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PRESENTATION

Operator

Welcome to the Xylem third quarter 2014 earnings conference call. At this time, all participants have been placed in a listen-only mode and the floor will be open for your questions following the presentation.

(Operator Instructions)

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

Phil De Sousa - *Xylem Incorporated - VP of IR*

Thank you, Lori. Good morning, everyone and welcome to Xylem's third quarter 2014 earnings conference call. With me today are Chief Executive Officer, Patrick Decker and Chief Financial Officer, Michael Speetzen. They will provide their perspective on Xylem's quarterly results and discuss the full-year outlook for 2014.

Following our prepared remarks, we will address questions related to the information covered on the call. At that time, I will ask that you please keep to one question and a follow-up and then return to the queue so that we will have enough time to address everyone on the call. 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 A replay of today's call will be available until midnight on December 11. Please note the replay number is 404-537-3406 and the confirmation code is 812-5826.

Additionally, the call will be available for playback via the Investors section of our website under the heading Presentations. 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.

With that said, 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 10K and 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 could differ materially from those anticipated. Now please turn to slide 3. I will turn the call over to our CEO, Patrick Decker.

Patrick Decker - *Xylem Incorporated - President & CEO*

Thanks Phil and thank you all for joining us this morning. 2014 continues to be a critical year in the evolution of Xylem and the third quarter results we announced today reflect continued progress on our journey. By now, I hope you've all had a chance to review our press release and other earnings materials so I'll provide you with some headline thoughts and perspective on the quarter, our progress, and a look ahead.

So let's get started. Our teams are squarely focused on execution and as a result, we are delivering the fifth consecutive quarter of revenue and earnings growth as well as margin expansion. Our ability both to accelerate growth and continue to increase the efficiency of our operations is key to our success and ultimately the key to increasing shareholder value.

So let's get into the third quarter performance. Organic revenue growth was 1% while orders increased 8%. As a result, we exited the third quarter with record backlog, up 12% versus the prior year. We're continuing to focus on building our longer cycle backlog, which will help extend our visibility and ultimately support a longer-term growth profile.

I am encouraged by these results but the fact remains that some of our end markets are still challenged and continue to be slow to recover. Furthermore, we are cautiously monitoring economic conditions in key geographic markets, particularly in Europe.

Operating margin expanded 40 basis points to a record third-quarter level of 13.9%. This reflects continued progress on improving execution across Xylem. Just a few more comments on our overall performance. We improved our year-to-date free cash flow by $104 million versus the same period a year ago.

On the capital deployment front, we opportunistically repurchased an additional $30 million in common stock. This brings our full-year repurchases to $130 million and in the aggregate, the total return of capital to shareholders via repurchases and dividends increased year to date to $201 million, an increase of $94 million over the prior-year period, demonstrating our ongoing commitment to increasing shareholder value through disciplined capital deployment.

To wrap up the third quarter results, volume growth and improved operating performance drove earnings per share of $0.53 up 8% over the prior year. On a year-to-date basis, we have generated $1.35 and earnings per share, an increase of 21% versus the same period a year ago.

We had delivered a solid performance in the first nine months of the year. Importantly, our results show that we are moving the Company in the right direction and we remain on track to deliver our 2014 commitments.

Now turning to slide 4. We announced this morning that we are tightening our full-year EPS guidance, reflecting both our performance to date and our outlook for the fourth quarter. Given recent volatility in the foreign exchange rates, we now expect to generate approximately $3.9 billion in revenues.

In terms of operating income, we expect to improve our operating margin to approximately 13% and to deliver earnings per share growth of 15% to 19%. Shortly after I joined Xylem about seven months ago, I discussed a number of focused areas that we identified as opportunities to improve our operating efficiency and accelerate growth.

While there's not time this morning to cover in detail all the work that's underway, I did want to mention a few areas in which we continue to make good progress. All of our teams have been focused on improving execution and specifically driving productivity for growth.

For example, over the past couple of years, our Applied Water division has redoubled its efforts to get cost out of the system and streamline their processes. As a result, they been able to reinvest some of those savings into R&D and innovation which is led to new products that are hitting the marketplace now and there's much more to come.

We are confident that this will ultimately return that part of our business to better the market growth. Importantly, they're accelerating innovation while continuing to improve their operating performance. In the third quarter, the Applied Water division delivered an all-time high operating margin and that was achieved in an environment of mixed market conditions.

Now we are still in the early days of this work but I am pleased with this measurable progress. We've also discussed the opportunity for Xylem to accelerate growth by integrating our front end commercial assets and capabilities. In addition to the realignment of our sales organizations we have also been working to develop a multi-faceted IT solution that will better enable commercial excellence across the Company.

In other words, making it easier for customers to do business with us and for our sales teams to have the right tools to reduce core preparation time, share customer leads from one business line to another and work within a more standard ERP system. This will enable our sales teams to accelerate growth and will be a fully integrated set solution that is rolled out globally.

Let me touch on one component of that work. The deployment of a new customer relationship management, or CRM platform. Over the last few months, a dedicated team has been designing and programming our new sales and marketing process.

They have worked at a fervent pace and as a result, we recently launched our new CRM tool, salesforce.com in several businesses across our Americas region and Australia. This was an important milestone.

CRM allows us to present ourselves to key customers as one Company, capitalizing on the unparalleled expertise we possess in multiple verticals to bring greater value to our customers while growing our own business.

This rollout will continue and we expect to have it fully deployed by the end of 2016. And I do look forward to sharing some successes on this front in the coming months.

Finally, we're also continuing to execute our plans to accelerate growth by focusing our resources and efforts in faster growth regions, namely in emerging markets. For the quarter, revenues from emerging markets increased 10% and the teams succeeded in winning some larger project bids that are increasing our backlog.

