouldn't be calling share gains in '18. It really is more the market growth here, predominantly in the U.S. and Europe.

Operator

Our next question will come from the line of Joe Giordano, Cowen.

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

Let's start on the Sensus side. Obviously, things are well ahead of the growth rate that you have underpinning 2020. I just -- I wondered if -- and Patrick, you've just kind of commented on the big piloting revenues that are still ahead of you. But like we talked about, I think, you mentioned something like $100 million in revenue synergies would be almost a disappointment if you didn't get there. Are you seeing any of that right now?

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

In terms of the actual revenue synergy or in terms of confidence in our outlook?

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

Yes, I guess -- well, I guess both. I guess, I mean, the growth rates here are 15%, I hear you're starting to see -- is that something that would've happened without the Xylem portfolio behind it? Is that just a -- how much of this is, is stuff that you're sort of able to incorporate into the company?

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Sure, yes. I would say there is nothing that has been achieved to date that we would explicitly call out as Xylem-driven synergies. Now have there been cases where there's perhaps a bit of a halo effect in terms of winning some contracts and bids? Perhaps. But the things that we call the revenue synergy are going to be very explicit in terms of bigger, bigger deals that the team either wasn't even looking at before or were, but didn't have the relationship, and then some of these new offerings to the market that we've talked about earlier with Deane in terms of leveraging the Sensus technology across the portfolio.

Those areas, we continue to remain very confident. We've got a regular tracking here each month with the team in terms of what those look like, where they stand, and those are not reflected in the Sensus growth rates, to date, nor are they reflected in the guide that we've given you for 2018.

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

That's right.

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

And then when I think about that market, that metering market, in general, obviously, a huge fall off in terms of market share after you get through the first -- a few major players there, and have a big transaction in the space with Hubbell and Aclara. And I just wonder if you see any of these like smaller players as complementary to your business from a technology standpoint. Is there an opportunity there to kind of consolidate a little bit of that in industry?

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Yes. I would say, as I look at that sector right now, I wouldn't -- as I look at it today, things can obviously change. I wouldn't say that consolidation of the metering sector is a high priority for us. I think that the moves that have happened here, I think, are good for the metering sector. I think it's a healthy move in terms of that consolidation. There are a lot of players in the space. But certainly, when we look at our core offerings and what we're focused on, we don't see it really having a meaningful impact. If anything, it's net positive for us. But again, I wouldn't see us being a major consolidator in the metering space, as I look at it today in terms of what our overall priorities are for growth.

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

Okay. And then, Mark, you kind of talked about this a little bit earlier, apologies if I missed some of it. But when we think about the margin guidance for 2020, 17% to 18%, maybe exiting 2018 at a lower level than we thought, part of that doing the deals and things that you've done. Have the buckets that get you to that level changed somewhat? I mean, revenue's probably coming in a little hotter than we thought, and margin's probably exiting '18 a little bit lower. So how are you closing that gap with comfort there?

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

Yes. I don't think the buckets have changed materially in any respect. So I think either -- so we are growing a little bit higher than we thought in '17. Some of that was stronger growth in our treatment business and in emerging markets, which have a little bit more lower margin profile. But the biggest driver, our productivity savings, is right where we expected it to be, and we expect that to continue as we outlined back in April at Investor Day. The level of investments is relatively in line with what we expected. The timing might be a little bit off just in terms of the year-over-year compare, but relative to what we're -- the quantum of the spend is in line, and so there's -- it's very much what we expected, and there's really nothing that we see looking out ahead that would give us reason to believe that those buckets, in terms of what's driving the margin expansion, are shifting.

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

Great. And Patrick, maybe if you could just comment on like your appetite for large-scale M&A in this environment where multiples keep widening so. And, then, I'll leave it there.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Sure, yes. So look, we're going to continue to be strategic in our focus around M&A. Obviously, anything we do from an M&A standpoint really needs to tie in to what our overall growth strategy is, not just for the sake of going and getting bigger or doing something. And so I take this back to what I laid out at Investor Day last year in terms of the 3 focus areas, one being obviously building out the kind of smart infrastructure component. Two, was looking at the opportunities over time to expand our presence in the industrial part of the water sector, and then the third was, where necessary, obviously, we would defend our core franchises here in terms of any consolidation necessary there. In terms of capacity, we certainly have the financial capacity to be able to do this. We have the management capacity to do things of larger scale. But right now, we really are just focusing in on integrating what we've got here, building out these new capabilities, and really kind of, again, in my view, hopefully establishing a first mover advantage in some of these spaces. So that's where our focus and attention is right now, at this point in time, Joe. Again, we'll continue to look at things in this space as need to and as they come along, but nothing specific that we're looking at right now of size and scale.

