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XYL - Xylem Inc at Electrical Products Group Conference

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PRESENTATION

Unidentified Analyst

Okay, so we'll start right away with some comments and then mostly Q&A for Patrick Decker, President and CEO of Xylem. And thanks to Patrick and the team for being able to move around their presentation time at very short notice late last week.

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

So good afternoon, everybody. So first, again, thanks for your interest and staying on for what I'm sure has been a long day and the first of a few here.

So I'm going to be a little bit unorthodox here. I'm not actually going to go through any slides. And so you've got the deck in front of you. I am going to make a few comments here, maybe a couple of minutes, and then I really want to go straight to Q&A. Obviously, you guys are having a long day, and I want to keep it brief. But we're also coming off of a recent Investor Day that I think many of you attended and others were listening in as well as a recent earnings call. And I really want to focus on what's on your mind rather than sharing with you what's on my mind.

So for those of you that are somewhat new to the story, we are the largest pure-play water company that's publicly traded. We believe we've got a pretty powerful investment thesis. First of all, we focus on growth. We serve attractive and growing end markets around the world. We've got strong market leadership positions in fortress brands in each one of those areas.

We've made a number of successful investments since I was here a year ago, really helping us move up the technology curve and really addressing some of our customers' pain points around energy efficiency, labor cost reduction, nonrevenue water, things that are really big deals for them but doing it through investments and smart infrastructure.

We are in still the early stages of what we see as significant margin expansion. We believe we've got another 400 to 500 basis points of operating margin expansion between now and 2020. That's really being driven by deployment of Lean Six Sigma, simplification and organic growth. And we've also accelerated our capital deployment, obviously doing a large acquisition late last year that I'll speak about here in a moment.

What I'm also proud of is our strategies that we put in place when I joined a couple, 3 years ago remain unchanged, and right now we are really just focused on execution. The first is driving what we call commercial excellence and really making sure that we go after share gains in attractive markets.

The second is, as many of you know, we've made meaningful investments and focus in growth in emerging markets that have been paying off very nicely for us. We're doubling our investment in innovation technology in a few key focus areas to drive customer enablement.

Again, we're driving continuous improvement really with a primary focus on deployment of Lean Six Sigma, not just within 4 walls of the factory but also in terms of the entire supply chain and how we improve the customer experience.



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And then the fifth area is building a deep bench of talent. We believe we've got the best talent in the industry, but it doesn't go deep enough. And so we've had significant investments in time and money and really building out that broader base of talent.

At our recent Investor Day in Raleigh-Durham back in early April, those of you that followed us know that we increased our long-term targets both in terms of top line growth, margin expansion, working capital improvement and also affirmed that we are able to re-up our arsenal for capital deployment over the next few years vis-à-vis the acquisition that we made of Sensus, which, to that point, we acquired a company for about \$1.7 billion about 6 months ago, Sensus as well as Visenti. And the integration of those 2 acquisitions are going very much according to plan. We're on track, if not ahead of track, in terms of both cost synergies and feeling very good about the revenue synergies that we laid out at Investor Day.

To that point, I want to make sure that, on the record, I do reaffirm our -- both our Q2 as well as our full year guidance. So there'll be no question about that. And then lastly, as I said before, really focusing in on execution as a company. We're in the early innings of what I consider to be a long-term journey here that I think is very attractive for investors.

And so with that, I now want to open it up to Q&A.

QUESTIONS AND ANSWERS

Unidentified Analyst

Thank you, and thank you for being brief and clear. And if everybody did this, it would be a -- the best speed-dating conference in history of mankind, but...

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

I want to make sure you see the stage, [Scott]. So...

Unidentified Analyst

That's good, I like that. Anyways, the -- one of the things that's maybe not clear for me, I don't live in water like Deane Dray does, [the sardine], but I have another life also. But how do you integrate, like Sensus, Visenti, traditional Xylem sales force? And how do you really change that go-to-market strategy so that you don't maybe alienate those channels but still try to get some synergies out of those deals and drive growth?

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

Sure. It's a good question, [Scott.] I think the -- in these matters, I tend to be very pragmatic. And so given the price that we pay, which was a very good price, given the synergy that we have in front of us but also how attractive the base business of Sensus is, we've been very clear in the integration to make sure that we do not distract our sales teams and sales channels on the Sensus side or vis-à-vis the legacy Xylem side by trying to go after things that look good on paper, but in reality, the customer doesn't value them. So keeping the team's focus is clear. We do see opportunities in, certainly, Europe and the emerging markets to combine our sales team there because Sensus does not have critical mass in those areas. And so we can really leverage our distribution in channels to market there to cross-sell meters and other solutions. That's also where a number of the larger revenue synergies are going to come in terms of some large international deals that we're going after with customers that Xylem already has, a very strong relationship with either the C-suite or deeper in the organization to pull through the Sensus offering. But in North America, which is where the bulk of the current Sensus business is, we are not integrating the sales teams and channels there. What we are doing is we're focusing in on a very select group of customers. It's a large number, but putting in place the right incentives to make sure that our teams work together and figure out where those opportunities are to create revenue synergy there. I could speak to a number of those opportunities, but we're doing it through different intervention then forcing organizations together on the sell side.

