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PRESENTATION

Operator

Welcome to the Xylem third-quarter 2015 earnings conference call.

(Operator Instructions)

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

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

Well, thank you Paula. Good morning, everyone, and welcome to Xylem's third-quarter 2015 earnings conference call. With me today are Chief Executive Officer, Patrick Decker, and Interim CFO, Shashank Patel. They will provide their prospective on Xylem's quarterly results and discuss the full-year outlook for 2015.

Following our prepared remarks, we will address questions related to the information covered on the call.

(Caller Instructions)

We 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 in the investor section of our website at www.xyleminc.com.

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 the Company undertakes no obligation to update any

forward-looking statements publicly to reflect subsequent events or circumstances. Actual events or results could differ materially from those anticipated.

Also note all references today will be on an adjusted basis, unless otherwise indicated. And non-GAAP financials are reconciled for you in the appendix section of the presentation.

A replay of today's call will be available until midnight on November 15. Please note the replay number is 1-800-585-8367 and the conference ID is 33134966, and the web pin ID is 9510. Additionally, the call will be available for playback via the investor section of our website under the heading Presentations.

With that, please turn to slide 3 and I will turn the call over to our CEO, Patrick Decker.

Patrick Decker - *Xylem Inc. - CEO*

Thanks Phil, and good morning everyone. Thank you for joining us on the call.

Today we reported another solid quarter for Xylem with better than expected growth at both the top and bottom lines. We are also reaffirming our full-year organic revenue growth expectations of 1% to 2%, as well as our full-year earnings expectations of $1.82 to $1.87 per share. I'm pleased with our team's overall execution, and we are continuing to build our capabilities. We are in the early stages of executing against the long-term objectives that we laid out at Investor Day last month, and I look forward to updating you on our progress.

Before I get into the business highlights of the quarter, let me start with some color commentary on our marks. As I have discussed previously, Xylem is well positioned in key end mark that have solid longer term growth profiles. While some concerns do exist in the broader industrial end market and certain sectors of our emerging markets, I am quite encouraged by the fundamentals and underlying trends impacting our business. For example, we continue to see positive signs of steady recovery in the public utility market, which constitutes roughly one-third of our global business.

We are seeing improvement in the break-and-fix side of the market. This is an area that has been suppressed for the last few years as municipalities have deferred needed repairs and upgrades. But eventually this equipment either breaks down or reaches the end of its operational life and must be addressed.

In addition, project quotations in our longer cycle treatment business, which we view as a bellwether for the more capital investment cycle of the public utility market, remains strong. In fact, our treatment bid pipeline has grown 17% versus a year ago. This is a positive leading indicator for continued order growth that should benefit our entire Water Infrastructure segment.

Our third-quarter organic revenue performance in public utilities up 5% demonstrates that we are successfully capitalizing on improved market conditions and increasing our capabilities to gain market share. We are optimistic on the growth outlook in this important end market, and we are confident that our strategy will continue to drive above-market performance over the long term.

Industrial is also a significant market for Xylem, and similar to other companies in this space we certainly are impacted by the underlying market trends. However, we are better positioned than most. Our industrial market exposure is more weighted to the general industrial sector. Oil and gas, which has faced extremely steep declines, represents less than 5% of our total revenue. So consistent with our performance year to date, we continue to anticipate modest growth in general industrial offset by the near-term headwinds in oil and gas, which we began to lap in the second quarter of 2016.

From a regional perspective, I remain optimistic on the US markets, particularly the public utility and commercial building sectors which we'll address in more detail later on the call. Europe is more stable than a year ago, and we expect a more favorable outlook given our strong presence in the public utility market there and early signs of success with certain product launches in the residential and commercial building sectors.

I also want to address the emerging markets, which I recognize has been the cause of much hand-wringing over the past few months. During the third quarter our business in emerging markets grew 9% overall, driven by continued investment in infrastructure and we remain on track to deliver high single digit growth for the year.

As we discussed at Investor Day, we have a clear strategy to drive growth in these regions, including localizing more research and development, building our manufacturing capabilities, and strengthening lower local teams. These initiatives will position us to continue to capture a larger share of the growing infrastructure investments being made in the emerging marks.

While there has been some deceleration in the commercial building and general industrial sectors, our business is over-weighted to the water and wastewater utility sectors in the emerging markets. For example, we posted 12% growth in China in the third quarter, significantly outpacing the market. That growth was fueled by an 18% increase in our Water Infrastructure segment, while our Applied Water segment grew 3% year-over-year.

In other regions we continued to expand and further penetrate the markets. Take India, where we grew more than 300% in the third quarter. I am very proud of our team there, which during the quarter won a $39 million project order which we will begin to deliver to the customer next year. And we made substantial inroads with our analytical instrumentation business on important government projects, such as the Ganges River cleanup.

Lastly, we continue to make good progress on our investment to expand our presence in the Middle East. These are just a few examples to illustrate why we remain confident that ongoing investment in water and wastewater infrastructure will continue to fuel growth for Xylem in these faster growth regions.

Now let's cover the business highlights for the quarter. Orders were flat organically year-over-year as we lapped last year's particularly strong quarter when bookings were up 8%. We continue to build backlog, exiting the quarter with just over $810 million in projects. Of this, approximately $450 million is due to ship in the fourth quarter, representing 44% of our expected revenue. The remaining $360 million in backlog is expected to ship in 2016 and thereafter, which represents an 18% year-over-year increase on a constant currency basis, as well as a 50%-plus increase quarter sequential.

We delivered organic revenue growth of 2% in the quarter, which was better than we anticipated coming into the quarter. Our adjusted operating margin was flat year-over-year, exclude the unfavorable impact from foreign exchange translation.

The biggest challenge we faced in the quarter was the incremental mix headwinds from declines in our dewatering rental services and lower margin project deliveries in our Applied Water segment. We were able to mitigate these factors through continuous improvement activities and by taking action on discretionary cost measures, which also enabled us to continue to invest in future growth initiatives. Given the impact of the significant unfavorable mix issues, we were pleased with our team's ability to deliver earnings that were slightly ahead of our expectations for the quarter.

