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PRESENTATION

Operator

Welcome to the Xylem second-quarter 2016 earnings conference call. (Operator Instructions).

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

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

Thank you, Jackie, and good morning, everyone, and welcome to Xylem's second-quarter 2016 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 second-quarter 2016 results and discuss the full-year outlook for the year. Following our prepared remarks, we will address questions related to the information covered on the call. In addition, in order to have enough time to address everyone on the call, I'll ask that you please keep to one question and a follow-up, and then return to the queue. We do anticipate that today's call will last approximately one hour.

As a reminder, this call and our webcast are accompanied by a slide presentation available on the investors section of our website at www.xyleminc.com. A replay of today's call will be available until midnight, September 6. Please note the replay number is 800-585-8367 and the confirmation code is 294-89-904. Additionally, the call will be available for playback via the investors section of our website under the heading Presentations.

With that, 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.

With that said, please turn to slide 3 for a few key notes regarding today's presentation. First, I'd highlight that we have provided you with a summary of some of our key performance metrics we reported earlier this morning in our release. This includes 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.

Additionally, please note that references to 2016 outlook metrics include the financial impact attributable to previously closed acquisitions, and have been adjusted to exclude non-recurring transaction costs.

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

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

Thanks, Phil, and good morning, everyone. Thanks for joining us to review our second-quarter performance. Overall I'm pleased with the results we delivered in the first half of the year. Our ongoing focus on enhancing our commercial leadership is continuing to yield faster-than-market growth as well as share gains in key regions. Our teams continue to capitalize on a very strong public utility market which is not showing any signs of slowing down. This is helping to offset weakness in certain areas of the industrial sector, namely oil and gas and mining.

We're also making significant progress on our continuous improvement and business simplification initiatives, which is driving margin expansion and earnings growth.

We have been and will remain keenly focused on the factors we can control -- namely, enhancing our customer-centric selling approach, leveraging our broad portfolio of solutions and channel partners, improving our working capital efficiency, and optimizing key aspects of our operations.

This strategy is enabling us to capture more than our fair share of growth in certain key verticals and optimize our performance in those markets where conditions are mixed.

All of these efforts have positioned us well to deliver on our full-year commitments, and we believe we are on track to meet our longer-term objectives as well.

We expect many of the macro trends, including the mixed market conditions that existed in the first half of 2016, to continue through the end of the year. This includes some volatility in the timing of major project awards, which slipped out of the second quarter even as the underlying market conditions in public utility remain strong. This is not an unusual circumstance; and, importantly, we continue to cultivate a growing bidding pipeline.

Having closed out the first half of 2016 with 3% organic growth, we are confident in our ability to deliver a similar result in the second half of the year. So we are narrowing our full-year revenue growth guidance to reflect both our first-half results and the timing of orders. As a result, we are tightening our projection of 2% to 4% organic growth to between 2% to 3%. We are pleased with our margin expansion, and expect that progress to continue even as we invest for future growth.

For the full year we are increasing the upper end of our operating margin target. We now expect to deliver a full-year operating margin in the range of 13.4% to 13.8%.

Finally, we are narrowing the range of our full-year EPS guidance while maintaining the midpoint. We now expect to deliver adjusted EPS of $2.00 to $2.06. I'll come back to the details behind this change in a few minutes.

Please turn to slide 5. Our top-line organic growth in the quarter was 2%, and consistent with our expectations. This excludes 1 point of growth from acquisitions. The strong growth in public utilities helped to mitigate the softness in the industrial and residential end markets.

Looking at our end markets, growth in public utility remains robust. Globally, we grew 15% in this sector in the second quarter, with contributions across all major regions, and the US delivering a 22% increase for the second consecutive quarter. And as I just mentioned, our teams continue to report strong bidding pipelines and steady demand.

Our industrial business continues to be negatively impacted by the weak oil and gas sector, as well as mining; though it's worth noting that we are now seeing sequential improvement. And the commercial and market, which was up 2% in the quarter, was a mixed bag. Our business in Europe is strong, driven by new products introduced over the past couple of years, as well as the investments we've made in strengthening our sales channels there.

The US commercial building market is stabilizing. But after seven consecutive quarters of growth, we were down in the second quarter.

Regionally, Western Europe led the way, delivering 7% growth in the second quarter. The US market was flat, despite the strong performance in public utilities. And looking at our emerging market regions, the results were mixed; though, overall, we delivered 1% growth in the quarter.

China continues to be soft, down 11% year-over-year, as we had expected. We saw a sequential improvement there, and investment in infrastructure remains steady. In addition, we continue to capitalize on other growth opportunities across the Asia region. Our Middle East business is solid and growing, up 10% in the quarter.

