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PRESENTATION

Operator

Welcome to the Xylem First Quarter Earnings Conference Call. (Operator Instructions) I would now like to turn the call over to Matt Latino, Manager of Investor Relations.

Matt Latino

Thank you, Paula, and good morning, everyone and welcome to Xylem's First Quarter 2017 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 first quarter 2017 results and discuss the full year outlook for 2017. 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.xyleminc.com. A replay of today's call will be available until midnight on June 2. Please note, the replay number is (800)585-8367, and the confirmation code is 41774098. Additionally, the call will be available for playback via the Investors section of our website, under the heading Presentations.

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 the 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 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. - CEO, President and Director*

Thanks, Matt, and good morning, everyone. We appreciate you joining us to review our first quarter results. We started off the year well, delivering solid results in the first quarter that were in line if not slightly better than our expectations. Once again, our diversified product portfolio and end market exposure helped to balance our performance. This positions us well to deliver on our full year commitments.

We entered the quarter facing some challenging year-over-year comparisons, namely in our businesses serving the public utility sector. While those tough comps are reflected in our results, we remain encouraged by the underlying fundamentals in that end market, which I'll get to in a few moments. Our Sensus business is off to a great start this year, delivering strong top line growth. We're continuing to integrate this business with early work underway to begin executing against a promising revenue and cost synergy we discussed at our recent Investor Day. Lastly, our teams executed well. Our focus on driving productivity initiatives delivered a 33% year-over-year increase and continuous improvement savings in the quarter, further demonstrating that we are still in the early chapters of our self-help story. This progress enabled us to offset cost inflation and continue to invest strategic growth initiatives.

At our Investor Day last month, we had a comprehensive discussion about our objectives and long-term plans as well as market outlook. So for the benefit of those who weren't able to join us, I thought I'd touch on a few of the key points we made there, and talk about our results for the quarter in that context. A primary theme of our discussion in Raleigh was how we are driving growth. This is a critical lens through which we are prioritizing our activities, and we have a number of actions underway to accelerate profitable growth. First, as we discussed there, we've made 2 significant organizational changes that are realigning sales teams and businesses to take better advantage of our scale and our broad product and service offerings. We've combined Xylem Analytics, Sensus and Visenti to create one optimized business that focuses on sensing technologies. This is a powerful combination that will enable us to better leverage the strengths and capabilities of each entity and move faster in developing smart solutions for customers.

Second, we've consolidated our various Water Infrastructure and Applied Water sales teams across North America into one commercial team that is now organized around what we refer to as industry verticals. Said another way: common customer sets. This structure will make it easier for consumers to do business with us because they have one point of contact who can provide easy access to our full portfolio of solutions that are relevant to their business. We've already done this in Europe and the emerging markets, and the results give us confidence in the value of this structure. These organization moves are well underway and we expect both to be growth accelerators.

Now as I mentioned earlier, our diverse end market exposure continues to benefit our overall performance. During the quarter, our total pro forma organic revenue growth, which includes Sensus, was up 1%. Our Sensus business delivered a 7% increase with growth across the water, electric and gas sectors. On an organic basis for base Xylem, revenue was down 1% for the quarter, primarily reflecting a particularly difficult year-over-year comparison as we generated a 12% increase in the public utility sector globally in the prior-year period. We do continue to see signs of strength in public utilities. Orders were up 3% in the quarter, primarily driven by public utilities, and treatment orders more than double that. In fact, the treatment bidding pipeline was up double digits, and as I've mentioned before, this project pipeline is a strong leading indicator for the longer-term health of the public utility sector. Mark will give some more details on this in a few minutes. So the demand in public utilities continues to be robust, and we expect that to manifest in stronger revenue growth later in the year and in 2018 and beyond. And with the increased exposure to this end market that Sensus provides, we're better positioned to benefit from what we believe will be a period of sustained growth.

Another pillar of our strategy is to drive growth in emerging markets. This is an area where we see momentum building after a period of softness, and importantly, we're very encouraged by the longer-term growth prospects. During the first quarter, orders were up 14% in emerging markets, and revenue grew 3%. This is building off the early signs of growth that we saw in the fourth quarter, and bolsters our confidence in being able to achieve our objectives for the year and longer-term. In [Sanaa], a year ago, we faced very challenging conditions, but our team remained focused on our long term objectives, and now we're realizing the benefits as conditions are beginning to stabilize, and our business returns to growth. Revenue was up 4% in the quarter, and momentum is picking up in orders. We're also continuing to increase our product localization, and we've expanded our supply chain there.

India continues to be a standout, and we are growing our team there to take full advantage of the opportunities. Momentum in both revenue and orders continues to grow as the government's commitment to investing in infrastructure supports the longer-term growth thesis. The Middle East continues to be a challenged market, but we remain positive on the long-term prospects given the obvious needs there: water scarcity, infrastructure demand, continued growth in construction and more. In fact, the project pipelines funnel in the Middle East is strengthening, particularly in the areas of construction and building services. Orders in the quarter were up 9%, and we see that momentum continuing.

Shifting gears. Another part of our growth strategy that we discussed at Investor Day is our focus on strengthening innovation and technology. One of the ways that we're accelerating our progress in this area is by building a broad-based ecosystem of partners to bring together ideas, capabilities and new products to help solve our customers' challenges and add value to their operations. We're doing this with a more integrated approach to our own internal R&D efforts by partnering with a wide range of academic and research institutions, and by working directly with customers and other partners who can help us bring value-add solutions to the market more quickly. Let me provide a couple of examples.