We intend to intensify this focus and sharpen our strategy in order to capitalize on attractive opportunities we see in these developing regions. As we look into 2015, China and the Middle East will be the most important areas for us to accelerate further localization of our supply chain and building stronger local capabilities. Other fast growth markets such as Brazil, India and greater Asia, remain important to us and we will be further assessing specific growth accelerators in those markets as well.

I firmly believe that no Company is better positioned than Xylem to lead in this industry. Our ability to leverage our global footprint and breadth of solutions and expertise to address our customers most complex water issues and deliver strong results is unmatched.

But we must execute aggressively and continue to evolve our organization and make the most of our global assets and strengthen of our team. With that, let me turn the call over to our CFO, Mike Speetzen, to walk you through the results and the Company's financial position in more detail. Mike?

Michael Speetzen - *Xylem Incorporated - CFO*

Thanks, Patrick. Please turn to slide 5. We generated revenue of $963 million, essentially flat to the prior year, reflecting both impacts of our divestiture and unfavorable foreign exchange translation. On an organic basis, revenue was up 1%.

From an end market perspective, we saw strength in industrial and commercial, partially offset by declines in public utility and residential. Industrial was up 3%, with growth in the US and emerging markets partially offset by weakness in Europe. As a reminder, Xylem serves a wide variety of industrial customers with applications from both our segments. As for the third quarter specifically, we generated industrial growth in Water Infrastructure segment and had flat performance in Applied Water. I'll cover both of these in more detail in the next two slides.

In commercial, strong markets across all regions helped us drive 6% growth in the quarter. Europe was exceptionally strong, up double digits with growth primarily attributable to the successful launch of new products. In the US, leading indicators have been generally positive for several quarters and we are starting to see the impact of that recovery in our business.

Wrapping up in commercial, we continue to see strong performance out of the emerging markets, particularly in regions such as the Middle East, Asia and Latin America, where each delivered double-digit growth. Revenue from the Public Utility market was down 3%, slightly below our expectations. The year-over-year decline primarily reflects a continuation of a soft CapEx or environment in developed regions that we experienced last year and during the first half of 2014.

It's important to note that our order trends in this market have generally improved in recent quarters and we are seeing some positive signs in our long-term backlog, suggesting that the market has stabilized. OpEx activity remains stable with growth in both the US and Europe. I'll cover on more specifics by segment but overall, we saw strong revenue growth from emerging markets, up 10% and modest growth in the US,up 4%, partially offset by a 6% decline in Europe.

Operating income of $134 million was up $4 million, or 3% over last year. As Patrick mentioned, despite modest topline growth, we delivered a record third-quarter operating margin of 13.9%, up 40 basis points. We continue to deliver strong segment performance as margins expand 110 basis points to 15.6%. This was partially offset by higher corporate expense.

Corporate expense was $16 million, reflecting a normal quarterly spend rate. Cost reductions totaled $46 million and included approximately $10 million of restructuring savings with the balance coming from sourcing and Lean initiatives.

Partially offsetting these tailwinds was inflation of approximately 270 basis points and unfavorable price and mix in our Water Infrastructure segment. Wrapping up on the consolidated results, organic growth and solid operational performance, coupled with strong execution against our cost reduction initiatives, resulted in EPS of $0.53, up 8% versus the prior year.

Core operations drove the year-over-year EPS improvement, contributing $0.03. The growth includes $0.04 of restructuring savings as well as $0.03 of year-over-year corporate expense headwind. And finally, lower share count contributed a benefit of $0.01 in the quarter.

Now let me provide more details for each of our reporting segments. Please turn to slide 6. Water infrastructure reported revenue of $619 million, up 1% on an organic basis. Regionally, we saw the most significant growth come from emerging markets, which were up 13%. US revenue increased 7% but Europe declined 7% overall.

I'd further summarize our revenue performance as follows: Test applications were up 4%, posting growth for the fourth consecutive quarter. Note that based on performance to date and expected growth in the fourth quarter, this platform is on track to achieve record full-year topline performance.

Transport was up 3% overall, with noteworthy regional differences. In the US, we continue to see strong performance in Industrial Transport applications, including mid-teens growth in dewatering. In Europe, the business was down low single digits, primarily due to lower book and bill activity in France and the ramp down of the AMP 5 cycle in the UK.

Finally, Treatment revenue was down 15%. This decline reflects a lower deliverable project backlog in the US and Europe that we had entering the quarter and the timing of projects in emerging markets. While we delivered minimal revenue growth overall, perhaps a more important result was our strong orders performance.

For the third quarter, we booked orders of $680 million, up $63 million, or 10% year over year, and 11% on an organic basis. During the fourth quarter, Water Infrastructure had a total backlog of $656 million. Of this amount, $380 million is scheduled to deliver in the fourth quarter, an increase of $27 million, or 8% relative to a year ago. The balance is scheduled to be delivered in 2015 and beyond.

For the third quarter, we're reporting operating income of $97 million, an operating margin of 15.7%. Performance was driven by the increase in organic volume and savings from cost reductions, which totaled $29 million, including approximately $7 million in restructuring savings, with the balance coming from sourcing and Lean initiatives. Partially offsetting these tailwinds was inflation of approximately 3% as well as unfavorable price and mix.

Let me now turn to slide number 7 to address our Applied Water segment. We delivered revenue of $362 million, up 1% year over year. Regionally, we saw growth come from the US and emerging markets, which were both up 2% overall. Europe however declined 1%. By application, building services grew 2% and industrial water was flat. Irrigation, which represents less than 10% of Applied Water revenue, was down 2%.

I further summarize our revenue performance as follows: in the US, we generated broad-based growth across both Commercial and Industrial Water applications. Our emerging market performance was driven by mid-teens growth in China and was partially offset by weakness in Eastern Europe and Latin America.