Operator

(Operator Instructions) Our next question will come from the line of John Walsh, Vertical Research.

John Walsh - *Vertical Research Partners, LLC - VP*

So thinking about the margin bridge for 2018, you've obviously covered a lot of ground, I mean, cost inflation, headwinds have kind of been pretty steady here through '17. Just wanted to get your view as we think about '18 there in terms of cost inflation and what are kind of the biggest pain points in that line? Are they around people, inflation and/or commodities?

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

Yes, John, sure. Once again, we are expecting the biggest driver of margin expansion will be the benefits from our productivity programs. That will be in that 300-basis point plus range. We do expect to see some nice volume drop. I mean, with higher growth rates, we'll see margin expansion from volume leverage. Some of that -- there will be a little bit of unfavorable mix as we continue to grow our -- see outsized growth in emerging markets. Inflation, we're seeing it tick up a little bit. Our expectations for the full year is roughly 200 basis points of headwind. A lot of that is just -- it's labor cost, benefit costs. There's certainly a tick up we're seeing in some of the commodities, but it's not rampant. I mean, aluminum, steel, copper, but they're not huge components of our product build. And then we'll continue to invest in -- at rates that are fairly consistent with where we've been in -- over this past year.

Operator

Our next question will come from the line of Brian Lee, Goldman Sachs.

Brian Lee - *Goldman Sachs Group Inc., Research Division - VP and Senior Clean Energy Analyst*

And not to beat a dead horse here, but I think you guys had targeted, if I recall, $40 million in revenue synergies with Sensus in 2018. Is that target officially shifting out some here? I just want to clarify because it sounds like it's not part of the 7% to 8% view on Measurement & Control Solutions. And then I guess if it is pushing out, maybe the reasons as to why that might be the case.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

No, I wouldn't say it's shifting per se. I mean, in my view, it's just -- we -- these things take some time. We're talking, I'm thinking more run rates at this point in time in terms of contract wins. Look, we're going to get some revenue synergy here in 2018. We'll be clear on mapping out what that is. But we're still, I'd say, not in the early stages of this, but we are still in the stages of pilots on a number of these areas, and the pilots and these large deal efforts that we're going after, I talked before about the dozen or more large international deals that we were pursuing. Those things shift around. They take time. There's a lot of investment up front that we have to do in those areas in terms of time and resource. So look, I hope that at least that much, if not, more comes through this year, but we didn't feel it prudent necessarily to explicitly build that into our guide for the year.

Brian Lee - *Goldman Sachs Group Inc., Research Division - VP and Senior Clean Energy Analyst*

One quick one for me, and I'll pass it on, and I might have missed this. But Mark, I noticed that Canada was -- it was highlighted as an area of strength in the Water Infrastructure segment. Can you give us some context as to what drove that? How much exposure you have there and if that's a trend line that sustains into the new year?

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

Sure. Yes. It's really a function of strong recovery in oil and gas and mining. The commodities are -- really, really picked up in that country over this past year, and we saw the benefit of that. It's around $150 million of revenue. So it's relatively sizable, but not one of our largest geographies, but it was -- it's good to see a [bounce] back there this year.

Brian Lee - *Goldman Sachs Group Inc., Research Division - VP and Senior Clean Energy Analyst*

And just any quick thoughts around the trend line from these levels?

E. Mark Rajkowski - *Xylem Inc. - Senior VP & CFO*

Well, listen, with that kind of growth, it's going to be a tougher compare. The good news is that the -- those markets continue to remain stable, and we'd expect low mid-single-digit growth in 2018. Just a very tough compare when you're in the 20s this year.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Yes, and I would just add that I think that what we saw in Canada this past year really was a recovery and catching up of things that have been deferred and delayed because Canada had been on its back for the last couple of years, at least, in terms of how our business is going down year-over-year. So we saw some of that recovery, but it really will be kind of low single digits expected, as that market kind of normalizes to typical spend. It's largely driven by, again, the public utility piece, and then a little bit less in our dewatering business.

Operator

And our final question will come from the line of Scott Graham, BMO Capital Markets.