At the bottom line, we delivered earnings per share of $0.49, up 4% year-over-year, excluding the impact of foreign exchange translation. And finally, we delivered another quarter of solid free cash flow performance with conversion of that income of 132% for the quarter.

Now turning to slide 4. Those of you who joined us for Investor Day will recall that I laid out a very clear investment thesis for Xylem. First, we are well positioned to benefit from a favorable macro outlook in our key end markets and growing presence in faster growth regions. This positioning, in combination with our focused execution, will enable Xylem to drive faster than market growth.

Second, we have a clear runway for margin expansion, driven by our focus on continuous improvement and business simplification initiatives.

And the final element, which I want to touch upon further, is our commitment to larger scale balanced capital deployment. With our strong cash flow generation and capital structure, we are well positioned to create more value for our shareholders.

During the third quarter, we repurchased more than 2 million shares for $75 million, and we have approximately $475 million available under our authorized program. In addition, we paid $26 million in dividends to shareholders in the quarter, or $77 million year-to-date, reflecting a 10% increase per share year-over-year.

Finally, I am pleased to announce that last week we completed our acquisition of Hypack, a software firm that specializes in delivering unique solutions and services in the coastal and hydrographic market. Strategically, within our $300 million analytics platform Hypack strengthens our position in the surface water, ocean, and coastal markets and importantly, Hypack expands our analytic capabilities in software development. This transaction is a good example of how we can and will use M&A as a proxy for research and development.

As we indicated earlier this year, we have a solid pipeline of targets ranging from small bolt-on businesses to larger targets that can enhance our current portfolio or extend our strategic platforms. Xylem will continue to be active on the M&A front, and my expectation is that we will close on a number of bolt-on acquisitions over the coming few quarters. Meanwhile, we continue to cultivate targets of larger size.

Now turn to slide 5 and I will cover full-year outlook. Consistent with our previous guidance, we expect to generate 2015 organic revenue growth of 1% to 2%. We now expect full-year operating margin to be approximately 13%, up 30 basis points, excluding the impact of foreign exchange translation as benefits from productivity actions and volume leverage will likely be partially offset by unfavorable mix.

We are reaffirming our previous earnings per share guidance of $1.82 to $1.87 for the full year, which includes $0.23 of negative foreign currency translation impact. Excluding this headwind, year-over-year EPS growth is still expected to be in the range of 4% to 7%.

Finally, we will continue to execute a balanced approach to capital deployment, which we expect to result in 100% free cash flow conversion.

With that, let me now turn the call over to Shashank Patel to walk you through the results and full-year guidance in more detail. Shashank?

Shashank Patel - *Xylem Inc. - Interim CFO*

Thanks, Patrick. Please turn to slide 6.

We generated revenues of $902 million, down $61 million from the prior year. The year-over-year decline reflects the anticipated foreign exchange translation headwind, driven by a stronger US dollar. Excluding this impact, organic revenue increased 2%, slightly above our expectations.

We saw growth across our key end markets, the strongest being public utility which was up 5%, driven by an uptick in municipal spending. Additionally, we generated growth in industrial up 1%, residential up 6%, and commercial up 1%. This growth was partially offset by a decline in our smallest end market, agriculture, which was down 7%.

From a regional perspective, we again saw the strongest performance coming from emerging markets which grew 9%. We continued to experience growth in Western Europe and Australia during the quarter, but we also felt the unfavorable impacts of a weak oil and gas market, which drove declines in Canada and the US.

Operating margin was 13.7%, flat year-over-year, excluding the negative impact of foreign exchange translation. Global procurement, lean initiatives and restructuring savings reduced costs by $29 million in the quarter, driving 320 basis points of margin expansion. Offsetting these reductions were material, labor, and overhead cost inflation, unfavorable mix driven by lower dewatering rental and sales and lower margin project deliveries, and to a lesser extent, foreign exchange transaction headwinds. Overall, pricing was neutral for the quarter.

At the bottom line, earnings per share declined by $0.04 to $0.49. However, excluding the foreign translation headwind of $0.06 we grew EPS by 4%. Our tax rate was generally in line with our expectations. Our share repurchases during the quarter were executed opportunistically in late August and early September, and therefore had a relatively insignificant impact to our share count expectation.

Now let me cover each of our reporting segments. Please turn to slide 7.

Water Infrastructure recorded orders of $590 million, down 1% organically, reflecting a tough comparison with the prior year when we posted 10% organic growth. The high single-digit growth generated in water and wastewater transport applications was offset by declines in our dewatering

business, driven by oil and gas market weakness. Our book-to-bill ratio was 1.07 in the quarter, slightly better than last quarter but not as strong as last year.

Overall, we exited the quarter with backlog of $624 million, up 6% on an organic basis. Of this amount, approximately 52% is due to shipping in the fourth quarter with most of the balance expected to ship in 2016. While this represents a relatively small portion of our anticipated 2016 revenue, we are encouraged by the 23% organic growth relative to the comparable figure last year.

Revenue of $551 million was up 2% year-over-year on an organic basis. Treatment revenues grew 10% and test increased 2%. As was the case last quarter, transport was flat overall.

Regionally, we generated most of our growth in the emerging markets where we continued to see growth driven by increased regulations and demand for both public utility and industrial water and wastewater infrastructure. We posted 9% organic growth in these faster growing regions, including 18% growth in China.

Australia and Western Europe grew 19% and 4% respectively. This growth was partially offset by weakness in the United States and Canada, primarily due to declines in the industrial oil and gas markets.

Growth accelerated in the public utility sector, where we posted better than market performance in the aggregate. Our performance this quarter reflects the positive longer term outlook we have for this attractive and stabilizing end market. As I mentioned earlier, transport was flat overall for the quarter.

We saw significant growth in our water and wastewater pump business, up 9% organically including [accelerated] growth in the US and Europe. Offsetting this growth was weaker than expected performance in our dewatering business, which was impacted by a year-over-year 45% decline in oil and gas application. We expect these headwinds to continue until we lap the first quarter next year.