Last week, we announced a new agreement to be the exclusive distributor of Pure Technologies' water applications in key emerging market regions. We will sell these advanced solutions in the Middle East, India, Singapore, Malaysia, primarily in the public utility and industrial sectors. Pure's portfolio of solutions is designed to address several of the more challenging pain points we know our customers are struggling to solve, such as nonrevenue water, operational efficiency and asset utilization. Another example is the agreement we entered into this past quarter with our customer, DC Water, a widely regarded thought leader in the water utility space in the U.S. This agreement outlines specific areas of collaboration on a wide range of research and future innovation initiatives. This includes field-driven pilots that focus on new treatment technologies, and increasing the productivity and resilience of their operations. We kicked off the collaboration by delivering their first Flygt Concertor pump for installation at their flagship treatment plan. This serves as an important reference case in North America.

Finally, our Sensus integration is well on track to accelerate our work in the area of smart water infrastructure. As we discussed in Investor Day, we are confident that we will deliver significant revenue synergies by leveraging the systems intelligence capabilities of Sensus to develop new offerings for Xylem's customers. Our teams are making good progress, and we expect to be piloting prototypes of new solutions at customer locations sometime during the summer.

To finish up on our first quarter results, let me quickly touch on our ongoing progress in the area of Continuous Improvement. As I already mentioned, our teams delivered a substantial increase in cost savings in the quarter, which enabled us to find the investments needed to achieve our longer-term value creation objectives. We are expanding training in various continuous improvement practices, which will further drive a productivity for growth mind-set deeper into the organization. We are well on our way to achieving our full year goals in this area.

Our adjusted EBITDA was up 100 basis points to 16.2%. At the bottom line, we generated adjusted earnings per share of $0.39 in the quarter, an increase of 17% year-over-year, excluding the impact of foreign exchange translation. We delivered solid improvement in free cash flow, which positions us well to deliver another year of free cash flow conversion in excess of 110% of net income. Finally, we are raising our full year earnings guidance to reflect our updated assumption for foreign exchange impact which has strengthened recently. We increased our adjusted earnings per share by $0.03 at both ends of the range to $2.23 to $2.38 per share.

So we're off to a good start in 2017. Our teams have made good progress, and we're encouraged by the momentum we see building in the marketplace and across our business. This gives us confidence in our ability to deliver on our full year commitments.

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

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

Thanks, Patrick. Let's turn to Slide 5. I'm very pleased that we got off to a good start in the first quarter and we've built solid momentum heading into Q2. Overall, revenues were up 26% in the quarter. On a pro forma organic basis, this represents 1% growth, with Sensus contributing 7%, and the base Xylem business down 1%. Additionally, foreign exchange reduced revenues by $11 million or 1 point. From an organic perspective, the 1% decrease in base Xylem revenues largely reflects a 4% decline in the public utility end market versus a strong prior year comparison that was driven by timing of project deliveries and favorable weather conditions. Partially offsetting this decline was strong growth in residential, up 14% and a modest increase in commercial of 2%.

Industrial revenues were down 2% overall, roughly in line with our expectations entering the quarter. Market conditions were soft in our Applied Water business, and last year's results also benefited from a few large equipment shipments in Water Infrastructure.

We started to see some positive signs in this end market with improving order rates and revenue trends as we entered the second quarter. Regionally, the organic decline for the quarter occurred in the U.S., which was down 4%. Western Europe performance was flat as expected, and as Patrick mentioned, our momentum in emerging markets continued to build as revenue was a bright spot, up 3% year-over-year.

Moving to operational performance. We increased our adjusted EBITDA margins by 100 basis points to 16.2% in the quarter. This increase was primarily driven by the strong operating results of Sensus and the continued ramp-up of productivity savings.

Adjusted operating margin declined 40 basis points to 10.5%, which includes 70 basis points of noncash amortization related to purchase accounting for the Sensus acquisition. Our teams continued to gain traction in the area of productivity, where we delivered $33 million in cost savings in the quarter, which is up 33% from the prior year. This 310-basis point improvement enabled us to offset inflation and fund strategic investments for growth. Excluding the 70 basis points of dilution from the Sensus intangible asset amortization, our operating margin expanded by 30 basis points.

Given the tough prior year comparison we faced this quarter, I'm pleased with our team's performance in delivering earnings per share of $0.39, an increase of 11% year-over-year and 17%, excluding foreign exchange translation. Please turn to Slide 6, and I'll provide additional details on our segment performance.

I'll start with our first quarter order activity and backlog position at the end of the quarter. Water Infrastructure recorded orders of $546 million in the quarter, up 3% organically year-over-year. This reflects growth in all applications within the segment and was led by treatment orders, which were up 8%. This performance builds on a positive upward trajectory that we've seen in our pipeline and order activity. However, a majority of the treatment projects require longer lead times and will not ship until 2018 or later. That said, we exited the quarter with total backlog for this segment of $584 million, up 4% organically year-over-year.

Of this amount, $262 million is due to ship in the second quarter, also up 4% year-over-year on an organic basis, which gives us good confidence on returning to positive revenue growth in the second quarter. Water Infrastructure revenue of $496 million represents a 3% year-over-year decline on an organic basis. Foreign exchange was a $7 million headwind.

In the U.S., the segment declined 8%, primarily driven by declines in the industrial end market. On a positive note, we're seeing some stabilization in the U.S. oil and gas markets, and for the first time since the fourth quarter of 2014, we saw oil and gas revenues grow year-over-year in the dewatering business, which is an encouraging sign.