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Unidentified Analyst

Yes? Yes?

Clifford F. Ransom - Ransom Research, Inc. - Founder and President

Cliff Ransom. Look, I'm a big fan of your company, and it's true that Deane Dray and I are going to have a wrestling match out by the pool because we both concentrate on water. For 35 years, I thought this was a wonderful area to invest in. And I said the Holy Grail is that person who puts together components and sales systems and solutions. But the fact of the matter is that through ITT, first CEO at Xylem, the interim CEO and now you're rectifying it, I could argue over the long period of time that Xylem flunked in that mission. GE flunked in that mission. Zenon's flunked in that mission, and it sure looks like Pentair flunked in that mission. Why will you be different?

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

It's a fair question. I mean, I think the reality is -- I think I've said this before, when people -- people throw around the word integrated solutions and selling solutions very loosely. I try to keep it very, very simple, Cliff, and that is, to me, a solution sell is simply understanding what problem is the customer trying to solve. It could be selling them a product. It could be selling them product plus data. It could be a suite of service and solutions around that. But I think when companies bet the ranch on going after one model with customers because it sounds sexy to do so, they're putting it at risk. And that's why we looked at the opportunity to acquire Sensus and getting far more than meters but really bringing in the telecommunications capability and the data analytics capability. We're being very focused right now on which customers are we going after and using them as reference accounts to understand how does getting access to Big Data and more technology solve their pain points. I always say people throw in IoT, Big Data very loosely. At the end of the day, it's quite simple, and that is if there are real pain points that a customer has, we're bringing data to them and a solution that's going to help them solve a problem, they're going pay you value for it. But don't go out and try to shop that to everyone that's out there or you're going to end up losing your focus and spending a lot of unnecessary resources. So I'm, by no means, declaring the journey behind us or successful. But from my experience and the conversations we're having with customers right now, they are very excited and very compelled by what they see as this combination that we can bring them now.

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

Okay. Yes, Patrick, I'm thinking that the next chapter for Xylem really starts with this acquisition of Sensus and the ability to harness the FlexNet technology and put that into the various products that you have today and make them smart. That's kind of a dummed-down version of it. But can you give us a realtime update as to what you've heard from voice of the customer and where you will deploy that technology first and how that will translate into revenues over whatever term, medium term, that you're envisioning now? But this will really be the first onslaught of smart water networks being introduced commercially.

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

Yes, it's terrific question, Deane. I think the -- so as we did some basic value mapping, a term that I probably overused a couple years ago, which was based on a lot of voice of customer work, was to understand depending, upon where you are in the water sector, whether it be helping water utilities deal with issues around surface water; which is lakes, rivers, dam, streams; which is typically a compliance with regulations around water quality or weather events that occur, whether you're talking about the clean water networks, so water that's already been treated. And the single-biggest issue that utilities face there, as you well know, is nonrevenue water. So up to 30% of potential revenue is lost by water utilities around the world because it's either hijacked, it leaks, or it's not appropriately measured or metered. It's the single biggest economic pain point that customers have in the utility space or whether it be on the wastewater network, where the biggest challenge that utilities face there is typically huge energy cost. So the movement of water to the wastewater network is the single-largest contributor to energy cost that utility has, whether it would be minimizing their labor cost by unnecessary truck rolls to go out and actually repair a broken water main or wastewater pumping station or whether it be, again, getting better data to understand in advance what is going to be the most efficient and effective form of treatment when



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the water finally arrives to the treatment facility to be recycling. All those pain points are very real for customers and, clearly, getting access to data off the network is going to be very impactful and very powerful in that regard. And so it really depends on which one of those pain points one is trying to address. What we're talking about here is the benefits of the FlexNet platform. It's not the only form of telecommunications. I mean, there's open cellular. There's mesh technology. We sync up with those also. We believe FlexNet is a very powerful platform because it's got lower life-cycle cost because the customer actually owns the network. They own the spectrum. Two, it's reliable. It's got built-in redundancy. And think about reliability during extreme weather events, which is typically when there is damage to water infrastructure, and utilities need the system to be up and running. Those, in our experience, are very powerful selling tools, and we're still in the early innings of that kind of market penetration.