Finally, India continues to thrive as we continue to deliver on a major infrastructure project. Our team also shipped its first custom pump export order from India to Germany, an important milestone for this business. We have a very robust pipeline in India, and anticipate some significant project wins that we hope to communicate in the coming weeks and months.

Coming back to Europe for a moment, I did want to make a few comments about Brexit. Like most companies, we are assessing both near- and long-term impacts from this decision. But it's very early in the process. To provide some perspective, the UK represents approximately 6% of Xylem's total revenue, with about 70% of that in our water infrastructure segment.

This customer base is predominantly water utilities, which are inherently more resilient to economic volatility because of the country's five-year water infrastructure investment plan, known as the AMP cycle. Right now, the UK is in its sixth five-year AMP cycle, and we do not anticipate any significant changes. Our applied water applications, which generate about 30% of our revenues in the country, are tied into more economically-sensitive markets, including residential, commercial, and industrial; and, therefore, are more vulnerable to economic headwinds.

Overall, we aren't drawing any definitive conclusions at this point, but we do not foresee the Brexit decision resulting in a significant impact in the immediate term on the markets we serve in the UK, or more broadly across Europe.

Back to our results. Organic order bookings in the quarter were weaker than expected. This primarily reflects project timing fluctuations and a tough year-over-year comparison. In robust environments such as the US, we have experienced some delays between the time we receive commitments and when we receive the actual order. This is due to E&C firms juggling a growing portfolio of larger, more complex projects, which can cause some delays in the process. This is not an unprecedented dynamic, as we've seen from previous periods of significant market recovery. And this is a high-quality problem.

Despite this variability driven by timing, we continue to cultivate a growing project pipeline. As I already mentioned, we are seeing consistently strong design and bidding activity in the US water utilities sector. Our treatment business, which we consider to be a bellwether for the long-term health of the water utility business, has a steadily expanding project funnel. In the second quarter, we saw year-over-year growth of approximately 15%, with quarterly sequential improvement as well. This growth was driven primarily by increased bidding activity in China and India.

There are also signs of potential growth acceleration in parts of Europe, and a growing project pipeline in our emerging market regions.

I am particularly pleased with the progress our teams have made in the first half of the year on driving productivity. Our initiatives around continuous improvement and business simplification have already and will continue to create significant value for Xylem.

In the quarter, operating margin expanded 100 basis points to 13%, with volume leverage and favorable mix driving 70 basis points of improvement. Price was neutral overall for the quarter. Collectively, global procurement, Lean and Six Sigma activities and restructuring savings reduced our cost by $30 million in the quarter, resulting in 320 basis points of margin improvement.

Partially offsetting these savings were cost inflation of 170 basis points and the funding of our strategic growth initiatives of 90 basis points. Our growth initiatives included increased new product R&D spend, investment in our selling and continuous improvement capabilities, and localization of assembly and production in attractive, faster-growth regions.

A couple of points on our continuous improvement efforts. In addition to the dollars saved through our Lean and Six Sigma initiatives, we are changing processes and eliminating barriers to productivity. In the first half of the year, we completed the 80 kaizen events that are generating measurable improvements. While some focus on internal processes, others target improvements in how we engage with our customers. These initiatives are creating sustainable change that will continue to pay dividends down the road.

Our global procurement group has really hit its stride, and is well on its way to meeting our full-year goals. The result will be another year of record savings from procurement. We've launched our new e-sourcing tool, which resulted in more than 15% average savings in the first two online auctions.

In addition to going after direct spend opportunities, we are increasingly looking at our indirect spend the categories, as well. As I've said before, this productivity for growth mindset is enabling us to fund important initiatives for our medium- and long-term growth, while continuing to expand our operating margins.

One other point: we are seeing positive benefits from the restructuring actions we've already taken this year.

Shifting back to our results. At the bottom line, we generated adjusted earnings per share of $0.48 in the quarter, an increase of 12% year-over-year. We continue to generate solid cash flow. The year-over-year decline in the quarter reflected increased investments in growth initiatives, but we are well on our way to a second consecutive year of free cash flow conversion north of 100% of net income.

Our sharp focus on improving working capital performance continued. In the quarter, we generated a 100 basis point year-over-year improvement, excluding the impact of foreign exchange translation and acquisitions.

Now I'll turn it over to Mark for more details on the quarter, and then I'll come back to our outlook for the year.

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

Thanks, Patrick. Please turn to slide 6, and I'll provide additional details on our reporting segments. Water infrastructure recorded orders of $562 million, down 4% organically. As Patrick mentioned earlier, we had a challenging year-over-year comparison to last year's second quarter when we had two major projects that totaled $18 million. Excluding the impact of those projects, our orders would've been roughly flat year-over-year. We exited the quarter with total backlog of $546 million.

Given the strength of the project pipeline that our teams are working and our solid win rate, we believe this year-over-year decline is due primarily to project timing.