Our public utility business also declined in the U.S. by 4% as we lap the 22% growth in last year's first quarter. Further impacting revenue was an interruption at our manufacturing facility in Sweden, which was caused by a vendor supply issue that resulted in some shipping delays. We are addressing these issues but expect some modest impact in the second quarter.

Western Europe decreased 2% overall, primarily driven by the timing of shipments in the U.K. We continue to expect solid mid-single-digit growth in the U.K. for 2017, largely due to the AMP6 public utility investment cycle. Emerging markets results were mixed, but up 2% overall. We had 11% growth in Asia, which was primarily driven by the timing of revenues on several large projects and growth in China was up mid-single digits. This was largely offset by the ongoing weakness in the Middle East where the level of government spend for infrastructure continued to be constrained, resulting in a 20% decline in year-over-year segment sales. Operating margin for the segment decreased 160 basis points to 10.5%, driven by lower volumes, unfavorable mix, inflation as well as increased strategic investments for growth. These items were partially offset by cost savings of 380 basis points, driven by our productivity programs. Please turn to Slide 7.

Our Applied Water segment booked orders of $354 million in the quarter, which was up 2% organically. Our book-to-bill ratio was 1.06 in the quarter, which is in line with our historical performance. We exited the quarter with backlog of $178 million, which is down 7% organically compared to last year. However, of this amount, $108 million is due to ship in the second quarter of 2017, up approximately 6% on an organic basis, providing another proof point for our confidence in achieving year-over-year revenue growth in the second quarter.

Revenue for Applied Water was $333 million, up 2% organically versus the prior year quarter. In Europe, revenue increased 6% with particularly strong growth in Germany, Italy and the U.K. where our recent investment in sales capabilities and channels continues to pay off. Continued traction with new products also bolstered performance.

Emerging markets revenue grew 4%, reflecting growth in Asia, and to a lesser extent, Eastern Europe, partially offset by weakness in Latin America and the Middle East. In the U.S., segment revenue was down 1%. This decline was primarily driven by the segment's industrial vertical, which declined 8% from continued weakness in its oil and gas business, soft general industrial applications and a challenging year-over-year comp in revenues from fire pump projects.

Largely offsetting the industrial decline was 15% growth in the residential vertical, which was largely driven by the timing of promotions as well as modest share gains. Our U.S. commercial and building services business also grew 1% in the quarter.

Segment operating margin in the quarter increased 90 basis points to 13.5% year-over-year. Strong productivity drove a 390 basis point margin improvement, which more than offset 180 basis points of cost inflation, unfavorable mix and other minor headwinds.

Now let's turn to Slide 8 to discuss the performance of Sensus. As a reminder, these first quarter results reflect only our Sensus and Visenti businesses. When we report our Q2 results, we'll report the new segment that we announced at our Investor Day, which is a combination of the Sensus, Visenti and Xylem Analytics businesses. We will provide restated historical segment financial information in advance of our second quarter earnings call.

Revenue for Sensus was $242 million, up 7% on a pro forma organic basis versus 2016. In the U.S. revenue increased 9%, with growth primarily attributable to the deployment of several large electric projects. Further driving this strong performance was demand for new products, including the Stratus meter for our electric customers and the iPERL water meter. Our emerging markets business grew 20%, predominantly driven by smart water applications in the Middle East.

Western Europe was down 5%, which primarily reflects the lapping of significant service fee revenues related to the deployment of the Thames water contract in 2016. As a reminder, the timing of project deployments in the Sensus business can create some lumpiness in quarterly growth rates. While we saw a growth at the high end of our guidance range in Q1, we expect that to temper in Q2, which we'll cover in our outlook discussion.

Adjusted EBITDA margins increased 50 basis points to 19.8%. Margin expansion was driven by higher volumes, improved mix and productivity savings, partially offset by inflation.

Adjusted segment operating margin in the quarter decreased 160 basis points to 10.7% year-over-year. This decline is directly attributable to the noncash impact of incremental purchase accounting depreciation and amortization. Excluding these noncash items, margins expanded by 170 basis points.

Now let's turn to Slide 9 to discuss cash flows and the company's financial position. We closed the quarter with a cash balance of $287 million. As you may recall, the first quarter is our seasonally weakest period for cash flow, however, the $26 million of free cash flow in the quarter increased significantly from the prior year, and was driven largely by the addition of Sensus. Free cash flow conversion was 39% in the quarter compared to 6% conversion last year. During the first quarter, we invested $43 million in capital expenditures, and also returned $33 million to our shareholders through dividends. In February, we announced a 16% increase to our dividend payout, our fifth consecutive annual increase.

While working capital increased overall, the improvement as a percentage of revenue primarily reflects the addition of Sensus versus 2016. As a reminder, Sensus positively impacts our working capital performance with their very efficient working capital model. We remain committed to maintaining our investment grade credit rating, which will require that we primarily focus our capital deployment on debt repayment over the next 12 months.

Please turn to Slide 10, and Patrick will cover the update to our 2017 outlook.

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

Thanks, Mark. As I said earlier, we're off a solid start in 2017, and are well positioned to deliver on our financial targets. With the exception of our foreign currency assumptions, our full year 2017 guidance has not changed. On a pro forma basis, we continue to anticipate organic growth of 2% to 4%, which includes organic growth from the base Xylem businesses of 1% to 3%, and Sensus organic growth of 6% to 7%. As we drive our continuous improvement work deeper into the organization, we continue to accelerate our lean and global procurement initiatives, and expect to realize $130 million in savings for the full year, a 10% year-over-year increase. With our Q1 results in this area, we're on pace to meet that target.