Unidentified Analyst

There.

Unidentified Analyst

Patrick, so 2 from me. One, I think the strategy to be more tech-centric has been well articulated and well taken by the market. But as a leader in water broadly, is there almost pressure to not look at some things that are more boring that might be logical assets for you to own just because of your positioning with customers? So are you kind of precluded from looking at that for fear that it might be taken as a departure from strategy or anything like that?

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

It's a fair question, [Joe.] I wouldn't -- I don't worry too much about that. I mean, at the end of the day, I think we've got a well-articulated strategy. We understand where we want to play and how we're going to win. And if there are moves that make sense for us to consolidate our position to be even stronger, I would not certainly walk away from that because of only focusing in on so-called smart water infrastructure. There are elements of industrial treatment that we've talked about moving into industrial services that are out there. I don't consider those boring. Some might along the way, but again, they're critical pain points for customers that they're willing to pay money for. And so I'm not going to be, again -- Deane's favorite word -- I'm not going to be dogmatic on only going after one angle here in the water space, and so we'll keep our minds open.

Unidentified Analyst

And just to one point on the guide, the longer-term kind of commitments. So 4% to 6% as an organic rate simply is not a level that Xylem has been at historically. I know Sensus brings a new part, a new leg to that story. Is there an area of -- maybe areas of where you're less dominant, maybe some areas on applied that maybe either make sense to have a different owner or move to make a splash and consolidate some of that to fortify the rest of the business there?

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

We -- so we like the businesses in the portfolio. We take a look at them on a regular basis to see whether they're meeting the hurdles in terms of return on capital as well as growth, and there's nothing material there right now that we would say -- that we believe needs to be in different hands. At the same time, I don't see they're necessarily being a major consolidation plan with their opportunities that are out there, whether that's the best move in terms of capital deployment remains to be seen. And so we feel pretty good about where we are and the path that we're on.

Unidentified Analyst

Patrick, yes, so when you talked about moving up the technology curve, how do you see getting paid for that? Do you see that as more of a volume benefit? Or to what extent do you see it as a volume versus kind of mix pricing margin?



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

Yes. I think it's an insightful question because there really are 2 outcomes based upon the value mapping work that we did. I think that, first of all, we're moving into a space in the water sector where you're going to have to have embedded technology and sensing capability in your equipment, whatever form of rotary equipment that may be along the network. And so I wouldn't say that's the differentiator, although we do feel that we're ahead of the curve on that in terms of our Concertor launch last year, which was the world's first smart submersible wastewater pump. And it's been extremely well received. And so we do see volume gains through that, but where we see the biggest value is going to be, again, some of the Software-as-a-Service play opportunities that are out there where -- because we have the largest installed base in -- especially the wastewater network. Customers are typically going to only want to deal with data providers that are also providing them the actual equipment because you have the subject-matter expertise around those products. So now that they have the data, what do they do with it? What problem are they trying to solve? And so I do believe, over time, it's going to be a combination of volume on the OEM that they want to add this extra value, but it's also going to be the Software-as-a-Service play.

Unidentified Analyst

Yes. And just a second, could you just update us latest thinking on what you're seeing in Europe? Had a couple of elections there. I know France, in particular, is an important market for you guys. Latest thoughts there.

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

Yes. So we had a little bit of a speed bump in the fourth quarter, and it continued into Q1 in Southern Europe, and that was predominantly driven by the uncertainty over the French elections and some overhang of Spain and Italy. Those conditions seem to have stabilized, and are proving a bit for us right now. Obviously, I think, as most disagree, setting politics aside, the French election was obviously a well-received outcome, and I think it's going to be favorable for the business climate there. The soft spot that we saw in Q1 in the U.K., which, for those of you that don't follow us that closely, the U.K. has a 5-year, it's called an AMP cycle. It's a government-funded program in water infrastructure, and this is the year of the sweet spot. We saw some softness there in the first quarter. We see that recovering over the back half of the year just based upon timing of spend on some of the water utility there. So that also brought our European number down in Q1. So we see right now, we're calling low single digits for Europe for the year.

Unidentified Analyst

Patrick, Sensus revenue, quick one -- I have 2. Synergies with Sensus. How should we be thinking about the relative opportunity within Water Infrastructure or Sensus? How would you cut that \$150 million, \$160 million opportunity that you see?