As I mentioned, Europe was down overall, as weakness in Residential and General Industrial markets was partially offset by strength in Commercial. Operating margin expanded 240 basis points to 14.6% year-over-year, a record level for this segment.

Cost savings from sourcing and Lean Six Sigma and to a lesser extent, restructuring, increased margins by 440 basis points and more than offset inflation. We also saw a positive lift from volume and price.

Now let's turn to slide 8 to cover the Company's financial position. Xylem maintains a strong cash position with a balance of $529 million at the end of Q3, with approximately 90% held outside of the US. We remain committed to our balanced capital deployment strategy, which is to maintain and grow the business while also enhancing shareholder returns through dividends and share repurchases.

Over the last three quarters, we invested $77 million into capital expenditures and we returned $201 million to shareholders. This includes a 10% increase in dividends per share and $130 million under our share repurchase program. We also generated $176 million of free cash flow, largely reflecting higher income and lower CapEx spends.

Relative to the prior year, our free cash flow performance improved by $104 million, with free cash flow conversion increasing to 77% from 45% last year.

Please turn to slide 9 and I'll turn it back over to Patrick to cover our 2014 guidance.

Patrick Decker - *Xylem Incorporated - President & CEO*

Thanks Mike. So let's start with the top line. We anticipate 2014 revenue of approximately $3.9 billion, which reflects organic growth of 2% to 3%. For water infrastructure, we expect organic revenue growth to 3% to 4% and for Applied Water, revenues will likely be flat to up 1% organically.

I'll remind everyone that the revenue range already reflects the reduction in revenue attributable to the UK Valves business we divested and now also reflects approximately $30 million of unfavorable foreign exchange translation that we expect to impact our fourth quarter results. Segment margins are anticipated to be in the range of 14.3% to 14.6% and operating margins are projected to be in the range of 12.9% to 13.2%.

We are pleased with the execution of a broad-based restructuring action this year, from which we expect to achieve savings of $17 million. This adds to the carryover savings of $25 million from actions executed in 2013 and brings our total savings to $42 million. Excluded from our overall results is 2014 restructuring and realignment costs of approximately $40 million to $50 million, the $11 million gain on sale of our UK Valves business and special tax items.

So overall, we now anticipate delivering earnings per share of $1.92 to $1.98 and I would highlight that our midpoint guidance remains unchanged at $1.95. Mike is going to walk you through the full-year and fourth-quarter details in a few minutes. But first let me provide some additional highlights around our end market outlooks.

Please turn to slide 10. This slide summarizes our expected 2014 organic revenue performance by end market. Beginning with Industrial, our largest end market, representing 45% of total revenues, through the first nine months, organic revenue was up 3%, slightly better than expected, driven by strength in the US and emerging markets.

For the full year, we expect revenues to come in towards the high end of a 1% to 3% range. This assumes continued growth in the US and emerging markets and that conditions in Europe do not deteriorate further.

Public Utility at 34% of total revenue is our second-largest end market. Through the first nine months, organic revenue grew 3%, reflecting strong emerging market performance and stable maintenance and repair activity in the US and Europe. While we do expect some organic growth in the fourth quarter, there is potential risk for delays in some projects scheduled to ship before year end.

With that said, we have adjusted our full-year expectation for Public Utilities to 1% to 3% from our previous outlook of 2% to 5%. One final note on Public Utilities. With a positive third quarter order performance and the current view on our project pipelines, we remain positive on this sector in 2015.

Moving to Commercial, which represents approximately 11% of our revenue we are maintaining our full-year outlook, which calls for flat performance year over year. In addition to the flat year-to-date performance, this outlook reflects growth from new product launches and an improving outlook for our US business, offset by weakness in Europe.

There is also no change to our Residential market outlook. We continue to expect low single-digit growth driven by the US housing recovery, partially offset by continued weakness in southern Europe. And lastly, at just 3% of our business, we expect full-year Agriculture revenue to be flat year-over-year.

So the takeaway here is that we continue to see mixed market conditions, particularly by region. US non-res markets have shown signs of improvement, public utility OpEx remains generally stable and the CapEx environment appears to be incrementally better. We are, of course, closely monitoring Europe.

So please turn to slide 11 and I'll turn it back to Mike to cover some additional details on the guidance.

Michael Speetzen - *Xylem Incorporated - CFO*

I'd like to spend a minute calibrating on the evolution of our full-year guidance. In February, we issued a guidance range of $1.85 to $2 with a midpoint of $1.93. This past July, we raised the low end of our guidance by $0.05 and the related midpoint by $0.02 to $1.95, reflecting strong first-half performance, slightly offset by the divestiture impact of the UK Valves business.

Given the significant decline in the Euro, we're taking into consideration a $0.01 headwind for foreign exchange translation in the third quarter and a $0.03 headwind for foreign exchange translation in the fourth quarter. Despite this headwind, we are maintaining our midpoint guidance, essentially offsetting the negative impact from foreign exchange with additional productivity.

Now let's talk about the fourth quarter. We expect revenue of slightly more than $1 billion, with organic growth in the range of 1% to 4%. Let me color some of the key assumptions we've made relative to our revenue projection. We've assumed a US dollar to Euro foreign exchange rate of $1.27.

We expect low single-digit organic growth in the US, down low single digits to flat performance in Europe and emerging market growth of more than 10%. We entered the quarter with a total of $504 million of shippable backlog which represents approximately 49% of our expected fourth-quarter revenue. This highlights the fact that we still have a fair amount of book and term business to deliver in the quarter.

There are two other items I'd highlight with respect to our guidance. First, fourth-quarter operating tax rate is expected to be approximately 21% and second, fully diluted share count is expected to be approximately 183 million.

With that said, please turn to slide 12 and let me hand the call back over to Patrick for some final comments. Patrick?