Our adjusted operating margin is expected to grow in the range of 20 to 70 basis points, excluding roughly 60 basis points of margin dilution from acquisitions. As I mentioned earlier, we've updated our foreign currency translation assumptions. As a result, we now anticipate generating earnings per share of $2.23 to $2.38, which excludes integration, restructuring and realignment costs of about $30 million. Excluding foreign exchange impact, EPS growth is expected to be in the range of 12% to 20%.

Finally, as we've outlined previously, we expect to deliver free cash flow conversion of at least 110% this year. This contemplates expected capital expenditures in the range of $190 million to $200 million. Please turn to Slide 11 and I'll walk through our end market assumptions.

Please note that our commentary and growth estimates on this slide reflect pro forma organic revenue from 2016 for Xylem and now includes the impact of Sensus. Public utility constitutes 47% of total pro forma 2016 revenue. In 2017, we expect pro forma organic revenue to grow in the low to mid-single digit range. Sensus is expected to generate organic growth of 6% to 7%. We anticipate 2017 organic growth of the base Xylem business to moderate after a very strong 2016, but to continue growing up low single digits. As mentioned previously, we face a challenging comparison in the U.S. market, given the exceptional 17% growth we delivered in 2016. As a result, we believe growth in this region will be in the low to mid-single digit range. We expect large project activity to drive mid- to high single-digit growth in the emerging markets, especially in China and India. And in Europe, we anticipate low single-digit growth.

Our industrial end market represents 37% of pro forma revenue. In 2017, we continue to expect that full year organic revenue will be flat to up low single digits. The soft market conditions in general industrial that occurred in U.S. last year are continuing into 2017, but we do expect modest growth over the second half of the year. We expect emerging market performance to be mixed, with some strength in China and Latin America offset by continued weakness in the Middle East.

Moving to commercial, which represents 11% of pro forma revenue, we expect organic growth in the low single digit range in 2017 with a solid U.S. market and a tough prior year comparison in Europe. Residential revenues reflect 5% of pro forma revenue, and we expect 2017 organic growth in the low to mid-single digit range. In the U.S., we continue to expect a flat to low single-digit growth rate despite a stronger-than-expected first quarter. The European market looks to be modestly stronger, as residential building permits increase. Now please turn to Slide 12, and Mark will walk you through more details on the outlook.

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

Consistent with what we disclosed last quarter, we're providing the seasonal profile of our business as well as highlights of our 2017 planning assumptions. For the second quarter, we expect modest improvement in both the public utility and industrial markets sequentially, with both returning to low single-digit growth. We continue to expect commercial to grow in the low single-digit range for the quarter, and we anticipate moderating growth in residential, up low single digits, reflecting the impact of the first quarter promotions. All-in, we anticipate this will result in organic revenue growth in the range of 1% to 2% for the base Xylem business. We also expect foreign exchange translation to unfavorably impact revenue by $20 million.

Acquisitions are expected to add approximately $230 million to $240 million with Sensus growing organically at 1% to 2% in the second quarter. Sensus has a tough comparison to the prior year, primarily due to the timing of distributor stocking of iPERL meters in North America last year as well as higher prior year revenues from rollouts for 2 large U.K. contracts.

One other note regarding Sensus. One of its primary battery suppliers had a significant incident at its manufacturing facility which has shut down production. We are making arrangements with other existing and alternate suppliers to minimize any potential disruptions in serving our customers. Given our current inventory of batteries, which substantially covers our needs through the second quarter and the initial commitments received from additional suppliers, we currently do not anticipate any material disruption in our ability to fulfill customer orders. Our teams are on top of this issue, and we're tracking the progress very closely. As for our second quarter segment operating margin, we expect margins to be up 50 to 70 basis points, excluding the 70-basis point reduction due to the noncash amortization of Sensus purchase accounting.

Finally, please note that the summary of our FX assumptions on this slide, which includes our updated euro guidance assumption at 1.07 from 1.04, which puts is in line with the year-to-date average actual rate of 1.07. Aside from our currency assumptions, all other assumptions remain unchanged from our previous guidance. And with that, I'll turn the call back over to Patrick for some closing comments.

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

Thanks, Mark. So a good start to the year, and we're encouraged by the growing momentum we see in our businesses. The market fundamentals are solid, and our teams are executing well. We remain focused on our long-term strategy while continuing to deliver on our full year commitments. So with that now, operator, let's open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Deane Dray of RBC Capital Markets.

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

I would like to address first some of the issues going on in municipal, both U.S. and Europe. And maybe we can start with, did you see any of the project delays, or some hesitation on project releases, in both U.S. and Europe? And then, on the second quarter outlook, you are facing another tough comp, especially in the U.S. And is the expectation that you would post another negative organic in U.S. muni for the second quarter.

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

Yes. Thanks, Deane. So this is Patrick. Let me take the second question first. So our outlook for Q2 is to be flat to up low single digits, and that's a global number. And so that does reflect some flatness to up low-single digits in the U.S. as well as in Europe, so we don't see it presenting the same kind of comp that it did for as in Q1. In terms of what we're seeing in both the U.S. and Europe, let me start first with Europe. Really, the only timing issue that we saw there was really in the U.K. in the AMP cycle, and there was nothing for us to be alarmed about. It really was just timing of shipments that hit us there in the first quarter, and so we're still expecting that to be mid-single digits for the full year as we'd originally guided to. In the U.S., again, nothing noticeable that we've seen in terms of any delay in projects being awarded, or in the day-to-day activity. It really is simply the fact that we had such a tough comp versus last year, both due to, again, heavy spending activity, timing of projects, but also you'll recall, we had unusually warm weather last year that drove some higher shipments and install in the quarter.