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

Yes, I think the -- so there are 3 buckets of revenue synergies that you may recall, Jim, from Investor Day. And we didn't put numbers on the split between the 3. We put numbers in the aggregate. But I'll give a directional feel for where each one of them would show up. The first was just basic cross-selling, where we can leverage legacy Xylem's channels to market, mainly in Europe and the emerging markets to basically sell meters. That would show clearly within Sensus. That's the smallest of the 3 synergy buckets that we have identified. The second one, which is the biggest near term because there's no required technology build to accomplish this, is helping Sensus pull through revenue on a handful of these large international deals that we're pursuing. That would clearly almost all go to the Sensus books in terms of revenue, and these are large multiyear contracts that we don't expect any of those to materialize until perhaps later this year or end of next year. But those would all accrue to Sensus. The third bucket, which would benefit Water Infrastructure for the most part, is when we talk about -- to Deane's question earlier, we talk about how do we put sensors on embedded equipment along the wastewater network and be able to draw data off the FlexNet communication platform to give data to those utilities. That would be revenue that would benefit Water Infrastructure. And that's the single-biggest area of revenue synergy over time, but that probably won't begin to hit until -- certainly no earlier than late this year and 2018.



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Unidentified Analyst

Okay. And a quick follow-up. Outside of those revenue synergies that I would think is a nice contributor to your share gain or what you envision in share gains, I think, is 1 point or 2 that you outlined at Investor Day. As the project funnel firms and as we move forward this year into next, I mean, where -- what exactly do you envision driving your share gain? Is it your brand? Is it your relationships? Is there -- you could take a little bit off price, just given wiggle room that your efficiencies are affording you or new product cycle?

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

Yes. So there are a couple, 3 areas that we're focusing in terms of share gains. So the first would be the beauty of being a market leader in a number of these markets that are attractive and growing is that you typically accrue a larger benefit when the market is rising than your competitors are. So we've obviously had a big benefit the last couple, 3 years, and we see it continuing. We're seeing record levels of water main breaks, which is great for our kind of quick-fix business. And so by definition, we're going to get a larger share of that revenue because we're fixing and replacing our own equipment in the marketplace. Think about the Flygt brand as being the most predominant there in wastewater. The second is we are -- we have rolled out and are continuing to roll out a number of new products in a couple of these channels that are really focused around energy efficiency. So in our Applied Water business, the -- we've increased our Vitality Index from 13% of our total revenue about 3 years ago. It's now up to about 18% of our total revenue. And the products that we've launched are actually growing 8x the rest of the portfolio at far better margins than we had in the base business as well, and it's all being driven by a focus on energy efficiency regulations in Europe, and those are set to come to the U.S. in 2020. So that's the second piece. And then third is we've done a lot of just basic -- it's not very sexy, a lot of basic blocking and tackling on how do we help our sales teams be more effective. We introduced a metric about a year ago that's called the sales force barometer, where we gauge from our sales team every month, how do they feel about -- are we making it easier or harder for them to do business with our customers. And then we get written feedback from them, their basic thing. But just actually showing them we actually give a (expletive) about what they're doing is a motivator. And so look, we've got a lot of things to work on (inaudible). We're far from perfection. But just engaging the sales team in this environment to understand what we need to do better, I find it's beginning to make a difference as well.

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

Patrick, you've talked about \$3.5 billion, \$4 billion over the next few years of capital redeployment. Are there products that you feel you'd like to have that you could apply Sensus' technology to or other technologies that you could apply to the legacy portfolio? Is it more about the end markets you want to gain? And you've talked about industrial water, just how you're thinking about that strategically over the next several years.

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

Sure. Great question, by the way. The...

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

Great quarter.

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

So the areas that I would say, Nathan, are key for us would be, I think we are -- and none of these are must-haves. And so obviously, at the end of the day, we're going to be disciplined in terms of what we'd ever go pay or acquire. So we're not going to be desperate in that regard. And hopefully, we demonstrated that with the Sensus acquisition. But I think about some gaps. So we've got a relatively small treatment business today. It's about \$350 million of our revenue, 80% of that goes into the municipal space versus industrial. Certainly, the industrial treatment space is an attractive area, and there's a number of assets that are out there that I think could be attractive over time. Another area is when you think about one of the



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big pain points that utilities face, it's things like energy cost, but labor cost is a big deal for them. And so there are technologies that are out there that we can leverage the FlexNet investment to be able to bolt on some of those technologies that help them manage their mobile workforce management, as an example. So that's another area that we'll look at. I'd say 1/3 would be -- we really like our dewatering business. And while it's gone through a rough patch here the last few years with oil and gas and mining being down and that's now less than 5% of our total revenue, I still think that there is good, attractive consolidation play in that space as well. So those are 3 things that kind of come top of mind. It's not the only list, Nathan, but I would say those are the 3 that I would point out.

Unidentified Analyst

I think that's it. Thank you very much.

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

Okay. Thank you all.

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