Worth noting is that in addition to a growing project pipeline, we did see a modest increase in our weekly order rates in June.

Revenue of $566 million represents a 3% increase year-over-year on an organic basis. Acquisitions added an additional $11 million to the top line, while foreign exchange was an $11 million headwind. We generated 15% growth in the global public utility market, with double-digit gains across most of our businesses.

In the US, our public utility business matched its strong Q1 performance with 22% growth in the second quarter. Our teams are executing very well, driving share gains in the healthy water and wastewater market. Western Europe grew 4%, driven by broad public utility growth over most of the region, including solid increases in the UK due to the AMP 6 cycle. There was also strength in the Nordics, France, and Germany, partially offset by a decline in Southern Europe.

Emerging market results were favorable, up 4% despite mixed market conditions. Our overall growth was driven by large custom projects in India and Laos, coupled with strength in treatment from infrastructure investments in the Middle East.

Finally, expected weakness in oil and gas and mining markets, coupled with a softer-than-expected industrial CapEx environment, drove mid-single-digit declines in our industrial vertical.

Operating margin increased 150 basis points to 14%, as volume leverage, cost reductions, and modest price realization more than offset cost inflation and increased strategic growth investments.

Please turn to slide 7. Applied Water recorded orders of $361 million, up 1% organically over the prior period, and entered the third quarter with total backlog of $180 million. In this segment, we saw a modest improvement in our weekly order rates over the course of this past quarter. Revenue was $366 million, flat organically versus the prior year.

In Western Europe, revenue increased 14% as industrial water and commercial building applications both delivered double-digit growth in the quarter. Here we continue to see benefits from energy-efficient product launches and our investment in building our regional sales capabilities.

In the US, residential was down 5%, primarily reflecting softer market conditions, including lower demand for well pumps in the West, which benefited last year from severe drought conditions. The segment's US industrial revenue declined 4%, reflecting softer general industrial, marine, and food and beverage demand. The most significant portion of this decline was attributable to weakness in regions more directly tied to the oil and gas market.

Segment revenue was down 5% in our emerging markets, primarily due to the as-expected 11% decline in China, driven by softer demand in the commercial and industrial end markets. On a sequential basis, our performance in China continues to improve.

Segment operating margin increased 40 basis points to 14.8% year-over-year. Cost reductions drove a 380 basis point improvement, more than offsetting 160 basis points of cost inflation, 110 basis points from strategic growth investments, as well as unfavorable mix. The year-over-year increase investments relate to the funding the localization of product assembly in the Middle East, and higher investments in new product development.

Now let's turn to slide 8 to cover the Company's cash flow and financial position. We closed the quarter with a cash balance of $586 million. Our net debt to net capital ratio is healthy, at 23%, and our revolving credit facility remains in place and unutilized. This underscores our financial strength and capacity for capital deployment. In that regard, we continue to pursue and execute on opportunities to profitably grow the business through organic investments and M&A, while also enhancing shareholder returns through dividends and opportunistic share repurchases.

During the second quarter, we invested $25 million for capital expenditures, and we returned $28 million to our shareholders through dividends. Free cash flow was $59 million, a modest decline from the prior year, reflecting increased year-over-year spending on growth CapEx. We continue to expect to deliver at least 100% cash conversion this year.

It's worth highlighting that we improved working capital as a percentage of revenue by 100 basis points in the quarter, excluding the impact of acquisitions and foreign exchange. The improvement was driven by better inventory management and receivable collections.

Please turn to slide 9, and Patrick will cover the update to our 2016 outlook.

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

Thanks, Mark. We continue to expect to generate revenues of approximately $3.7 billion for the full year, including 1% growth from acquisitions, and foreign exchange headwind of approximately 2%. As I mentioned earlier, we are narrowing our organic growth expectations. We now anticipate full-year organic growth in the range of 2% to 3%. Again, this reflects timing variability, as project awards have shifted from the first half to the second in a very strong public utility market.

Following the strong execution and productivity delivered by our team in the first half of the year, we are increasing the upper end of our operating margin guidance 10 basis points. We now expect our full-year operating margin to be in the range of 13.4% to 13.8% for the year.

As I reviewed earlier, we have narrowed our EPS guidance range to $2.00 to $2.06 to reflect a couple of items. First, we are reducing our foreign exchange translation headwind impact by $0.02, about $0.01 from the first half, and another $0.01 in the second half. And, second, this narrowing also reflects the adjustments to the top ends of our revenue growth and margin expansion guidance ranges. There is no change to our free cash flow conversion guidance.

Please turn to slide 10, and I'll walk you through the update to our end market assumptions for 2016, beginning with public utility, at 33% of total revenue. Through the first half, we generated organic revenue growth of 13%, but expect our second-half organic performance to moderate. This expectation reflects continued strong market conditions, but we do face tougher year-over-year comps. Some of you may recall that we delivered double-digit growth in the US in the second half of last year.