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

And then my follow-up on -- given all the items going on at Xylem today, the Sensus acquisition closing, the analyst meeting, raising your long-term targets. We got the most questions and the most excitement around this announcement with Pure Technologies, so maybe you'll just spend a moment there. How did this partnership come together, specifically about the go-to market, how will you coordinate your technologies? Is there any interoperability within your technologies? And any plans to expand beyond these initial emerging markets?

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

Sure. Well, thanks, Deane. We're certainly very excited about the opportunity to partner with Jack Elliott and the team there at Pure. We've known them for a long time. Obviously, we see them in the marketplace. We've been impressed by what their capabilities are. So we've been talking about this for a little while. They've got some capability gaps in very specific emerging markets, most notably Middle East, India, Singapore and Malaysia, which is really where we're starting, because we've got a strong set of channels to market there. I think this really makes sense now in terms of complementary technologies now that we've got both Sensus and Visenti in the portfolio, and we've put those businesses together. So we're going to be exploring to see what other opportunities there are in terms of the complementary nature of those products in those markets. Again, right now, it's really exploratory, it's really focusing on a few key markets here, and helping customers again with those very specific pain points that we laid out.

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

How about from the technology standpoint?

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

Remains to be seen. I mean I think there clearly is some interoperability there that we'll explore over time, but still very much in the early stages here.

Operator

Your next question comes from Scott Davis of Barclays.

Scott Reed Davis - *Barclays PLC, Research Division - MD and Head of Global Industrials Equity Research*

I feel like I need to ask about this battery problem because you mentioned at the end, but sometimes when we've seen supply chain challenges, they tend to linger and cause problems that are beyond sometimes what people anticipate. And so you commented that you've got inventory and such for 2Q, and you don't see any customer disruptions. How about the cost side of it, though? Are there concerns that your costs of procurement are going to go up meaningfully, back half of the year? And how long do you think this battery problem -- or how long does your supplier think this is going to linger?

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

Sure. That's a great question, Scott. So a couple of pieces there. One would be in terms of -- so we have a qualified backup supplier already, and we were in the late stages of qualifying a third source already. And so obviously, the teams are very much focused on accelerating that third qualification. And we think the combination of getting them both up and running as well as the inventory that both we and our current supplier have on hand, that certainly will help us bridge any of the supply chain gaps that we've got there. To your point around the cost side, very, very minimal impact from a cost standpoint. There will probably be a little bit of maybe freight expedition in some areas. And the suppliers that we've got there have been very good with us in terms of remaining true to previous negotiations, et cetera. Obviously, don't want to get into many more specifics other than that, just given the competitive dynamic in negotiations.

Scott Reed Davis - *Barclays PLC, Research Division - MD and Head of Global Industrials Equity Research*

Yes, fair enough. So just as a follow-up. There's 10,000 water utilities out there, and we can talk to very many of them, quite frankly, so it's tough for us to get a view. But how many of your -- do you get a sense from your customers at all that they're thinking about projects in terms of waiting until there's a federal infrastructure bill that -- waiting to see if money is available, and potentially you're kind of delaying things until you get into 2018?

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

I -- we don't see a common thread there, Scott, of people necessarily slowing down. I mean if anything, we've seen quoting activity up double digits again, and our bidding pipeline up very strong. But obviously, your question is more around when those things come to market. I think, certainly, maybe in some of the smaller utilities where they're reliant on state funding and maybe to a lesser extent, the possibility of federal funding, it's less about the money that may come to water projects, and it's more about the money that may come to other infrastructure investments that takes a little bit of pressure off their budget, and therefore, easier for them to go ahead and move forward with the water spend. But we're not -- we're really not seeing a lot of that. That's really not what's impacting us here, going through Q1 and into Q2. It really is simply the very tough year-over-year comp with the last year.

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

Yes. In fact our pipeline for treatment orders is -- it's up 16%.

Operator

Your next question comes from Nathan Jones of Stifel.

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

If we could go to the margins in Water Infrastructure. You were down, I think, 160 basis points there, which is a mid-50s decremental. But you did call out some additional strategic investments there. Can you kind of quantify what the levels of the strategic investments were and how long we should expect those to continue?

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

Yes, Nate. It's Mark. The -- in terms of the investment, specifically, it was around $5 million, and a lot of that was focused on continuing to add commercial capabilities, particularly in our emerging markets. Some product localization as well. So that was the bulk of it. There was also a little bit of investment in Europe as well, but that's a -- and that was roughly 100 basis points. But the big impact on the margin profile was really a function of volume and in mix. And we had a very rich mix of projects last year, particularly in our dewatering business, our highest margin -- one of our highest margin businesses, and also had a lot of aftermarket business as well with the warm weather. So it was more of a volume and mix story there.

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

Yes. I think the -- anytime, Nate, as you can appreciate, anytime, especially Q1 being one of our slowest quarters of the year, and given the fixed cost that we've got, especially in the Water Infrastructure side, any kind of volume softness there magnifies at least within the quarter. But we're very confident about getting to our margin expansion goals for the full year. As Mark mentioned in his prepared comments, we had some self-inflicted issues from a supplier in our Emmaboda factory. And so that revenue is very, very rich in terms of margin. And we'll get that back here, partially in Q2 and certainly in Q3.

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

And how long should we expect the investments to continue?

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

I'd say modest here, through the rest of this year there's really -- I mean the only investments we'll be making for the most part would be we'll continue to invest in some emerging market sales expansion, a bit more on the product localization given that we do see a full-on recovery in some of the emerging markets. And then we've got a little bit that we'll be investing in the integration of Sensus in terms of going after some of the revenue synergies that we talked about. So there will be a little bit of an uptick in R&D, but all of that's been reflected in our guide for the year. There's no change in outlook.