Patrick Decker - *Xylem Incorporated - President & CEO*

Thanks again, Mike. I'm pleased with our results this quarter and encouraged by our continued progress. Solid execution has us on track to deliver on our financial commitments for the year, which includes generating record revenue and earnings per share.

At the same time, we continue to focus on building those important capabilities that will enable us to extend our track record, deliver sustainable growth and increase shareholder value. Despite a year of tremendous changes at Xylem, our teams have remain focused on the future, identifying ways to work more efficiently and more collaboratively to leverage our full suite of products and services to our customers.

This work will continue and I firmly believe that we will elevate our performance across Xylem and it will help us to build our position as the global leader in water. Operator, we can now begin the Q&A session.

QUESTIONS AND ANSWERS

Operator

The floor is now open for questions.

(Operator Instructions)

Ryan Connors, Janney Montgomery Scott.

Ryan Connors - *Janney Montgomery Scott - Analyst*

Good morning.

Patrick Decker - *Xylem Incorporated - President & CEO*

Good morning.

Ryan Connors - *Janney Montgomery Scott - Analyst*

I wanted to talk a little bit about the pricing environment. It wasn't something that you covered in the prepared remarks there but I know that's been a headwind recently; it seems to be stabilizing a bit, especially in Applied Water but if you could just talk to us about kind of the pricing dynamics.

Michael Speetzen - *Xylem Incorporated - CFO*

Yes, Ryan, let me at least cover some of the financial implications. In the third quarter we saw about 10 basis points, which is pretty similar to what we saw in the second quarter. And the way I'd characterize is Water Infrastructure continues to see price pressure in the neighborhood of about 40 basis points negative year over year.

Applied Water, we've continued to see positive progress; they're reflecting about 0.5 point worth of positive pricing. I think many of the dynamics that we've talked about in the past are still there and they were evidenced by many of our peers, who reported that sales are still not at the levels that they have been historically which means that we've got excess capacity. And that's putting significant price pressure across the marketplace, as we see it today.

Patrick Decker - *Xylem Incorporated - President & CEO*

And I would only add, Ryan, that I think it speaks to what we saw in Applied Water and I think we're going to see it elsewhere is all the more reason it's critical that we continue to ramp up our new product development pipeline. We've got a number of things to market. We've got a number of things in the pipeline but any time you're able to do that, it gives you something new to talk about, it gives you a competitive differentiation and is very helpful on the pricing side.

Ryan Connors - *Janney Montgomery Scott - Analyst*

And I guess the related follow-up would be, as you look at this nice order growth you had in the quarter, would -- are we to assume that those orders reflect the kind of price dynamics you just mentioned, Mike, pressure in the water infrastructure side and some positive -- modest positive momentum in that order bulge on the Applied Water side?

Patrick Decker - *Xylem Incorporated - President & CEO*

Yes, I think in general, those would be the general characteristics that we would see and as we indicated, the order growth is predominantly in the water infrastructure segment. It's not only the core pumping business, for example, but we're also booking more on the project business which is a more difficult one to give you commentary on the pricing side because each one of those tend to be unique in nature.

Michael Speetzen - *Xylem Incorporated - CFO*

I think it's important call out, Ryan, that of the 8% organic orders growth that we had in the quarter, roughly 3% of that was from a couple of the big projects that we announced in the emerging markets over the course of the quarter.

Ryan Connors - *Janney Montgomery Scott - Analyst*

Got it. Thank you.

Patrick Decker - *Xylem Incorporated - President & CEO*

Thank you.

Operator

Mike Halloran, Robert W. Baird.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

Good morning, everyone.

Patrick Decker - *Xylem Incorporated - President & CEO*

Good morning.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

So could we just talk about -- a little bit about what your visibility to 2015 is right now? Obviously you made some positive commentary on the 2015 environment for your Public Utility side. Maybe if you could just take us a little deeper look on what you're seeing from a customer base at the end of next year, what the commentary looks like, and what gives you confidence in that public utility side?

Patrick Decker - *Xylem Incorporated - President & CEO*

Sure, Mike. Let me open with a few comments here and then Mike can kind of walk you through specifically what we do know about 2015.

I'd say, first of all, it is tough in this environment to assume or make any specific predictions at this stage. Obviously with the typical kind of slowdown in Europe in the third quarter it's tough to kind of draw a read in Q3. It's really from September and October and as we close out Q4, so how we close out Q4 is going to play a much bigger part in how we determine or formulate the views around 2015.

I would say that we are certainly planning, from an internal standpoint, around a low growth environment. We really want to make sure we keep our teams focused on driving the productivity for growth and the cost efficiencies. We do see some mixed bright spots that are out there.

Certainly the growing backlog that we've seen, some of the longer-cycle projects that we brought into the pipeline are encouraging. But I'd say it's too early to tell right now in terms of giving you a read on 2015.

Michael Speetzen - *Xylem Incorporated - CFO*

Mike, and I'd give you some specifics where we do at least have a beat on both headwinds and tailwinds as we head into next year. And I think given where the foreign exchange rates are and I'll use the Euro because it's our biggest exposure; if it's at about $1.27, we think that's going to be about a $40 million topline headwind and pose about an $0.08 EPS headwind.

The reason being is we have an awful lot of profit held in the Euro currency that goes through our Switzerland headquarters over in Europe. Pension, we anticipate a couple cents worth of headwind and that's anticipating what the discount rate could be as well some of the mortality tables that have been updated.

But the good news is we have carryover restructuring savings, so the actions that we've initiated in 2014, we're picking up some of that benefit that Patrick spoke to in his prepared remarks. We should pick up about an incremental $20 million worth of savings in the first half of next year.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

That's very helpful. And then the follow-up is when you look at the Applied Water margins, could you just talk about the sustainability of those levels? Whether or not there was any stocking benefits you guys saw from the new product launches and what the right run rate on a forward basis looks like?