With that said, we expect second-half 2016 revenue to be up mid-single digits; and, as a result, our full-year expectation is in the high-single-digit range. This outlook is improved relative to our previous expectations, and reflects the positive performance realized to date and momentum heading into the back half.

Our industrial end market -- which represents 44% of total revenues, and includes a wide range of industries, from general light industrials to the heavier sectors -- full-year organic revenue growth is now expected to be flat, which is slightly lower than we previously anticipated. Here we see double-digit declines in the oil and gas and mining sectors offsetting modest growth in general and light industrial applications.

While industrial overall was down 3% in the first half, we do expect that performance to improve over the balance of the year, primarily reflecting easier second-half comps as we lap more significant prior-year headwinds in the oil and gas market.

Moving to commercial, we are maintaining our full-year mid-single-digit growth outlook. This reflects first-half organic revenue growth of 3%, and modest improvement in the back half. That improvement is supported by solid underlying market conditions in the US and continued growth in Europe, driven by new product demand. In addition, we expect the weak conditions in China to begin to stabilize and then improve in the latter part of the year.

In our smallest two end markets, residential and agriculture, we project full-year revenue to be down mid-single digits. Both of these sectors have experienced challenging market conditions in the first half of the year, due in part to lower demand for well pumps as drought conditions moderated in the Western US. We expect those to continue in the second half.

Now please turn to slide 11, and Mark will walk you through more of the details on the second-half outlook. Mark?

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

Thanks, Patrick. I'd like to spend a minute calibrating everyone around what we expect our revenue and operating income profile to be over the balance of 2016. First, shippable backlog. Of the total $725 million in backlog, $525 million is shippable in the second half of this year, and the remaining $200 million is expected to ship in 2017. Third-quarter shippable backlog is approximately $365 million, which is down 2% organically versus the prior year. This represents approximately 40% of our expected third-quarter sales.

While we still have a lot of book-and-ship business to secure and deliver in the quarter, we believe that we have solid momentum in the public utility sector, as well as stable outlooks across most of our key regions.

In addition, our teams have stepped up their execution and are delivering more quickly to our customers.

Organically, we anticipate second-half revenue to increase in the range of 2% to 3%. We see the second-half revenue profile similar to past years, down 3% sequentially in the third quarter, before ramping up in the fourth quarter. This reflects the impact of seasonality in Europe in July and August.

We expect operating income performance in the second half to improve sequentially. This will be driven by volume, improved mix, and a continued ramp-up of savings from our productivity initiatives. In the third quarter, we anticipate margin expansion of approximately 50 to 100 basis points year-over-year. Finally, we expect full-year corporate expense of approximately $50 million.

With that, please turn to slide 12, and I'll hand the call back over to Patrick for some closing comments. Patrick?

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

Thanks, Mark. We've delivered a solid first half of 2016. And I believe we are building strong momentum in our commercial execution, as well as achieving significant progress against our productivity initiatives. We know there's plenty more to do, but that leaves us even more optimistic about our potential for future growth.

We will continue to increase our investments in strategic growth initiatives, including in the areas of innovation and technology, as well as in our faster-growing markets. Finally, we remain committed to driving a disciplined capital deployment strategy and continuing to improve our working capital performance, both important contributors to our growth.

Now, operator, we can open it up to questions.

QUESTIONS AND ANSWERS

Operator

Deane Dray, RBC.

Deane Dray - *RBC Capital Markets - Analyst*

I was hoping to get some more color on this high-quality problem regarding the surge in bidding activity. And specifically, maybe you can size for us what this funnel looks like; maybe some color on what that mix is in this funnel. How much would be advanced water treatment analytics, and so forth?

And then lastly, with this bidding outlook, what does it say about your 2017 visibility? Thank you.

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

Sure, Deane. Let me just characterize what we are seeing here. And I've seen this in the past, both in this market as well as even in the energy sectors, when projects begin to heat up, which is obviously not the case right now in that sector. But what you see here is you've got constraints on a number of the E&C firms, the construction firms; tight labor market. Obviously some level of wage inflation there.

They bid these projects, they put in their budgetary quotes; the quotes sometimes come in higher than what the municipalities were actually thinking at that point in time. They push it back. They rebid again. And although we've already been committed the project in the order from a customer into the contractor, they can't officially place the order on us until they actually have that in hand. It typically, from my experience, takes a couple of quarters for this to work through the system. It's hard to predict. But, again, it is not unprecedented. And as I said, it is a high-quality problem to have.

And those rebids on the quotes don't have an impact on our pricing or our margin structure. It really is just a matter of the timing of when the project actually flows through.