The good news here is that we continue to benefit from a healthy construction and public utility market, where combined we generated approximately 14% growth in the quarter. Our treatment was up significantly with strength in Western Europe, complimented by product deliveries in China and Australia. And to wrap up on the top line, test grew 2% overall primarily driven by the delivery of multimillion-dollar projects in emerging markets.

Operating margin decreased 90 basis points from 16.3% to 15.4%. Cost reductions net of inflation drove 60 basis points of operating margin expansion. However, operating margin was negatively impacted, primarily by unfavorable mix which was driven by lower dewatering rental volumes.

We also continued to invest in our strategic growth initiatives in the quarter, such as our expansion in the Middle East which we outlined during Investor Day. While FX translation negatively impacted operating income during the quarter, it had a neutral impact on margin.

Let me now turn to slide 8 and talk through our Applied Water segment. Applied Water recorded orders of $349 million, up 2% organically, as improving market conditions and new product introductions in Europe more than offset the anticipated slowdown in China.

In the US, our biggest regional exposure, we continued to see improving commercial market driven by the institutional building sector. We enter the fourth quarter with total backlog of $188 million, up 5% on a constant currency basis. Approximately $125 million of this backlog is expected to ship during the fourth quarter, representing approximately 34% of our anticipated fourth-quarter revenue.

Turning back to the third quarter results, revenue was $351 million, up 3% organically from the prior year. Building service applications were up 3% and industrial water increased 6%. Irrigation declined 7%.

Regionally, we generated 7% growth in emerging marks and 21% growth in Canada. The US and Western Europe were also up slightly for the quarter.

Let me provide a few more details on this performance. In Asia, our business increased nearly 10%, fueled by growth in India, Thailand, the Philippines, and to a lesser extent China where growth decelerated to 3%. Additionally, we delivered mid-teens growth in Eastern Europe and high single-digit growth in Latin America.

In the US, we generated mid-single-digit increase in residential and modest growth in commercial and industrial applications, partially offset by weakness in irrigation. Canada grew significantly this quarter, as we delivered on a high spec fire turbine project and experienced some strength in the commercial building sector.

Operating margin declined 40 basis points from 14.4% to 14.0% year-over-year, excluding FX translation headwinds. Cost reductions net of inflation drove 110 basis points of expansion in the segment. However, operating margin was negatively impacted, primarily by unfavorable mix driven by lower margin project shipments and a one-time impact of a retroactive Italian compensation tax change.

Now let's turn to slide 9 where I will cover the Company's financial position. Xylem maintains a strong cash position, with a balance of $611 million at the end of Q3. Our net-debt-to-net-capital ratio is a healthy 24.5% and our commercial paper and revolving credit facility remain in place and continue to be unutilized.

We remain committed to our balanced capital deployment strategy. During the third quarter we invested $21 million in capital expenditures and we returned $26 million to shareholders through dividends. As Patrick discussed, we opportunistically repurchased $75 million in shares under our existing share repurchase plan. Free cash flow was $116 million during the third quarter, which includes a strong conversion of 132%.

With that, please turn to slide 10 and I will cover our 2015 guidance. Beginning with our organic revenue outlook by end market. Industrial, which represents 44% of our total revenue, has been flat year-to-date and we anticipate a flat growth the fourth quarter as general industrial growth is likely to be offset primarily by near-term oil and gas headwinds. Given our fourth quarter outlook for general industrial growth, we still expect flat full-year performance within this market.

The public utilities sector, which constitutes 33% of our total revenue, is anticipated to grow at a low to mid-single-digit rate for the full year. You might recall that we had a low single-digit growth over the first half of the year. However, we experienced an acceleration in net growth during the third quarter, which we expect to continue through the end of the year. While we continue to expect above-market growth in key regions like the US, given that we have sizable projects scheduled to ship later in the fourth quarter, there is some risk of project deliveries slipping into 2016.

For the commercial market, we now anticipate full-year organic growth in the mid-single-digit range. Better than our previous expectations, and reflecting the positive growth trend in the US institutional building sector. We are also projecting slightly better full-year performance in residential. We now expect this market to grow at a low single-digit rate, with low to mid-single digit growth in the fourth quarter. We expect the fourth quarter to reflect growth in Europe, as well as continued growth in emerging markets.

In Europe we're driving share gains with new products that address customer needs driven by increased energy efficiency regulation. As we outlined at Investor Day, this is one example of how our innovation agenda is being developed around both immediate and emerging customer needs.

Finally, our smallest sector, agriculture will likely be down mid- to high single digits. Strength in the Western US region, driven primarily by continuing drought conditions, is expected to be more than offset by in the unfavorable impact from floods earlier this year.

Turning to slide 11, I will summarize our revenue outlook as well as cover the rest of our full-year guidance. At the segment level, we expect Water Infrastructure revenue of approximately $203 billion -- (Technical difficulties) billion, sorry. Organically, we now expect growth of flat to up 1%. This is 1% lower than we previously anticipated, and reflects tougher trends in dewatering, which is are related primarily to oil and gas applications. As Patrick mentioned earlier, we do expect these headwinds to moderate as we get into the second quarter of 2016.

And for Applied Water we expect revenues of $1.35 billion (sic -- see slide 11, "$1.42 billion"). Organically we now expect revenue growth of 2% to 3%, which is slightly better than our previous expectations. This reflects the commercial and residential performance I highlighted earlier.

Segment margins are anticipated to be 14.2% and operating margins are project to be approximately 13%, reflecting year-over-year margin expansion of 30 basis points, excluding the impact of foreign exchange translation. At the bottom line we still anticipate earnings per share of $1.82 to $1.87, excluding restructuring and realignment costs of $20 million and other special items.

We are on track to achieve 100% free cash flow conversion this year. And we continue to expect return on invested capital to remain at approximately 11%. Excluding the anticipated impact of foreign exchange translation, we would expect approximately 50 basis points of improvement in 2015.

While our business is impacted by several currencies, the most significant impact comes from the euro. Our euro/dollar exchange assumptions remains unchanged at $1.10. Our operating tax rate expected to be 21%, approximately 1% higher than 2014, given the expected mix in regional revenue. And lastly, fully diluted share count is now expected to be 182 million, reflecting our third-quarter repurchase activity.