Robert Scott Graham - *BMO Capital Markets Equity Research - Analyst*

So I have 2 questions for you. I suspect you did not enter 2017 with the level of inflation that we've seen as we exit 2017. So I guess what I'm assuming here is that the cost reductions, which have been extraordinary or maybe been a little accelerated. I don't -- you've made some comments about that they're being on plan. It looks like it's a little above plan, but even still, do you think that there's some stress on the organization, Patrick, because the price cost with you guys is negative by nature of the business. And are the cost reductions maybe providing excess stress in certain areas?

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Well, I think the short answer is no, although I never want to understate the challenge that you have in terms of change management in any organization when you're driving a number of initiatives and cost takeout and efficiency and so forth. But what I'd say has really, I think, helped mitigate that stress and anxiety for a couple of things. One, boy, is it a whole lot easier to do that when you are at least in a growth market, and people can feel growth going on around them. It was tougher when there was not as much growth. That's one. That certainly helps with the sales teams in terms of their motivation and inspiration. But I think it's also being clear and transparent with the organization as to what our priorities are, and that our cost efforts aren't just across the board, go after a thousand things at one time. We've got programs around global business services implementation. There's a lot of change management going on around that and communication. Two, I think it's important to recognize that a big chunk of our cost savings are coming out of the procurement and the deployment of Lean and Six Sigma. So these are basic process capabilities and skills that we're teaching the organization how to fish in these areas, as opposed to being always with a blunt object. And I think when you're giving people those skills and capabilities, that makes it easier because they feel empowered to go drive change and make things more efficient. And our CI efforts, continuous improvement, is not just focused on the cost takeout. It's about making it easier for our customers to do business with us and be faster to market, and that always makes an organization feel better. So I don't want to come across as too much CEO speak, as if it's easy, because it's not. This is hard work. It's heavy lifting. I would say if it was that easy, it would have already been done. So I recognize that level of stress. But no, I feel that the organization is very healthy, and healthier than it's ever been in my view. But it's something, you're right, Scott, that I pay a lot of attention to, and that's why I spend so much time out on the road with our teams, hearing how things are going.

Robert Scott Graham - *BMO Capital Markets Equity Research - Analyst*

Understood. My follow-up question is one of the things that you indicated in your year ago analyst meeting was the desire to push up new product, sales spending developments by about -- I think it was by about 150 basis points over a several year period. You also, you personally, championed the whole we need to get better in commercialization as well. I guess my questions are on those 2 metrics, where do you think they're impacting the most, and where do you -- which areas of the business are maybe lagging on those areas?

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Sure. Yes, so I think the -- I would say that 2 dynamics or 2 pieces of that. One on the driving kind of commercial leadership and the commercial excellence. Really, in my view, the whole purpose of me putting that out there as one of our top priorities was to move our organization away from where many industrial companies are, and that is spending way too much time focusing on inside the 4 walls of the company and being an administrative company as opposed to a commercially-driven company that is hungry, that understands why you lose an order versus why you win one, and that the center of gravity is with the sales team and the people that are serving the customers' needs every day. And so putting in things like a net promoter score mechanism, a salesforce barometer, so one, to measure how customers feel about us; two, to measure how our sales teams feel about what we're doing has, I think, been a big move forward for us. It shows them that we actually care about what's going on. And we've got a lot of areas to improve, and that's why -- that, to me, is all upside in front of us. We do not yet score well and high on either one of those. But the good news is, people are being very honest with us about where we can do better, and that's what we're very much focused on. I would say an area that we can do also a much better job in is broadening our key account management skills and capabilities, and that's an area that we are now investing in as we go forward. I feel good about the progress in R&D and the spending there and the activities. But now it's a matter of commercializing those and embedding those new skills in our selling organization, as we sell different value propositions here. And certainly, the acquisition of Sensus and Pure, EmNet, Visenti, those are all very different DNA in terms of how they sell value to customers, and that's certainly been a nice changing dynamic in our commercial organization.

Operator

Thank you. I'll now turn today's conference over to Patrick Decker for closing comments.

Patrick K. Decker - *Xylem Inc. - President, CEO & Director*

Well, thank you, all, for your interest and your questions and hanging on here. And so, again, safe travels. I wish you all Happy New Year. I know we're well into it, but I haven't seen all of you. Until I do, I get to say Happy New Year. And wish you all the very best, safe travels, and look forward to talking to you on our next earnings call. Thank you.

Operator

Thank you. This does conclude today's Xylem Fourth Quarter and Full Year 2017 Earnings Conference Call. Please disconnect your lines at this time and have a wonderful day.