When I take -- when I talk about the size of the pipeline, the total pipeline that we are talking about really are treatment projects. And those are the leading indicators for us, and that total pipeline is about $2.6 billion. And that pipeline is up 15% from a year ago. And so, it does give us pretty good visibility into what 2017 could look like.

Again, setting aside any ongoing shift out of the timing of some of these projects; but overall, it's actually a very encouraging sign to see this level of healthy bidding and tension in the system, Deane.

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

I'd add -- Patrick -- just to put an exclamation point on that, while it's up 15% year-over-year, we're up -- we've seen 10% improvement quarter sequentially.

Deane Dray - *RBC Capital Markets - Analyst*

And then just to clarify, when you talk about the preponderance of treatment systems in this pipeline, does the mix imply an interest in your advanced treatment and your analytics?

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

It does, Dean, and it also is a bellwether for the overall wastewater market. And so when you see healthy bidding pipelines here and project activity, that also bodes well for our Flygt submersible pumps. Anything that we are selling into the wastewater sector tends to benefit from that rising tide.

Deane Dray - *RBC Capital Markets - Analyst*

Great. And then just my last question -- Patrick, you and I have talked about this before -- is when you see municipal with this type of strength, then, we are not seeing any signs of slowing here. Could you give us a perspective on how long these cycles run in municipal recoveries, both in the US and in the developed markets?

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

Sure. I would say that it's a bit more cyclical in the US, and the cycles there historically would run anywhere between 5 to 10 years on the wastewater side. I would say the recovery that we are seeing in Europe will be steadier. And we see that improvement obviously being driven largely right now by the AMP cycle in the UK, which is a five-year program. And we are in the second year of that. So that's got a few more years of its tail behind it.

As I said earlier, we've continued to see quarter sequential improvement in the project pipeline for China and each of the emerging markets. And so we see a level of rebound happening there as well on the public utility side.

Deane Dray - *RBC Capital Markets - Analyst*

Yes. This is all great to hear, thank you.

Operator

Ryan Connors, Boenning & Scattergood.

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

Great, thank you. Actually I want to just continue on that same vein and maybe get some -- try to paraphrase your response to Deane there so -- and make sure I understand.

So, basically, you are saying that despite the pretty extraordinary growth rates we are seeing in municipal, you don't feel like we are setting up tough comparisons for next year. You feel like the project pipeline and the bidding pipeline is sufficient that we can sustain a strong rate of growth, despite these comps we are setting up here. Is that an appropriate way to read what you're saying?

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

Yes, Ryan. I think the way I would characterize it is we would consider, as we talked about at Investor Day, that once we got through this first year of extraordinary comps that we would see somewhere in the healthy mid-single-digit growth for 2017 and onward. Obviously that can vary from Year-to-year. It could be a little stronger than that in certain years.

But we do see -- the comps get tougher, and they get tougher in the second half. And that's why we've guided down to mid-single-digit growth in the second half, averaging out at high-single-digit for the year. But again, we would consider that kind of strong mid single digit growth to be healthy and sustainable for the next number of years.

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

Great. And then a follow-up would be, one of the parts of the thesis I think for the Company is that you've got a really strong innovation ethic in the Company, and the new products development cycle is strong. Do you feel like part of what you are seeing in municipal is share gain? Because I think you are certainly posting growth rates that are in excess of what many of your peers are doing. Should we read that as share gain? Or is that just project mix? Or what's your view there?

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

Yes, I think it's a combination of the two. I would say that there is some benefit of projects in there from quarter to quarter, but I do feel confident that we are gaining share in certain key markets in the wastewater side. I think that is attributable to two things. One, there have been some products that we've launched that are entering the market and are being extremely well received. And we will have more to talk about on that front in future calls here.

But, secondly, one of the benefits you have when you have a large share position like we do, especially on the submersible wastewater pump side of the market, by definition, as you see an increase in the level of repair and maintenance and kind of break-and-fix business, the person with the larger share does benefit disproportionately there in terms of growth because it's our installed base that is being repaired and replaced.

And these customers, as you well know, almost always replace in kind, and so we are certainly benefiting from that as well. And that's also helped our mix because that's a higher-margin business for us, relative to the initial OEM install.

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

Okay, great. Thanks for your time.

Operator

Nathan Jones, Stifel.

Nathan Jones - *Stifel Nicolaus - Analyst*

Patrick, I was going to get some more color on some of these growth outlooks for the rest of the year. With the 3% sequential decline in the third quarter, that kind of implies that it's kind of flat to maybe up 1% in the third quarter. And then you've got to see acceleration to something like 3% to 6% in the fourth quarter. We saw orders down 2% in the quarter, but you are sounding very confident that some of these projects are going to come through.

Can you just talk about what visibility do you have to that improvement in the fourth quarter to make that full-year number?