Patrick Decker - *Xylem Incorporated - President & CEO*

Yes, I'd say there's certainly would have been a little bit of a stocking benefit but not enough to really move the needle. I'd say we certainly do feel that the margins in that business are sustainable.

I mean, when you think about the fact that the team has achieved that level of improvement despite being in a no growth environment and in some cases, actually facing headwinds, that is a business that also levers nicely whenever we see some topline growth.

I actually think that with the new product introduction that we're bringing out to market right now, that's going to return us to growth in that business and I think you'll see some nice leverage fall through. So we would expect to continue to see margin expansion in that business as we return to growth.

Mike Halloran - *Robert W. Baird & Company, Inc. - Analyst*

So I appreciate the color.

Patrick Decker - *Xylem Incorporated - President & CEO*

Thank you.

Operator

Nathan Jones, Stifel.

Nathan Jones - *Stifel Nicolaus - Analyst*

Good morning, everyone. Good morning. When we were down at WEFTEC this year, we heard some pretty positive outlooks from people there on the project side in the US. Can you talk about what you're seeing in that market and maybe a little bit about global as well?

Michael Speetzen - *Xylem Incorporated - CFO*

Yes. Nathan, I think we're seeing that show up in our results and I'll give you just a little bit of a preview around our Americas region. We saw positive orders growth; in fact, they were of one of the largest components of the 8% that we saw within the quarter.

The Treatment business specifically was up, call it, in the low 20%s. And that's, I think, indicative of the commentary that we've given in the past, which is we've seen that market have significant headwinds over the past couple of years. This year, that dynamic appears to be changing.

I think for us the question is how much is dealing with pent-up project demand versus new growth, new projects coming online. And I think that's the piece that continues to be in the forward-look that we have. But overall, I think it's a big part of why, overall, we remain positive on that sector.

Nathan Jones - *Stifel Nicolaus - Analyst*

Just focusing in on Treatment there. Obviously some pretty negative revenue comps in this quarter which is from weak orders historically. When do we lap that and start seeing growth based on what's already in your backlog?

Michael Speetzen - *Xylem Incorporated - CFO*

Yes. I would anticipate us -- there will be some lapping as we get into the first half of next year but if you think about the nature and the timing of these projects, these can be anywhere from 12 to 18 months. So it will be more of the second half of 2015 is what I would anticipate.

We obviously still have a lot of work to do to build the details out. We're in the middle of our planning process right now so we'll provide more perspective on some of those linearity details when we provide guidance in February.

Patrick Decker - *Xylem Incorporated - President & CEO*

And the good news is that in a number of cases, part of the reason for the revenue decline was a push out of projects. So the project hasn't gone away; it's just -- the timing has shifted to the right. So that should help us as we get into 2015 as well.

Nathan Jones - *Stifel Nicolaus - Analyst*

Okay. And just a follow-up on Europe, down 6% in this quarter; outlook for down low single digits in the fourth quarter. What do you see is the risk there to actually just achieving that low single-digit rate with what we're seeing in Europe at the moment?

Patrick Decker - *Xylem Incorporated - President & CEO*

Nathan, if I look at what we had in the third quarter -- the 6% down, there was a good portion of that, that related to projects that's pushed out of third quarter into fourth quarter and into first quarter of 2015. So we've got a pretty good idea of what the book-to-bill rates are, the backlog levels as we go into the fourth quarter support the range that we've given. And we are anticipating that we will have a little bit of weakness in our book-to-bill business.

What I can tell you is that we have been monitoring our results obviously on a weekly basis. October is lining up consistent with the assumptions that we have built into the guidance so we haven't seen anything at this point that tells us anything different is going to materialize.

Nathan Jones - *Stifel Nicolaus - Analyst*

That's helpful. Thanks for taking my questions.

Patrick Decker - *Xylem Incorporated - President & CEO*

Thank you.

Operator

Jim Giannakouros, Oppenheimer.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Good morning.

Patrick Decker - *Xylem Incorporated - President & CEO*

Good morning.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

It seems like you're a little bit ahead of plan as far as gaining traction on your cost take-out or your better efficiencies versus your plan entering the year. Can you -- if I'm correct, can you kind of highlight where exactly you're accelerating or the sources of that incremental margin benefit versus where we were anticipating the kind of cadence for 2014 earlier in the year?

Patrick Decker - *Xylem Incorporated - President & CEO*

Yes. There were a few things that we did, Jim. One is, we've obviously taken the restructuring savings up. That is a direct reflection of the fact that, given some of the weakness we saw earlier in the year, the teams moved out more aggressively to make sure we were getting the actions in and picking up additional benefits.

I would say that we continue to have a hard-press around areas like Lean Six Sigma and our global sourcing as areas of opportunities. And that continues to play well for us as the teams are working hard given some of the ambiguity we've had in the topline and some of the jitters we've heard in the market.

That's been the appropriate action response from the team. So we're just seeing a lot of that play through.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Great. That's helpful. Thanks. And as far as M&A, if you can give us an update on how your pipeline is looking; valuation in the -- your targeted areas, and I guess a timing update as we enter 2015, just a couple months from now?

Patrick Decker - *Xylem Incorporated - President & CEO*

So I would say, first of all, we continue to cultivate the pipeline. We certainly lifted the pause on M&A and so certainly, the last few months after my arrival, the teams have been fervent about developing that pipeline again.

The good news is these are all targets that we've had in the pipeline for awhile that we've stayed close to. So the pause didn't hurt us there at all. We do expect to be active in 2015. Of course, the timing is less predictable in terms of when we would actually be able to pull off.