Now I will turn the call back over to Patrick.

Patrick Decker - *Xylem Inc. - CEO*

Thanks, Shashank. To wrap up, I'd again would highlight that we delivered another solid quarter.

We continue to see signs of an improving utility market and post above-average organic growth overall, overcoming industrial weakness. We still have a lot of work ahead of us to close out the year, as our teams delivered a very strong fourth quarter last year.

Looking ahead, we know our year-over-year comparisons will ease starting in the second quarter of 2016 as we finally lap the substantial declines in our dewatering rental business driven by the oil and gas sector. In addition, we are committed to maintaining focus on driving productivity and cost discipline, which will enable us to continue to deliver a stronger bottom-line performance. We are also focused on executing our capital deployment strategy, returning capital via dividends and opportunistic share repurchases, and cultivating a solid pipeline of M&A targets.

Lastly, I am encouraged by the progress we have made this year, and pleased that we continue to be on track to deliver on our full-year commitments. And now, operator, we can begin the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Nathan Jones of Stifel.

Nathan Jones - *Stifel Nicolaus - Analyst*

Good morning, everyone.

Patrick Decker - *Xylem Inc. - CEO*

Good morning, Nathan.

Nathan Jones - *Stifel Nicolaus - Analyst*

I wonder if we could just start with trying to get a little bit more color on slide 6, the volume/price mix at minus 50 basis points? I would assume that with plus 2% organic growth, volume was a very slight tailwind there. And the mix, just from dewatering I would think, was probably at least 100 basis points of headwind. So wanted to try and get some idea on how price is behaving overall for the Company there.

Shashank Patel - *Xylem Inc. - Interim CFO*

This is Shashank. I'll take that question. From a price realization standpoint we're neutral overall. So what we've experienced in the second quarter, we saw third quarter. So there's pockets of price pressure out there, but overall it was pretty much flat in the third quarter and that's our expectation in the fourth quarter. The mix dynamic you talked about was primarily coming from the dewatering side where the oil and gas headwinds were stronger than we had forecasted. So that impacted the mix part of the equation.

Nathan Jones - *Stifel Nicolaus - Analyst*

That's fair. Okay. So price was neutral, and it sounds like has been for the whole year?

Shashank Patel - *Xylem Inc. - Interim CFO*

Yes, correct.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. And you did say in your prepared remarks, Patrick, that you're expecting some modest general industrial growth going forward. I think that's probably better than the general industrial economy outlook. Can you talk about what's giving you confidence that you are going to show growth there? Perhaps what the different market exposures are that help you out.

Patrick Decker - *Xylem Inc. - CEO*

Sure. So I think first of all it's our geographic exposure that helps in that regard as well. So again, there's some of the emerging market strength that factors into that. But it's also, when you look at the nature of our industrial exposure, it is much less weighted to the energy sector and much more to broad-based general industrial. And again we do -- we just continue to see signs of strength that's there. If you look at where we are in the quarter, industrial growth, excluding oil and gas, was up about 2.5%. And that's roughly what we're continuing to expect through the balance of the year.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay, thanks. I'll jump back in the queue.

Patrick Decker - *Xylem Inc. - CEO*

Thank you.

Operator

Your next question comes from Scott Davis of Barclays.

Scott Davis - *Barclays Capital - Analyst*

Hi. Good morning, guys.

Patrick Decker - *Xylem Inc. - CEO*

Good morning.

Scott Davis - *Barclays Capital - Analyst*

Trying to get a sense of your M&A pipeline. And you announced your first deal that we've seen in quite some time. And I'm trying to get a sense of, this is the first of many in a flurry. This is a relatively small transaction, but is there stuff that's a little bit larger in your pipeline?

Patrick Decker - *Xylem Inc. - CEO*

Sure. Thanks, Scott. There certainly are acquisitions of larger size in the pipeline. We are actively in discussion with a number of bolt-on targets, kind of smaller tuck-ins, certainly even larger than the one that we announced here. But we are still continuing to cultivate some larger targets that are out there. And so we really highlight this one, not so much because of the size, I wouldn't consider this to be typical of the sizes we would go after. It was really to demonstrate as much that the pause is over. And two, the fact that we, as I mentioned in Investor Day, I really do see M&A serving sometimes as a proxy for R&D. And that really is largely what this acquisition is pointing to.

Scott Davis - *Barclays Capital - Analyst*

Okay, great. And then kind of a strange question, but I'm trying to get a sense, like break-and-fix, the infrastructure is old, we all know that. But is break-and-fix the type of thing -- you mentioned it's been weak for the last few years. I would assume that just based on the installed base you have and infrastructure that you have existing, it's pretty old -- the break-and-fix would be fairly decent growth through the cycle. How do you think about what that should be? Have you drawn out models or have a sense, I guess, of break-and-fix specifically should be a 5% grower, or is it something that could be a little bit better than that because there's pent-up demand?

Patrick Decker - *Xylem Inc. - CEO*

Sure. I'll take that one, Scott. I would say you're absolutely right. We've got a very large installed base, especially on the public utility side. And as a result of that, even throughout the cycle, we would normally see low to mid-single digits in terms of steady growth. I think what we're saying here is we're seeing kind of the upper end of that. And would expect that could probably be growing even faster as we go forward here because, as you have heard us say before, it really is a trade-off for these infrastructure owners that you can only kick the can down the road so long before it is going to catch up with you and you are going to be forced to deal with the break-and-fix aspect of things. Now obviously, that could moderate and balance towards greenfield infrastructure investment as well. So it's always a balance in the equation. But we would expect to continue to see probably the upper end of that mid-single-digit growth in break-and-fix.

Scott Davis - *Barclays Capital - Analyst*

That's really helpful. Okay. I will pass it on. Thanks. Good luck, guys. Thank you.

Patrick Decker - *Xylem Inc. - CEO*

Thank you.

Operator

Your next question comes from Deane Dray of RBC Capital Markets.