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

Nathan, it's Mark. I think part of this is just a function of the timing. Part of it is natural ramp-up that we see in the fourth quarter on a regular basis. But some of this is timing. And we've seen the delay from the first half of the year into the back half. And so some of this, we do expect to push out a little bit, with probably more of that in Q4 than we'd expect to see in Q3.

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

We also have the visibility, Nathan, that you will recall that last year we booked a $40 million project in India. That's shipping out this year, well into the second half of the year as well. So that gives us confidence in the Q4 ramp as well as some other projects that we already have in the back.

So, part of it is normal seasonality in terms of Q3 being down. Because we do have obviously some of the holiday periods in Europe, and timing around that. And that volume tends to then be re-shipped into Q4 or shipped out in Q4. So there's nothing there that alarms us at this point in time, based on what we see in the funnel and what we've got in backlog.

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

And I'd just add, so -- and I can cover this off with you after the call -- but you should end up with organic of about 2% here in the third quarter, and kind of 2%, 3% or so in the fourth quarter organically. We still expect FX headwinds over the course of the back half of the year, and do still have some impact from acquisitions as well. But I can walk you through the details.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. The visibility on that India project kind of helps that. You talked about some of these public utility treatment projects pushing out of the first half into the second half. What visibility do have to 3Q awards, 4Q awards, that kind of thing? And what do you view as the risk of that pushing out even a little further?

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

I think we've got good visibility within -- particularly our new CRM tool, which is salesforce.com. So we've got good tracking of the bidding pipeline and when these projects are likely to be awarded; what our confidence is and probability to win. We've got a whole rating system, like many companies do, on a project-by-project basis. So we've got very good visibility there.

I would say that when you look at our guidance for the second half of the year, the scenario by which we would deliver the lower end of that 2% to 3% would be if, in fact, there were some projects that were shifted out of Q4 into Q1. Again, we don't -- we aren't calling that. We don't see that. But we thought it would be prudent to at least build that into the lower end of the top-line growth range.

Nathan Jones - *Stifel Nicolaus - Analyst*

Yes, I get that stuff is kind of beyond your control, anyway. And just on the industrial performance and expectation, is it possible for you to split that out between the heavy industrial, mining, oil and gas, and the lighter industrial that should be doing better and be less cyclical?

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

Sure. Yes, so, Nathan, we've got -- of the 44% of industrial, I believe about 36% of that is what we call light industrial, so it's not being -- it's not tied to production output. It's pharmaceutical plants, chemical, marine, food and beverage. It's not tied to commodities. It's separate. And that's been growing very steadily in that low-single-digit rate kind, of tied to GDP, and it's been that way year after year. So no real change there.

The 8% of our industrial, which is tied to oil and gas and mining -- 3% of that is oil and gas; 5% of that is mining. Oil and gas is basically going to be basically flattish in the second half of the year, to maybe down low single digits that we are calling, depending upon the 2% to 3% range. And then mining, we are calling to be down a further 10% in the second half of the year.

Again, in the case of mining, it's not tied to output. As long as the mine is up and running, it needs to be kept dry. This really is a reflection of some continued shuttering and mothballing of mining sites around the world. And so that, we don't have a lot of good visibility, I'd say, beyond a quarter out. Because obviously we are not there with our customers who know exactly what their decision is site-by-site. So we think we are being prudent by calling it down a further 10%.

Nathan Jones - *Stifel Nicolaus - Analyst*

So, is it fair to say the weakness in first-half industrial revenue is largely tied to the heavy industrial side, and the improvement in the second half is just easier comps from last year?

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

That is correct.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. Thanks very much.

Operator

Chip Moore, Canaccord.

Chip Moore - *Canaccord Genuity - Analyst*

I wanted to stick with the logjam on the utility infrastructure side, just in terms of deployments. Is this a relatively small amount of larger projects? Or is this more of a broad-based phenomenon? And then, by geography, is this mostly in the US?

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

Yes, it is a US phenomenon. And I would say it is concentrated around some of the larger projects, some of the larger, more complex projects that are out there. I wouldn't suggest it's not happening also in some of the smaller ones, but we see it more in a few of the larger ones.

Chip Moore - *Canaccord Genuity - Analyst*

Okay, perfect. And then just switching up on commercial, another quarter where you are seeing some pretty good traction in Europe. Maybe where you think you stand there, in terms of new products and some of the sales efforts. Thanks.

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

Sure. So we saw tremendous strength in Europe. Commercial in Europe was actually up 20% in the quarter. That is off of a smaller revenue base relative to our competitors. So I'd say we're still a little bit off the radar screen and that's good. It's coming from new products, to a large degree, which are really focused in on energy efficiency which are taking good hold there.

But it's also really been enabled by some targeted investments that our team there has made in what we call our city teams, where they are working very well together across the entire portfolio of AWS, including our water infrastructure side as well, and really focusing in on select key cities there in Europe and really penetrating along with our channel partners, and have made some very, very good traction. Now, those comps, too, will get a little tougher as we lap, but we see that ongoing penetration for some time now, and to continue.