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

Okay. And then my follow-up, you talked about treatment orders being the leading indicator. And we've seen the treatment pipeline be pretty strong for probably 1.5 years now. Can you talk a little bit about if you're seeing some of that -- the transport and test stuff that's supposed to come behind that, strengthening in the pipeline as a result of those treatment orders leading that kind of revenue?

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

Yes. I mean we would normally see about probably an 18 month, kind of 12 to 18 month kind of lag between orders actually being received on a treatment as opposed -- our comments here are as much about bidding pipeline being up. Obviously, we did see good treatment orders in the quarter, 8% growth. So we do think that bodes well for the test and the transport piece of the business year. But I think we're seeing some of that now in terms of our orders lift here in this last quarter, but that would really I think buoy us even more strongly for the latter part of this year into 2018.

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

Okay. So that's kind of the time from that we should think about those orders ramping up would be mid- to late this year?

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

That's correct. And I'd say late this year, into early '18.

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

Yes. You might recall, Nate, we had a bit of a hole in our orders in the first half of last year, first and second quarter we were down organically 2% and 4%, respectively. But that momentum has been building up in Q3 and Q4 of last year, Q1 and -- but some of that is treatment, which does, as Patrick said, have a little bit longer incubation period in terms of actually manifesting itself in revenues.

Operator

Your next question comes from Jim Giannakouros of Oppenheimer.

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

A question on Sensus. Revenue increased 9%, I think in -- you said in the U.S, those large electric projects. I'm sorry, they weren't on my radar, and I apologize if you had telegraphed it before. But does that mix -- I guess, well, first that aspect, does that set up for tough comps? Or is there acceleration elsewhere in Sensus that 6% and 7% growth in '18 isn't a stretch? And I guess any and all comments on mix, both organic growth contribution by component within Sensus, and any impacts to margins we should be aware of?

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

Sure. We'll take -- into pieces here. So on the -- in terms of does it set up for tough comp, let me start first with even the rest of this year. And you'll recall that we've got a rather easy comp in Q4 because we had lower growth last year because of some delays in Saudi on their shipments due to lesser credit, et cetera, so that sets up for an easier comp in Q4. That gives us confidence of getting to that 6% to 7% growth. Now we remain confident about the growth outlook for -- over the planning period of that 6% to 7%. We've got some large project deployments that are front-end loaded as we head into 2018, and so that will help us with this comp in Q1 next year, but also through the entirety of '18. In terms of margin mix, I'll share a few comments here, and Mark can certainly chime in. Not unusually large mix issue organically within Sensus in terms of margins between say, the water deployment versus electrical or gas. You get a little bit higher margin on the water side than electric, but given the fact that we had a large deployment here, that also tends to be favorable from a margin standpoint. So it kind of blends out to where -- there was no noticeable shift, from my perspective.

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

Yes. You look at their margins quarter-over-quarter, they don't move that much. They're fairly consistent because you might have a richer mix in terms of some of the rollouts of large projects, but you can also have some mix coming from software as a service too, depending on the timing of that. So but they are, while the volume can be a little bit lumpy, the margins are fairly -- the gross margins are fairly consistent.

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

Got it. And I guess sticking on Sensus, or I guess the revenue, projected revenue synergies with the Water Infrastructure. How should we be thinking about, and I apologize if I should know this -- how should we be thinking about bucketing the growth between Sensus and Water Infrastructure? Is it pretty balanced over the next few years, or is there greater potential in one or the other?

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

I'd say it remains to be seen. We haven't given that level of specificity yet. We're obviously still working through some of the prototypes. It will be a combination of the 2. There will be -- the way to think about that is where we are getting synergies by connecting our equipment in the field on the wastewater side, those revenues would flow through the Water Infrastructure. Where we are winning any of these large international deals by way of Xylem helping pull them through that, obviously, will impact Sensus and analytics as we go forward. So that's the way to think about it. We haven't yet split the dollar amounts that we teed up at Investor Day amongst those buckets. But we'll have certainly more to share on that as we get later into the year and we get some of these prototype deployments out in the field.

Operator

Your next question comes from Chip Moore of Canaccord.

Chip Moore - *Canaccord Genuity Limited, Research Division - Senior Associate*

Obviously, not a big part of the portfolio, oil and gas markets, maybe we could talk a little bit more. Nice to see dewatering turning positive. What sort of trends are you seeing in Q2, and has your outlook changed at all?

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

Yes. And on dewatering, while, as I'd mentioned, it was nice to see growth for the first time since the fourth quarter of 2014, it was pretty modest, okay? The trend line has definitely changed, but it's really we're seeing that -- some of that growth in pockets, in some areas of fracking. Certainly, Permian Basin continues to be a pretty hot area. So while the inflection point is good, we don't see any significant take-off in that part of our business, although the comps get a heck of a lot easier over the next several quarters.

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

Yes. I mean just to parse it a little bit more as well. You recall, probably, I think it was last quarter's call or even at Investor Day, we talked about the biggest challenge that we faced in the dewatering sector from an oil and gas and mining standpoint was more on our indirect channel side with our distributors. We've seen flat to a little bit of growth in our direct channel for the last quarter or so, but it was being more than offset by double-digit declines continuing in the indirect channel. And the good news was the indirect channel flatlined for the first time in Q1. So that's really what helped us get to a net positive growth on that piece of the dewatering business.