Deane Dray - *RBC Capital Markets - Analyst*

Thank you. Good morning, everyone.

Patrick Decker - *Xylem Inc. - CEO*

Good morning, Deane.

Deane Dray - *RBC Capital Markets - Analyst*

I was hoping you could expand on the data point you gave regarding the bid pipeline being up 17%. Just remind us about the methodology, the parameters, how you're tracking that, win rates, and how it converts to backlog.

Patrick Decker - *Xylem Inc. - CEO*

Sure. So our teams have a very -- especially on the project side, have very good visibility to all of the active projects that are out there within the EPC community, as well as the property owners themselves. And certainly as we've continued to build out the utilization of salesforce.com, we've got even more good visibility to the pipeline and what the conversion rates are. And we have seen some improvement in our win rate, as well as an increase just in the level of quoting activity. And so pretty rigorous pipeline reviews that we do on a regular basis.

So as I mentioned earlier, Deane, in my prepared remarks, we're not really looking at that pipeline so much as a view towards what our treatment business would be, per se. Because as you know, the project side is still a relatively small portion of our overall revenue. It's just historically been a leading indicator as to demand that's coming for our broader Water Infrastructure business overall.

Deane Dray - *RBC Capital Markets - Analyst*

Just to remind us, that mix between the break-and-fix and projects, historically it's been around 70/30. Is that still the case?

Patrick Decker - *Xylem Inc. - CEO*

Yes, I would say that's the case right now. It's probably shifting a bit more towards maybe a 75/25.

Deane Dray - *RBC Capital Markets - Analyst*

Okay. With 75% on the break-and-fix, just so we're clear?

Patrick Decker - *Xylem Inc. - CEO*

That's correct.

Deane Dray - *RBC Capital Markets - Analyst*

Okay. And then hopefully you can expand on China. Lots of focus in terms of what their economy is doing, but we're seeing real differences across the multi-industry sector on China growth, depending on their vertical exposures. Obviously, you are on the favorable side of this. So talk about your mix in China, pipeline, and who you're competing with for these projects. How much of is it domestic Chinese players versus other Western players?

Patrick Decker - *Xylem Inc. - CEO*

Sure. I'll take various aspects of that, Deane, and if I don't address each of your questions here, just remind me again of some elements of it. So, we saw again in the third quarter continued robust growth, as you pointed out. And that really is driven by our over-weighting towards public utilities and the municipal side. And that really is being driven by largely the government's mandate there around pollution control and water preservation. So that's the overall macro driver that's there. We obviously, have seen a slowdown in the commercial building sector, although it was still growth for us in the quarter and we expect that to continue to grow, albeit at a slower pace.

In terms of the who we're competing against there, it is a combination of global players but also local players. Obviously part of what we're doing in terms of localizing our product design in China and looking at ways to augment what we call our Tier 1 offering with a Tier 2 offering there as well is to protect ourselves on the flank in terms of local competition. We're optimistic about the opportunities we have there to be able to even grow that kind of Tier 2 segment while still preserving margins in that business because of the features and benefits that we think that we can decouple and deliver that at a better value for customers more in the Tier 2, Tier 3 cities that can't really afford, nor do they need, the larger pumping stations that the large cities do.

Shashank Patel - *Xylem Inc. - Interim CFO*

This is Shashank. Just to add to that, as far as the international players, obviously [DaGrew Force] is a big one, we completely directly head on against. And on that side, that is premium value segment of the market, and that's a lot of where we participate today. As Patrick said on the infrastructure side, the investment continues there. So we've continued to see strength there. As we've all heard there's been a slowdown on the construction side, and that's where we've seen the slowdown, in commercial building services. But there again, with the localized product where we are going to be looking at competing more on the, let's call it the value segment, which is where you see a lot of the local players.

Deane Dray - *RBC Capital Markets - Analyst*

Great. That's real helpful. Thank you.

Patrick Decker - *Xylem Inc. - CEO*

Thank you.

Operator

Your next question comes from Brian Konigsberg of Vertical Research.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Good morning. I just wanted to touch on the fourth-quarter guidance. So just looking at the sequential change, from Q3 to Q4 you had a pretty big uptick, or a decent uptick on sales, which is a bit higher than what you traditionally see. Then separately just on the margin, you were down a little less than 100 basis points in Q3 year over year, but you're expecting that to take a pretty big step up into Q4. I know there was some mix, you said, on the water side -- excuse me, applied water. But you also noted the oil headwind being a mixed negative, which I assume will continue in Water Infrastructure in Q4. So can you just address maybe revenue and margin, how you see the progression sequentially?

Shashank Patel - *Xylem Inc. - Interim CFO*

Yes, let me take that one. From a revenue perspective, first point is we do have an extra day versus the prior year last year. That's worth about 1% as far as organic growth. If you all recall, last year we had a very tough compare. We were up about 6% in the fourth quarter, but when you look at normalized growth it was more like 3% to 5% in Q4 last year. As we equate that and we look at the guidance this year, it's about 1% to 3% organic growth over fourth quarter last year, which with the extra day and normalizing last year it's kind in line and it's supported by the strong order activity we've seen.

On the margin question, clearly in the third quarter we had margin headwind not only from the softness in the -- from the oil and gas and dewatering, but also the points I noted especially on the AW side where we had the Italian tax true-up, which was a one-time true-up, as well as FX transaction. And those were primarily driven by the strength in the UK pound. But when we take a look at that headwind going away, as well as the extra volume leverage we get in the fourth quarter, that's how we anticipate the extra margin expansion Q3 to Q4.

Patrick Decker - *Xylem Inc. - CEO*

Brian, this is Patrick. I would just add a couple of things. On the margin side we also, as is normally the case, our global procurement savings accelerate over the course of the year. So we will have some additional procurement savings in Q4 as well. On the revenue side, within that range, obviously we talked about there's always risk of project delays at the end of the quarter shifting from one to the next. The way I would handicap it for you all would be within the guidance range that we gave you, I'd kind of go right down the middle of the fairway in terms of what that revenue guide would be. And that would help mitigate any of that risk that may be out there. Just to help you guys do your models, I would say right down the middle of the fairway on the revenue guide.