Chip Moore - *Canaccord Genuity - Analyst*

Thank you.

Operator

John Walsh, Vertical Research Partners.

John Walsh - *Vertical Research Partners - Analyst*

I wonder if we can get some color around what you are hearing out of Washington, kind of around there's been some movement here in the WRDA. And then any kind of thoughts around public-private partnership funding or investment that President Obama was talking about late last year.

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

Yes, sure, so I'll give you what we know as of right now. As you pointed out, there is proposed legislation that has bipartisan support. And it does continue to work its way through Congress. Our intel suggests that obviously nothing will happen there until after the election. And certainly, one candidate has made comments on what her approach would be on this, and obviously we are waiting to hear what the other candidate has to say about this.

But both have clearly indicated the importance of making these investments in infrastructure and that's encouraging to us. So we are optimistic that something will move forward there. Wouldn't obviously have meaningful impact on the market until sometime next year. So right now for us it's a wait-and-see approach.

On the idea of P3 partnerships, we do see a growing level of discussion and interest in that concept. I would say we are in the early stages of getting traction in the US overall around understanding how P3s work, and convincing some of the public utilities around the US that those can be very attractive ways to fund and finance these kind of projects. So I'm optimistic, but these things always tend to take longer than we would like for them to in terms of adoption.

John Walsh - *Vertical Research Partners - Analyst*

Gotcha. Then just as a follow-up, any update on the M&A pipeline and the opportunity you see, if anything, before the end of the year.

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

Sure. So we obviously play in a highly fragmented industry, including some attractive adjacencies. So as I mentioned at our Investor Day late last September, we continue to believe that M&A is going to be a significant accelerator of our growth over time as the right opportunities come forward.

We do have a strong and attractive pipeline. And we are very focused on opportunities that are higher up the technology curve, really focused on four key areas: smart water infrastructure, advanced treatment, industrial water services; and then of course opportunities to defend our core businesses were necessary.

I'd say, naturally, we don't control the timing of the opportunities. It takes two to tango. And we strive to be disciplined in our evaluation and our pursuit of any potential deals, both from a financial and a strategic perspective. As you know, we did complete two small acquisitions, fourth quarter of 2015 and first quarter of this year. And as we sit here today, we feel we have a strong balance sheet to support transactions of larger size and scale.

John Walsh - *Vertical Research Partners - Analyst*

All right, thank you very much.

Operator

Robert Barry, Susquehanna.

Robert Barry - *Susquehanna Financial Group - Analyst*

Just a couple of questions on the margin front. It looks like you are now expecting a little less op margin expansion in the second half -- 60 to 120 bps. I think it was 80 to 130. I just wanted to clarify what was driving that.

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

Yes, this is Mark. But some of that on the high end is just related to some of the volume drop. But that is partially offset by what we see as continued improvement in ramping up our productivity initiatives.

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

Yes, and it's also some of the investments that we've got scheduled for the second half of the year, the timing of some of those investments. We are wrapping up investments in the Middle East expansion, as well as some of the investments that I talked about earlier in our European sales team, on the city teams' initiative that's driving that growth.

Robert Barry - *Susquehanna Financial Group - Analyst*

I see. Did some of it just shift a little more to the back half?

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

That's correct. And we'll continue to manage and rate the pace on that.

Robert Barry - *Susquehanna Financial Group - Analyst*

And then earlier, Patrick, I think you mentioned that post- this first year, you see a good case for healthy mid-single-digit growth in water infrastructure as the cycle plays out. What is the right incremental margin that we should be assuming on that growth?

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

Yes, I think as we look at it right now, I would say it's probably around the 35% plus incrementals. And that's down a little bit from what we would historically see in that sector. But that's really a reflection of higher project mix. And so obviously, depending on how that plays out and what drives the revenue, it could be at 35%. It could be higher than 35% incremental margins. Historically we've done close to 40%.

Robert Barry - *Susquehanna Financial Group - Analyst*

What's the mix dynamic with treatment leading the growth here, and actually test looking like it's lagging a bit? Is that a mix headwind, that dynamic?

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

It would be a mix headwind. Although what I would say is that the relative size of the treatment and test businesses are much smaller. And they are also very similar in size, almost identical in size. And so they really kind of negate each other to some extent in terms of depending upon how they play out. But obviously the larger piece of our water infrastructure revenue is being driven by the submersible wastewater pump business in Flygt, which has very attractive incremental margins. And that's also really driving a lot of our impressive growth right now in that sector.

Robert Barry - *Susquehanna Financial Group - Analyst*

Great, thank you.

Operator

Joe Giordano, Cowen.