We said before and I would stand behind that, that we'd be looking to target about 2% to 3% of our total revenue in terms of size of acquisitions. That's our target. We continue to actively cultivate that.

The acquisitions that we would do through 2015 would likely be bolt-on, kind of close to the core and then really be in focusing on developing that pipeline into 2016, on some of the larger-scale, maybe, adjacency-type acquisitions.

Jim Giannakouros - *Oppenheimer & Co. - Analyst*

Thank you.

Patrick Decker - *Xylem Incorporated - President & CEO*

Thank you.

Operator

Kevin Maczka, BB&T Capital Markets.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Thanks, good morning.

Patrick Decker - *Xylem Incorporated - President & CEO*

Good morning.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Question on your comments about ramping in China and the Middle East. I'm wondering if you can say a little bit more there about what kind of investments you'll have to make to make that happen? How much you think that can move the needle for you and if you can give any sense of timing on when we might start to see some of that?

Patrick Decker - *Xylem Incorporated - President & CEO*

Sure. Let me start by saying that even with the intensified focus on China and the Middle East, we certainly would not be looking to go outside of our CapEx range of between, say, $120 million to $130 million per year. So we got opportunities by way of which we've kind of reprioritized our deployment of capital internally, doing it much more as the one company approach as opposed to a collection of businesses. And that's spurring up some capital to put behind some of these more focused plays like in China and the Middle East.

In terms of the type of actions that we are already working on and putting in place and that will continue through 2015 is a heavy focus on further localization of things like product design. Our R&D capabilities locally, building out key account management capabilities. We've got some great relationships with customers there already that, as we begin to really market to them, the full portfolio of capabilities that we've got beyond just the Flygt pump, as an example.

They're really driving a lot of demand for that but in many cases, we don't have the localization requirements to be able to meet that. So it's really going to be more a matter of investment of management time and attention than it is financial capital per se itself.

In terms of when we expect to begin seeing real benefits of that. I mean, obviously, we're already growing nicely in these markets but we're going to be setting a much more aggressive, ambitious kind of target for ourselves relative to market growth in those areas. And I would certainly expect to see the benefit of that begin to come through in late 2015 into 2016.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Okay, and just as a follow-up, you also mentioned, I think, more of a general comment about rebalancing the portfolio and new product introductions. Can you just say a little bit more there? How much more aggressive are you getting there because that's been part of your initiative for some time?

Patrick Decker - *Xylem Incorporated - President & CEO*

Yes, see, so we spend today anywhere between 2.5% to 3% of our total revenue on R&D. I don't envision that in the near term, that number necessarily changes very dramatically.

Obviously, over time here, you heard us talk about productivity for growth mindset, which is all about how do we get out the next 200 to 300 basis points of revenue of cost out of the system, so that we've got the flexibility where we need to, to put that money back into innovation, technology, systems development, et cetera.

But that's going to be over a multi-year timeframe. In the immediate term, it's really been a matter of reprioritizing where the teams are investing their R&D dollars.

We do believe with a heavier focus on emerging market growth as well and building local capabilities from the design standpoint, we'll actually get more bang for the buck in terms of every dollar that we spend. And obviously as we grow the topline, by definition even holding our percentage constant in terms of R&D, is going to put more absolute dollars of investment into the system.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Okay --

Patrick Decker - *Xylem Incorporated - President & CEO*

The last thing I would say on that is one of the capabilities that we are focusing on building right now but we don't have consistently across the Company is what we call industry vertical marketing capability where we sit with our customers and really understand the full suite of what their water challenges are.

And then map that against what our current offering is. And then fill those gaps either with new product development. It could be business model innovation but it can also inform our M&A pipeline in terms of where we want to fill the gaps.

Kevin Maczka - *BB&T Capital Markets - Analyst*

Got it. That's helpful. Thank you.

Patrick Decker - *Xylem Incorporated - President & CEO*

Thank you.

Operator

Chip Moore of Canaccord.

Chip Moore - *Canaccord Genuity - Analyst*

Morning, thanks. Another nice quarter for the dewatering business, up mid-teens. Can you just walk us through where you're seeing pockets of strength are?

Michael Speetzen - *Xylem Incorporated - CFO*

Yes. Overall, the business was up kind of mid-single digits. The US is where we saw the significant performance in the teens. And it was really related to oil and gas.

I mean all of the underlying markets seem to be doing well with the exception of the mining market which is down kind of low single digits. But the oil and gas area has continued to be robust for us as we've expanded throughout the US and that's really been the driver of the growth.

Chip Moore - *Canaccord Genuity - Analyst*

And just as a follow-up, maybe you could talk about oil and gas exposure just for the Company as a whole. With crude coming down, are you seeing any impacts there? Thanks.

Patrick Decker - *Xylem Incorporated - President & CEO*

At this point, no. We've got about $200 million to $250 million of exposure and it's relatively broad and I would say there on the natural gas side, that's where we've seen probably the biggest pick-up. But even on the crude side, we haven't heard much in terms of pullback. So things have held relatively stable there.

Operator

David Rose, Wedbush Securities.

David Rose - *Wedbush Securities - Analyst*

Good morning. Thank you for taking my call. A couple -- (multiple speakers).

Morning. On the SG&A side, can you provide us a little bit of color on some of the headwinds you may have faced from the CRM and some of the other initiatives? I mean, you had great cost control but what were some of the offsets?

Michael Speetzen - *Xylem Incorporated - CFO*

Yes, I mean, a couple of things, David. I mean, we're down year to date $32 million from where we were last year, almost a couple hundred basis points and it's been primarily around the G&A side where we've gone from being kind of mid-9% down to under 9%. A continued focus for us as we try and drive the efficiency in the business, obviously some of that's coming from leverage of the topline and the balance is really coming from some of the actions that we've taken.