Brian Konigsberg - *Vertical Research Partners - Analyst*

That's on the Water Infrastructure side that you noted possibly (multiple speakers)

Patrick Decker - *Xylem Inc. - CEO*

That's overall. Yes, that's -- it's mainly on the Water Infrastructure side that would you see some of the bigger projects, right.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Okay, great. And then just maybe comment a little bit more on the oil and gas. So you are lapping the steep decline starting Q2 of next year, but are you starting to see stability at low rates? Or is it still falling at pretty substantial degree, even sequentially?

Patrick Decker - *Xylem Inc. - CEO*

Yes. So it's a good question, Brian. Just to maybe help size it up for everyone. So again, the oil and gas exposure for us for the total Company is roughly a little less than 5% of our 2014 revenue. It is actually going to be down around 3% to 4% of our 2015 revenue, given the sharp drop that

we've seen. That exposure really has begun to stabilize. And we've got 44 branches in the US, [7] of which are the ones that are really tied to fracking. There's the ones that have really been hit the hardest.

The team has done a lot of great work in managing the cost side there, mothballing in some locations, moving equipment to other international markets to open up opportunities there. And so, we really don't see another leg down from a dewatering standpoint in oil and gas, given that our exposure has really now been contained. That's why we're making the commentary around getting through Q4 and Q1, and then we finally lap that tough compare on that small piece of our revenue, but disproportionately profitable.

Shashank Patel - *Xylem Inc. - Interim CFO*

Just to add to that, the 5% that Patrick talked about as far as the percentage of total revenues, we expect that to be down 50%. So that's the touch-step function change we saw with the oil and gas.

Brian Konigsberg - *Vertical Research Partners - Analyst*

That's helpful. Thank you.

Operator

Your next question comes from Ryan Connors of Boenning and Scattergood.

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

I wanted to revisit this topic of mix in public utility and think about it about a little more strategically. Not in the fourth quarter or even 2016 but as the cycle plays out, in theory you've got a pretty good divergence in mix there. Your project business is more subject to bid, and therefore I would assume lower margin, but yet your repair-and-replace is almost -- has some aftermarket-type elements and higher margin. As we move years into this up-cycle, where do you see that mix evolving and what do you see the impact on the margin being?

Patrick Decker - *Xylem Inc. - CEO*

Yes, certainly there would be some shift towards a larger project mix, but certainly over the time frame that we talked about at Investor Day, looking out over the next three to five years, I certainly wouldn't expect that to shift dramatically. There's probably, if you look at it historically, that might go up to maybe one-third of our overall revenue that would be on the project side versus where we've been tracking here over the course of the last few years.

Shashank Patel - *Xylem Inc. - Interim CFO*

The other point to note is as we discussed during Investor Day, one of the big initiatives on the innovation technology side will be the work around VOD, which is really taking cost out of the material component of our product. So obviously, you talked about long term. That's the big long-term driver over the next five years. That has an impact directly on the gross margin line. Some of the other business simplification work we'll be doing, obviously will improve those margins as well.

Patrick Decker - *Xylem Inc. - CEO*

To be specific, Ryan, on -- just to give you a feel and maybe to take it back to Investor Day in terms of the targets that we laid out there for you all, that we're marching towards, historically our incremental margins have been around that 35%, give or take. What we factored into our long-term

outlook was, through a combination of some slight uptick in project mix as well as faster growth rates in emerging markets, that that long-term incremental margin that we assumed might be more around that 30%, maybe a little slightly better than that; but probably down about 5 points from historical average. We've got that already modeled in. That obviously, drives our thinking also then around simplification, VOD, some of the other things that we're doing to offset that to really drive the bottom line expansion that we committed to.

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

Okay. Great. And then my second one had to do with the new product pipeline. Obviously you have a strategic focus on innovation. That was a big theme of the Analyst Day. So can you provide any real-time color on what's hitting the market for you and whether there's anything that will move the needle, either from a pricing or a volume standpoint over the next, say, 12 months?

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

Ryan, it's Phil. We just had a little bit of a technical difficulty here. You just flipped over to our backup line. If could you repeat the question for us just one time from the beginning?

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

Sure thing. Yes, just asking about the new product pipeline is something that you focused on quite a bit, innovation at the Analyst Day, And wondering whether you can provide any update on the potential for new product introductions to drive pricing over the next 12 months or so?

Patrick Decker - *Xylem Inc. - CEO*

Sure. Ryan, this is Patrick. We feel very good. First of all, can you hear me?

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

I can.

Patrick Decker - *Xylem Inc. - CEO*

Okay, great. So I feel very encouraged and very good about what's happening in our innovation funnel and pipeline. The areas that we highlighted at Investor Day focused on elements such as energy efficiency. Obviously, as the Internet of Things makes its way to the water segment, our whole monitoring and control platform that we're building here, those are things that we are already bringing to market. And we have a number of introductions that are scheduled here through the end of this year and into 2016 and onward. We do feel and see that that does give us a pricing opportunity as we increase the value we're giving to our customers.

And as we have seen in parts of our business where we've really activated that pipeline, the growth rate, as you would expect, in that part of the business where we're actually introducing new products has grown step function over the rest of our base business, and has come at more favorable margin. So we'll have more in our coming earnings calls, we'll be announcing some of the new product that we've actually launched.

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

Great. Well, thanks for your time.

Patrick Decker - *Xylem Inc. - CEO*

Thank you.

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

Operator?

Operator

Your next question comes from Brent Thielman of D.A. Davidson.

Brent Thielman - *D.A. Davidson & Co. - Analyst*

Thank you. Appreciate the comments on the pipeline and backlog of public utility work. I'm curious, regionally has the mix of that pipeline shifted more toward emerging markets compared to recent years, or is it relatively unchanged between developed and emerging?