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Joe Giordano - *Cowen and Company - Analyst*

I just wanted to -- I keep harping on the same thing, but I just want to make sure I'm clear here. With the orders on muni and water infrastructure, so we are looking at a zero comp in 2Q 2015 for the whole segment. I just want to know, what were orders for muni this quarter and year-to-date? And what were the comps? And maybe you could talk about that by geography.

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

Joe, we probably wouldn't get into all that level of detail here; certainly don't want to open that Pandora's Box and be expected to comment on it. (laughter) Quarter in and quarter out, you would appreciate that.

I'd highlight, if you recall last year, we got a pretty large Panama Canal expansion job in our dewatering business. That was about $6 million worth of order that we got in Q2. We ended up shipping it in Q2 and in Q3, or recognizing revenue.

We also got a pretty sizable public utility or municipal job in the Middle East. Can't name the customer, only because we're not allowed to. That was a $12 million job. It was a global projects job worked on by -- well, a lot of different contractors and vendors. That was also a pretty unique order that we got that we delivered later in the year. And so those are really the drivers in the water infrastructure and muni side of things.

We would have seen flat order growth last year in Q2 overall for water infrastructure. But these would've driven, if there were 4% or 5% orders growth in the municipal side of the water infrastructure order book last year, that would have been offset by the beginning of headwinds that we started to see in the oil and gas business, predominantly in our dewatering business in Q2 of last year. So that was the offset there.

Joe Giordano - *Cowen and Company - Analyst*

And then if we look at where you are starting to see -- whether it's bidding or actual orders coming through -- any particular geographies within the US? Or are we focused -- is it more, are you seeing more like reuse stuff in California type areas or is it pretty balanced nationally?

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

Yes, Joe, it's pretty broad-based. I would say we are seeing it happening in a couple of sectors. Obviously, those -- in those Metropolitan areas that are experiencing very attractive increase in tax receipts: California being an example, Texas being an example; Florida is a very hot market for us right now. We are seeing strength in the Northeast. But it's pretty broad-based in terms of the munis that are showing those signs of recovery.

And I would say in terms of applications, we certainly are seeing a significant increase in both our wins but also bidding pipeline on reuse project in places like California and Texas and elsewhere. But those are not yet hitting our revenue or our order book in a big way just yet, but expect them to do so later this year into next year. That's specifically on the reuse side.

Joe Giordano - *Cowen and Company - Analyst*

Okay, thanks.

Operator

(Operator Instructions) Jim Giannakouros, Oppenheimer.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

The margin -- again on the margin, sorry. Trying to understand that you see a little bit of upside here. I'm just trying to make sure I understand. Is that more on the productivity initiatives, the greater traction there? Or are you starting to tighten up at all discretionary items versus original plans?

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

This is being driven by productivity.

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

Yes, we are seeing increased rates of success in terms of our Lean projects, and Patrick mentioned it early on. Global procurement is doing an outstanding job. So it is really the large productivity initiatives, as opposed to a lot of discretionary spending.

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

Yes, I mean certainly, as I mentioned earlier, as well, as we look at our rate of strategic investments, we'll continue to be responsible and monitor and moderate that if we saw any weakness in the top line. So we've got good line of sight to that from a contingency standpoint, but what we are committing to right now is productivity gains and upside.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Thanks. And on the Middle East, you guys sounded quite bullish. One other company I listened to this morning had incremental caution in the region, just given oil down versus its recent highs. That's impacting their expectations. Again, just versus their outlook coming into calendar 2Q, what exactly are you seeing there? And is -- any specifics will be helpful. Sorry if I did miss some things.

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

That's fine. That's fine. We were up 10% in the Middle East in Q2. And our full-year outlook is to be in the mid-single digits. There is some project timing in there, moving around, so we are calling mid single-digit for the full-year.

A couple of things that are driving that for us. We've had some really -- first of all, we are serving the public utility market and the commercial building sector. And so we are a little bit immune from the commodity prices of oil and gas. The Middle East is building out basic, rudimentary wastewater infrastructure at this point in time. And we continue to see healthy commercial building growth there as well.

And then also the fact that we are completing our grand opening of our new manufacturing facility; dedicated sales people on the street and localization of R&D there later this year. And so we don't have a lot of that baked in from a growth standpoint because it's not done yet. But that gives us opportunity here to take share in the market.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

That's helpful, thank you.

Operator

There appear to be no further questions at this time.

I would like to turn the floor back over to Patrick Decker for any additional or closing remarks.

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

Great, well, again thank you all for your continued interest and support. I look forward to either seeing you on the road or hearing from you on our next earnings call here in three months. So, thanks, all. Safe travels, and have a great end of your summer.

Operator

Thank you. This does conclude today's Xylem second-quarter 2016 earnings conference call. Please disconnect your lines at this time and have a wonderful day.