As it relates to the quarter, I would say that we saw a more typical corporate level of spend. I assume that's kind of what's underneath the question that you have. There's really two dynamics there.

One, if you remember last year, third quarter we were coming off of a pretty bad performance in the second quarter and so we had taken a significant number of actions to defer cost initiatives within corporate. Then you have on the other side of that. This year, we had deferred things out of the first half, if you remember some of our commentary around concerns over the weakness we've seen in January, February related to the weather and we essentially greenlit, I remember those initiatives so CRM is a prime example.

It's not a significant amount of outlay. You're talking about something that's in the $1 million, $1.5 million range. But in totality, we were essentially moving forward given that we've gotten more comfortable with the topline environment.

Patrick Decker - *Xylem Incorporated - President & CEO*

And I would just add to that. I think that as I look at where we are as a Company and organization right now, there's clearly an opportunity to continue drive business simplification, and drive operating efficiency and that same approach is going to be applied to our corporate cost. Now as we standardize certain things, integrate certain things, ERPs, et cetera, you may see some cost shift around between the segments in corporate but the goal is to reduce SG&A further overall as a Company.

I would also say that when I look at the capabilities as a Company, that we need to augment ISS opportunities like simplification, where we are going to be organizing differently here in the very near future where we'll be organizing our global sourcing and our Lean deployment differently to drive better standardization across the Company. Second of all, I talked about the need to improve our Xylem-wise focus on innovation. Really, increasing our focus on disruptive technologies as well as better coordination amongst all of our different businesses so we would be organizing differently around that.

And then third, as I mentioned earlier, we need to do a better job of getting voice to the customer and really augmenting our capabilities around certain key industry verticals and so there will be some moves we're making on that front of well. All of those together, in my view, will be with the spirit of driving an approach as one Company and drive operating efficiency and growth.

David Rose - *Wedbush Securities - Analyst*

Okay, that's helpful. And then one follow-up, if I may, on the inflation front. It seems relatively high versus what we're seeing on a global basis and maybe you can provide some color on where you're seeing the inflation?

Michael Speetzen - *Xylem Incorporated - CFO*

Yes I mean there's a couple things David. One is, you have to remember that we have the pay increases included so we're not including just the material inflation, we're including labor inflation in that calculation as well.

I would say that there are pockets where we're definitely seeing a reduction and we've seen inflation coming down. We're now sitting around 2.7%, 2.8%.

I can't point to any specific item. I'd say things have, for the most part, stabilized. We're not seeing any significant movements up or down at this point. And as we look forward into next year, we think the levels are going to be pretty consistent with what we're seeing today.

David Rose - *Wedbush Securities - Analyst*

So when you start to lap the labor inflation?

Michael Speetzen - *Xylem Incorporated - CFO*

Well, we continue to give increases every year so you've got third quarter -- I'm sorry, first-quarter lapping but you're essentially lapping what you've done in terms of pay raises that go in effect at the end of the quarter.

David Rose - *Wedbush Securities - Analyst*

So there wasn't really any from your perspective, a catch-up that you implemented early on. You're just --

Michael Speetzen - *Xylem Incorporated - CFO*

No, this is just typical merit increases that we do each year.

David Rose - *Wedbush Securities - Analyst*

Okay. That's perfect. Thank you very much.

Michael Speetzen - *Xylem Incorporated - CFO*

You bet.

Operator

Brian Konigsberg, Vertical Partners.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Yes, hi, good morning.

Patrick Decker - *Xylem Incorporated - President & CEO*

Good morning.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Morning. Mike, maybe actually the first one for you, actually just coming back to FX. I was surprised just as far as the impacts you noted for 2015. $40 million of revenue and $0.08 of profit.

I know you mentioned something about that. Just a little, maybe a little more color on that. I mean, an $0.08 hit on $40 million of revenue; it's almost like a 40% margin fall through on that. It just seems externally high.

I don't sense that we had that type of dynamic in the past. Is that new? Is something kind of changing the sensitivity to FX? Or is it -- maybe just touch on that a little bit more.

Michael Speetzen - *Xylem Incorporated - CFO*

Yes, well, I mean, we definitely saw it play out in the third quarter and we anticipate in the fourth quarter. And the commentary around next year, again -- using the Euro is a proxy because we obviously want to see how rates settle out and bake that into the final guidance that we'll provide in February.

But the long story short is as we've discussed in the past, given the structure that we have in Europe, there's a significant amount of our profit that goes through Switzerland. And that is a Euro-denominated functional currency and so when we translate that profit back, it is at about a 40%, 45% drop rate. So on that $40 million worth of revenue, again assuming $1.27 to EUR exchange rate, that's going to convert over and give you about $0.07 to $0.08 headwind from an EPS standpoint.

Brian Konigsberg - *Vertical Research Partners - Analyst*

And there's nothing to suggest that, that's the same on both sides of the coin; correct? I mean --

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Michael Speetzen - *Xylem Incorporated - CFO*

In terms of (multiple speakers) --

Brian Konigsberg - *Vertical Research Partners - Analyst*

If we see a striking of the Euro, it's going to work with the other way. I just want to make sure --

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Michael Speetzen - *Xylem Incorporated - CFO*

Yes, absolutely.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Okay. The other question I had was -- actually just around just more cost savings. So you're expecting another $20 million to carry over into 2015. Maybe just talk about where you think we are?

How much more low hanging fruit exists? I don't know if you want to put it in innings type of analogy but how much more obvious restructuring is there to do versus just kind of growing the business and getting savings to leverage?

Patrick Decker - *Xylem Incorporated - President & CEO*

Yes, I would say that the analogy of low hanging fruit, I wouldn't suggest it's low hanging. So I think that everything we do at this point in time is going to have to be strategic around where we look to drive efficiency, redeployment of capital and cost. And so that's really the work that we're doing right now as we finalize our plans around 2015, is what more is out there for us to get in 2015 and even in 2016 and 2017.