Patrick Decker - *Xylem Inc. - CEO*

I would say right now there's not been a big shift between the two. Obviously, there are some large projects that you have heard us announce that we've booked here, I would say over the course of the last year or so, whether that be in parts of Asia, whether that be in Latin America, the Middle East. We've certainly had a number of those high profile, big project wins. But in terms of what we see in terms of bidding pipeline as well as other bookings, we are seeing again, emerging strength in the US that we've discussed again thus far this year.

Secondly, we would expect more so in 2016 and 2017. Not sure if you are familiar with the UK amp cycle, which is a five-year investment cycle, really targeting the water sector by the UK government. We're now in that first year. There's typically a bell curve associated with that five-year time frame. So it's typically year two and year three, which is next year and the following, that you will also hear us talk about ramp-up in project and order activity there in the UK, which is not our largest market but it certainly moves the needle in terms of our overall order activity.

Brent Thielman - *D.A. Davidson & Co. - Analyst*

Okay, great. Taking a step back, as you're kind building momentum in emerging markets where these market shares are still up for grab, how are you seeing the competitive environment evolving here lately? Because you look around, many of your global peers are suffering through some pressures in oil and gas or other industrial markets. I'm wondering if that is accelerating some of their interest in pursuing business on the utility side where clearly things look better?

Patrick Decker - *Xylem Inc. - CEO*

Certainly there is heightened level of interest in these emerging markets, especially on the public utility side. I would say that where we have, and I certainly never take that for granted, but where I think we really do have a distinct advantage is, if you take an example like China, we've already got a very well established footprint there. We've got great customer relationships. We've been there for a number of years. To our customers there, we really feel like a local company.

Obviously, although we're run as a professional global organization, the Xylem name is well-known there. We're well penetrated. I really think that we benefit from the integration of our portfolio. So oftentimes it may be that our Flygt brand, as an example, is the calling card based upon the great relationship we have. But that now is pulling through in many our treatment and our analytics opportunities there in the country as well. The same is happening in India, as well as in the Middle East and certainly in South America as well.

Shashank Patel - *Xylem Inc. - Interim CFO*

I think just to add to that, is clearly the competition for all companies there focusing to more of the emerging markets because that's where the growth is. That's how we're addressing that is with a local presence. The investment in Middle East, North Africa, and Dubai, that's one way to address it. But then a greater way is for localizing the product content and getting the lower cost into (inaudible) so we can be more competitive in those marks as well.

Brent Thielman - *D.A. Davidson & Co. - Analyst*

Okay. Thank you.

Patrick Decker - *Xylem Inc. - CEO*

Thank you.

Operator

Your next question comes from Robert Barry from Susquehanna.

Filippo Falorni - *Susquehanna Financial Group - Analyst*

This is [Filippo Falorni]. I'm on the call for Rob today. So first question. If you can comment on the outlook going forward for the Canada business, given the impact of lower oil price on the broader Canadian economy? So how do you see the business going forward?

Patrick Decker - *Xylem Inc. - CEO*

Yes, I would say, fairly simply we've seen some level of stabilization, at least in terms of the exposure that we've got there in Canada. Obviously, we benefited this last quarter from some growth there and some project activity. But again, I would say for us it is pretty stable at this point.

Filippo Falorni - *Susquehanna Financial Group - Analyst*

Okay. That's helpful. And then if you can maybe break out the 5% growth in public utility in 3Q, to what extent that was driven by your share gain versus the end market improving?

Shashank Patel - *Xylem Inc. - Interim CFO*

I would say that out of that 5%, it's tough to split up between what is share gain and not, but I think roughly speaking probably 30% to 40% of that would probably be share gain and the balance is just that the overall market is improving.

Filippo Falorni - *Susquehanna Financial Group - Analyst*

Okay. Very helpful. Thank you.

Operator

Your next question comes from Nick Prendergast of BB&T.

Nick Prendergast - *BB&T Capital Markets - Analyst*

Good morning. I just had a question on your corporate and other expense. When I look at your EBIT calculation, you give the two segments and then you give the consolidated number, and obviously, the delta is that corporate expense. Anyway, that was significant lower than we were expecting in the quarter. Was there anything going on there specifically?

Shashank Patel - *Xylem Inc. - Interim CFO*

You're right, corporate expense was lighter -- light in the quarter. And what we did is we aggressively managed discretionary costs in order to mitigate some near-term margin (inaudible) because we saw that in the third quarter, especially with the volatility with the China devaluation and the turmoil out there a lot in emerging markets but there was collateral damage. So we aggressively managed the project-type costs that we have in corporate. And that's why we had a lower cost in Q3. But the more typical run rate that we see is in the $11 million to $13 million range for each quarter.

Nick Prendergast - *BB&T Capital Markets - Analyst*

Okay. That was very helpful. And then finally on your share repurchases, in your guidance you said that that reflects the repurchase activity that you had in Q3. Does that imply that you are not looking to repurchase any more in Q4?

Patrick Decker - *Xylem Inc. - CEO*

No, I mean, we're certainly not implying that. I think we'll continue to be opportunistic in terms of share repurchase. We clearly have the capacity with the authorization that we already have there, as well as our balance sheet. We've got the capacity here to do both share repurchase as well as accelerated M&A activity. So I wouldn't read anything into the comments as it relates to Q4.

Nick Prendergast - *BB&T Capital Markets - Analyst*

Okay. Thank you very much.

Patrick Decker - *Xylem Inc. - CEO*

Thank you.

Operator

Your next question comes from David Rose of Wedbush Securities.

David Rose - *Wedbush Securities - Analyst*

Good morning. Thank you for taking my call. I have a couple of follow-up questions, and just to dig a little bit deeper into the order rates. I mean, this is sequentially continuing to move downward versus upward. And I know you talk about the funnel of RFPs being up 17%. But help us reconcile that direction? I can understand maybe one quarter it's a little bit lumpy. But again, this is the third quarter where you're a little bit soft.

And then just think about the timing, if you can articulate the timing for us of how we should think about some of those projects going into at the end of 2017, What do you need -- or end of 2016 rather, what do you need to see in terms of the RFPs coming through, or orders coming through, in order to see growth in 2016?