Operator

Your next question comes from Joe Giordano of Cowen.

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

Unfortunately, I had to jump on a little bit late, so apologies if I kind of go over of something that was already discussed. But I wanted to talk about the industrial outlook here, flat to up low single digits. I know you have some oil and gas and mining and stuff in there that's not your general industrial. But can you kind of scale that versus what we've seen earnings season so far? Seems to be an acceleration there. That flat to low seems pretty modest versus what we've heard so far the last couple of weeks. So kind of, what are your thoughts there? Does that feel more conservative to you than the rest -- than the other outlooks for the rest of the end market?

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

It's a -- Joe, this is Patrick. It's hard to call at this point. I mean that business is rather short-cycle for us. It's largely a replacement business to our Applied Water segment. And so because it is general light industrial being the lion's share of that, at the end of the day, we've always said that it is very much kind of a GDP at best kind of business, typically grows around that kind of 2% to 3%. We've baked in the flat to low single digit simply because of what we saw in Q1. And therefore, what would one have to believe for the next 3 quarters to get to a solid low single-digit. So there are some early positive indicators that we're seeing, but it is still early. And this is again, a light industrial business. So it's not going to be nearly as volatile in ramped as you see in some of our peer companies.

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

And maybe just a high-level question, and maybe this is too high-level for this call. But when I think about your portfolio now moving to your Sensus, stuff with Pure, like how do you see Xylem becoming positioned over the next -- I don't know, call it your -- over your time as CEO there? It's kind of like a more of a smart city provider, and kind of fitting that niche more than a traditional equipment provider. How do you see the business evolving into that sort of discussion?

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

Yes. So I think -- that's a great question, Joe. I think that the way I would describe it is we believe strongly that there is clearly a number of large unmet needs, from helping our customers both in water but also across other elements of the utility space, provide smart solutions to them. And we think we're building a very nice suite of offerings here and capabilities, including the data analytics side. There are still gaps in those offerings that we will either get through acquisition or through commercial partnerships like we announced with Pure. There are more to come on those types of partnerships that are out there. I would want to make sure, though, that no one ever be confused around the fact that, I think, it's critically important that even though we are looking to build that kind of smart solution, we are not going to move away from our OEM heritage as a business. Because it's my experience that you really need to have the subject matter expertise around the equipment itself as well, so you can really bring a holistic solution to the customer as opposed only becoming a Software as a Service or data analytics kind of provider. So we'll continue to invest in making our equipment smart, and much as other industrial companies are doing, so it'll be a mix of those 2. And lastly I would say it's not limited to the smart infrastructure around systems intelligence. There are -- we've talked before about advanced industrial treatment. We've talked about industrial services being a bigger part of our offering. So there's more to it than just the smart infrastructure element, but that is certainly what mine and our primary focus is right now in terms of where we invest our money, both organically and inorganically.

Operator

Your next question comes from Brian Lee of Goldman Sachs.

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

Digging into the public utility trends, I know you guys have talked a little bit ad nauseam on this. But given the year-over-year decline is due to mostly tougher comps, particularly in the U.S., just wondering if you can maybe comment a bit on how much of the bookings pickup you're seeing is in the U.S. versus elsewhere? And then what trends you can talk to geographically on bookings, specifically?

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

I would say a lot of the booking momentum has been in emerging markets, but we are also seeing solid order growth in the U.S. as well, low single digits but good momentum. But the -- I'd say the biggest source of order growth has been in emerging markets but a nice upward tick in the U.S. as well.

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

Okay, great. That's helpful. And then I'll just do a quick housekeeping one if I can. The Sweden manufacturing issue you mentioned, could you quantify if there was any impact in the quarter? And then I think you had mentioned there may be a little bit of residual impact into Q2. Maybe what exactly that impact was, and then what the remediation steps are from here?

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

Yes. Brian, it was roughly $3 million in the first quarter on the revenue side, and we would -- we're managing it as best we can, but it's probably -- we think it's going to continue into the second quarter. We'll get it nailed down, but probably a similar impact in Q2 as well from a revenue perspective.

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

And the good news is here we're not losing business, so the business comes back. It's simply a matter of the timing of the shipment deliveries.

Operator

Your next question comes from John Walsh of Vertical Research.

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

So a question around the margin. Clearly, you've been able to more than offset cost inflation pressures with cost reductions. But given what we're seeing in raws, can you talk about your ability to kind of capture price in this environment?

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

Sure, yes. This is Patrick, so I'll start here and then Mark can chime in. So we're very much focused on marrying up the views on cost inflation with pricing in the market. And so our supply chain teams and our commercial teams are joined at the hip, kind of country by country, understanding kind of what the dynamics are. Obviously, in those businesses where we have a shared leadership position, we're being very disciplined in terms of being the price lead, and preserving that. That's much more the case in elements of Water Infrastructure, where we are seeing a more favorable supply-demand dynamic, coupled with inflation, so a little bit easier -- never easy to get price pass-through but a little easier there. A little tougher in Applied Water, just given some of the competitive dynamics there, and a little bit more softness in the end markets of industrial but also the resi business. And so you saw where we did some promotions there to drive share gain in that part of the business, albeit small. So it's a mixed bag, but it's something we're very much on top of, and I would say, again, mixed results up to this point.

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

Yes. We're making sure the teams get out ahead of it. We saw a modest bump on the raws in -- when you look at it in Q1 compared to last year, 10 to 20 basis points in our 2 operating segments: Water Infrastructure and AWS. But the first step is awareness, and we're making sure that the commercial teams are getting good information from global sourcing, so they understand in terms of specific product lines what that impact, in terms of the creep in raws is, so they can be more effective in the marketplace.