So I would say I would characterize it that we are in the middle innings at this point. I think the teams done a good job of executing the restructuring over the last year and a half. As I mentioned earlier, I do believe that there's another couple of 300 basis points of cost and percentage of revenue that can be taken out of the system over time.

But again, that's going to be a multi-year journey. I think you'll see some steady progress against that in 2015 and 2016. But again, we'll have more to say on that in the February earnings call.

Brian Konigsberg - *Vertical Research Partners - Analyst*

So just to be clear, that couple hundred basis points, is that going to be driven by additional restructuring or is it -- it's just going to be topline leverage to get there?

Patrick Decker - *Xylem Incorporated - President & CEO*

It's going to be a combination of the two.

Brian Konigsberg - *Vertical Research Partners - Analyst*

Okay. Thanks very much.

Patrick Decker - *Xylem Incorporated - President & CEO*

Thank you. Talk you later.

Operator

Joe Giordano, Cowen.

Joe Giordano - *Cowen and Company - Analyst*

Hi guys. How are you doing? Thanks for taking the call. Just wanted to talk about orders for a little bit. So second consecutive quarter over $1 billion, that's a nice number.

We've seen some big orders out of the emerging markets the last couple so I just wanted to get your sense on the sustainability of that kind of run rate in terms of orders. And outside of those big project wins, kind of where have you seen the geographic breakdown of the remaining orders?

Patrick Decker - *Xylem Incorporated - President & CEO*

Let me maybe touch on the geographic breakdown first. Definitely the emerging markets continue to be strong for us, places like China and greater Asia, specifically as we've seen continued project wins and those bookings have maintained robust.

I would say in the Americas for some of the comments that I made earlier, we've seen strength pretty much across all of our water infrastructure lines, primarily around treatment. So obviously, a good indicator of some of the project activity and things starting to stabilize and pick up, growing it to next year.

Europe has been a bit mixed. The Transports out of our business was positive in the third quarter. The other elements were essentially flat to down.

And I'd say that's going to be the area that we're going to be spending a lot of time and making sure that we're keeping an eye on. The other areas seem to be holding up well and at this stage, we think that the way we've got the teams aligned, the opportunities, the project funnels that are out there, they're getting a bite at all the appropriate opportunities.

Michael Speetzen - *Xylem Incorporated - CFO*

I would only add that when you look at our emerging market revenue today, roughly 20% of our revenue comes in the emerging markets and what I would say is that's obviously a great area of opportunity for us you've heard us talk quite a bit about. I will caution you as you fill in on the quarter that these larger projects that come through can be lumpy in terms of timing.

And we'll certainly do the best possible way that we can to make sure that we're keeping it clear and clean for you so you understand what the base business is versus the larger project wins.

Joe Giordano - *Cowen and Company - Analyst*

Great. So emerging market is about 20% of revenue, I'm assuming that they have been carrying bigger weight over the last couple in terms of orders; right?

Patrick Decker - *Xylem Incorporated - President & CEO*

No. Look, the Americas were up double digits in the water infrastructure segment in the third quarter so we certainly have seen it in some of the developed regions. That said, emerging markets have been very strong for us.

Joe Giordano - *Cowen and Company - Analyst*

Great. Thanks guys.

Patrick Decker - *Xylem Incorporated - President & CEO*

Thank you.

Operator

Jim Krapfel, Morningstar.

Jim Krapfel - *Morningstar - Analyst*

Good morning. Thanks for taking my question. Most of my questions have been asked already but just one question on future divestment opportunities and what potential you see for further areas to sell off some of your businesses to improve your overall business mix?

Patrick Decker - *Xylem Incorporated - President & CEO*

Sure. I -- so we've done a pretty exhaustive review of the businesses that we've got. The team has done a good job. At the time that I was arriving early this year on mapping out the historical growth profile, the returns on capital of each one of the businesses, the incremental returns on capital, all the things that good allocators of capital look at when we're making investment decisions or divestiture decisions.

And I would say other than the UK Valves business that we divested here recently, there's really nothing of any meaningful value there that I would say, size and scale that you should expect to hear from us on. We'll continue to always take a hard look at some of the smaller businesses in the portfolio but there's nothing really there right now. I would say right now, we are very much focused in on the acquisition side of the house.

Jim Krapfel - *Morningstar - Analyst*

All right. Thanks. That's helpful.

Operator

Brian Konigsberg, Vertical Partners.

Brian Konigsberg - *Vertical Research Partners - Analyst*

I'm back. Thanks for taking the question. Just one point of clarity. On page 5, in the key performance drivers, you talk about volume, price, mix and other being at 180 basis point headwind yet in both of the segments, both of those buckets are tailwinds in the quarter. Can you just explain the discrepancy between that? Am I just reading it incorrectly?

Michael Speetzen - *Xylem Incorporated - CFO*

I think the biggest part, Brian, is going to be the corporate cost. It's about $6 million, as I pointed out in my prepared remarks. That puts us back at more of a typical run rate versus what was a very low level worth of spend last year.

Brian Konigsberg - *Vertical Research Partners - Analyst*

I got you. All right. Thank you very much.

Michael Speetzen - *Xylem Incorporated - CFO*

Thanks.

Operator

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

Patrick Decker - *Xylem Incorporated - President & CEO*

Great. Well, thank you everybody. I appreciate your -- we appreciate your continued interest in the Company and following us. I look forward to catching up with you in early February to discuss our fourth-quarter results and provide our overview on 2015 outlook. So thank you all and have a good day.

Operator

Thank you. This does conclude today's Xylem third quarter 2014 earnings conference call. Please disconnect your lines at this time and have a wonderful day.