Patrick Decker - *Xylem Inc. - CEO*

Yes, I would say that I wouldn't read too much into the last couple of quarters or so of the order movement. I really would focus more on what's happening to our backlog that's shippable in 2016 and beyond. We've had -- in any given quarter there are a number of projects in any given year. And we try to call that out to you guys in terms of what's in there.

I realize it may be choppy over time. But I just look ahead to 2016 and beyond, certainly based on what we're seeing here in terms of our public utility strength, again the modest strength we have in industrial and certainly the strength in commercial building, I think you should see a continued pattern in terms of organic revenue growth here through the first quarter. And then as I mentioned earlier, when you get into Q2 and we pass this difficult dewatering compare, then I think you begin to see a further acceleration of our top line. So not quite so dependent upon the long-term bookings and project. Really being driven as much by the short-cycle nature of our business and what we're seeing in the trend lines there.

Shashank Patel - *Xylem Inc. - Interim CFO*

Just another note. When we look at the third quarter last year, this was the tough compare note that we had in prepared remarks. Last year Q3 we were up 10%. So it was a very tough compare. It was our strongest quarter from an order booking standpoint in 2014.

David Rose - *Wedbush Securities - Analyst*

I appreciate the color. That is helpful. Maybe we can do the same thing as we think about the margins. I know Ryan touched upon the mix shift of longer term. But as we think about even the mix shift going to 2016, you have a number of puts and takes. As we look at -- maybe talk about total care in terms of your service component adding to margins, and maybe even the mix shift in terms of treatment and analytics helping the margin story. Can you provide maybe a little bit more color about what can help margins in 2016?

Patrick Decker - *Xylem Inc. - CEO*

Sure. I'll hold back from giving any kind of perceived guidance for 2016. We'll certainly cover in that our February call. But in terms of the trend lines that are there, when you think about the impact this year of the unfavorable mix impact of dewatering, which is a small -- the oil and gas piece of our revenue is small but it was disproportionately profitable. So when you think about getting through Q4 and Q1, you then should expect to see a return to kind of our normal incremental margins that we've had in the past, that kind of 35% range. In terms of the things that help that, obviously, we'd be lapping the dewatering compare.

Secondly, you would get the normalized incremental margins on volume fall-through. Obviously we're going to continue to be driving lean and procurement and simplification opportunities. As we talked about at Investor Day, there obviously will be some reinvestment for growth, as well. But we'll outline all that for you in the February call.

David Rose - *Wedbush Securities - Analyst*

Okay. That's helpful. Thank you.

Patrick Decker - *Xylem Inc. - CEO*

You're welcome.

Operator

Your next question comes from Joe Giordano of Cowen.

Joe Giordano - *Cowen and Company - Analyst*

I just wanted to ask about the systems integration on the margin side. I know that's a longer term project, but it's a real opportunity for you guys regardless of the markets you're in. What are you seeing there in terms of, I guess it could be on the front end and the back ends? I know the front end you're looking at the sales side in terms of the CRM as well.

Patrick Decker - *Xylem Inc. - CEO*

We're pleased with the progress that the teams have made there. Obviously, it's a lot of work. It's more than just putting systems in, as you well know, Joe. It's a cultural change, and it's training and education and getting people accustomed with the tools. But the adoption rate on the salesforce.com, our CRM, is very impressive here in North America, which is where we've largely focused our efforts. We're now obviously, doing it in other countries as well.

We're doing a lot of work right now on the project quote configurator software that we've got to make that easier for our customers and our sales team to work with. And so we're in the middle of that implementation as well. I certainly echo your comments that that's going to be, in my view, a significant competitive advantage for us. We are at early stage in that. It is a multi-year implementation that we're focused on.

The other piece that you alluded to was the back end. And that was also a big piece of our simplification game plan that we laid out at Investor Day. And we already have some level of shared services implementation in North America. We're prioritizing Europe next. And we are very advanced in the planning phase and moving into execution on that.

Joe Giordano - *Cowen and Company - Analyst*

Great. Thanks for the color there. And I hesitate to ask a question on oil and gas for you guys because I know how small it is as a piece of the overall pie, but I'm hearing people talk about spending in North America being down potentially another incremental 20% next year. I know your business took a major hit this year, kind of an immediate hit as spending drops. So now if that was to happen next year again on the E&P side, how do you think your business would fare relative?

Patrick Decker - *Xylem Inc. - CEO*

Yes, I think that if you look at the direct exposures that we have in oil and gas, which by the end of this year would be somewhere between 3% to 4% of our total revenue. And it is really isolated largely to a certain number of branches in dewatering, and to some extent our Applied Water business, I wasn't suggest we're completely immune to it. But I think it's a manageable kind of impact for us. And so we keep a close eye to it. But a number of these locations, we're about as close to mothball as you can get and we've redeployed some of the pumps to other markets. So, I think the team has done a great job in sheltering us from another leg down in that area. But we certainly keep a close eye on it.

Joe Giordano - *Cowen and Company - Analyst*

That's kind of what I was thinking. And just last from me, I just want to touch on the buyback. It that's most active quarter in the Company's history. So know what you have left on the authorization, but wondering from a pace perspective, should we start thinking this is more representative of a more average rate?

Patrick Decker - *Xylem Inc. - CEO*

I wouldn't read anything into it. Again, we're going to be opportunistic. Like I said before, we have the capacity to do both that as well as acquisitions. Where we think it's smart to do so, we'll continue to do so.

Joe Giordano - *Cowen and Company - Analyst*

Great. Appreciate the time. Thanks.

Patrick Decker - *Xylem Inc. - CEO*

Thank you.

Operator

At this time there are no further questions. I would now like to turn the call back over to Patrick Decker for any additional or closing remarks.

Patrick Decker - *Xylem Inc. - CEO*

Great. Again, I want to thank you all for your continued interest in Xylem. Thank you for joining the call today. Look forward to updating you on fourth quarter, as well as our 2016 guidance in early February. So between now and then, safe travels and happy holidays. And we'll see you soon.

Operator

Thank you. This does conclude today's Xylem third-quarter 2015 earnings conference call. Please disconnect your lines at this time, and have a wonderful day.