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

And I would just maybe wrap that up with the fact that when I look back over the last 3 years, certainly since I've been here, and I talk to the leaders in the business that have been around, I would say historically, they've been very effective and very disciplined at understanding the inflationary dynamics and driving price discipline where they need to. And what's simply gotten better, I think, is both our focus on cost-out productivity but also having enhanced and developed our procurement capabilities. Through Tony Milando and that team, we've got a lot more awareness now, earlier on, I think, than we would had historically.

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

Got you, got you. And then just a quick one on Sensus. Obviously, directionally, you helped us with the comps on the back half, but wanted to know if you kind of can provide the explicit organic growth comps for Sensus in Q3, Q4? And then in terms of the margin, should we build off of the 10.7% in Q1? Or you called that there was the benefit of that large project. Does this maybe from an operating margin perspective take a sequential step-down? And then build the back half of the year for Sensus?

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

Yes, let me take that one. I think -- so what we've provided to date is -- we've provided the full year margin profile for Sensus. We don't see that changing. We still expect EBITDA margin to be in that 19.5% range and adjusted operating margin for the full year to be in the low 10s. So as I said, while there's modest movement from quarter-to-quarter, it's not all that significant and we did have, although I would say given some of the mix that we had in the first quarter, it's probably a little bit higher-margin mix than what we'll see throughout the remainder of the year.

Operator

Your next question comes from Robert Barry of Susquehanna.

Robert Barry - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Just a couple of things, we've covered a lot of ground. I think last quarter you talked about core growth on the legacy business of flat to up low single. Is that refined slightly better to 1% to 2% now? Or is it (inaudible) no change...

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

Which periods, Robert?

Robert Barry - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

In 2Q.

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

Full year?

Robert Barry - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

I think it was a flat to low. No, 2Q.

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

Yes. That's right.

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

Yes.

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

For 2Q, Robert. Yes, it's up about 1 point from where we had guided before. And that's really just baking in the momentum that we saw coming out of Q1. And the -- when we talked about what our shippable backlog within the quarter looks like, would support that number as well.

Robert Barry - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Got you. Any change to the back half? I think it was 3% to 4% in 3Q, and a little better than 4Q?

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

Yes. I'd say, it's in line with what we'd said before. Obviously, we'll take a look at that again as we get through Q2, and see kind of what the momentum is. But right now, we've held the back half as where we've had it before.

Robert Barry - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Okay. Just conservatism or anything you're seeing in the backlog?

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

No. I think it's just still early, and it's again, we're still a relatively short cycle business, other than the visibility we have on treatment. So we're just trying to be prudent here.

Robert Barry - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Fair enough. And if we could just chat quickly about this promotional activity in resi, up 14%, added almost 1 point of growth to the quarter. Just -- are you getting more aggressive there? Don't usually see that kind of growth in resi, looking back.

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

Yes. I mean, it's timing, some of it's terms, it's not all price. So we're trying to be aggressive commercially without giving away the store on price at all.

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

Yes. So I'd say, Robert, to me the -- there's been a lot going on in that part of the market as you know, as you follow other companies. And so I think just keeping our teams focused on let's win share, let's leverage things beyond price to do so. There's always some timing issue. It's a relatively small piece of our business. So even a little bit of absolute dollar impact there can swing it pretty significantly either direction, so I wouldn't get too focused in on the 14% number in 1 quarter. I think what we're encouraged by was the fact it was a good growth, and we saw good backlog build in that business. And so hopefully, it helps us normalize for the year. We've had a couple of rocky -- a couple of lumpy years the last couple of years, due to the weather and other things. And so we hope we're smoothing things out now.

Robert Barry - *Susquehanna Financial Group, LLLP, Research Division - Senior Analyst*

Yes, fair enough. Yes, I was more focusing on the promotional activity and just whether there was any change in kind of the pricing...

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

No, no. It's not a margin or pricing thing, it was really more on the payment terms.

Operator

Your final question comes from Jose Garza of Gabelli.

Jose Ricardo Garza - *G. Research, LLC - Research Analyst*

I guess going back to that, one of your competitors purchased some distribution recently in the U.S. on the groundwater side. Just wondering if you could give us your thoughts on any kind of impacts that you foresee? And how you're kind of thinking about that business in the longer-term, Patrick?

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

Sure. So we were aware of this move coming for quite some time and so we had been already building in backup plans in terms of what the future would be for us. Just to put it into perspective, the impact on us on this one bit of disruption it's less than 1% of our total Applied Water segment revenue, so even less than that for the total company. We've already got backup plans in place. We are -- we're working with Franklin on this, we have some other alternatives that we're working through as well, and so we don't expect any disruption at all on that part of our business. In terms of other questions that we've gotten in the past have really been around, what's our strategy between direct and indirect and does this move kind of change that? And I think it's important that I state here that we are absolutely committed to support our channel partner relationships. They have -- they're valuable. They've got long-term relationship with us. They've got a lot of reach in the marketplace, and so we place a value on that at least certainly within that part of the business. And we think making sure that we've got a broad and diverse network, both direct and indirect is our best way to serve the market both from a access standpoint but also from a cost-to-serve standpoint.

Operator

This concludes our question-and-answer session of today's conference. I will now turn the floor back over to Mr. Patrick Decker for any additional or closing remarks.

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

Great. Well, thank you. Thanks, everybody, for your continued interest and joining the call. A lot of good questions. Look forward to seeing you guys on the road and in the meantime, we'll catch up with you on our next earnings call. Thank you all very much.

Operator

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