Company Name: Xylem Inc. (XYL)
Event: Baird 2018 Global Industrial Conference
Date: November 6, 2018

<<Michael Halloran, Analyst, Robert W. Baird & Co.>>

Good afternoon, everybody. My name is Mike Halloran, an industry analyst here at Baird. And we're pleased to once again welcome Xylem to our conference today. Patrick Decker, CEO, he's going to be giving some formal remarks followed by a Q&A session. We also met with Tina up on stage, newly married, I might add. And we're going to be doing a formal – informal Q&A after Patrick gives his prepared remarks. So again, if you have any questions, raise your hand or fire me an e-mail, and I'll make sure to weave in any questions into the Q&A session.

With that, please.

<<Patrick Decker, President and Chief Executive Officer>>

Okay. So good afternoon. So quiet. Well, thanks for joining. I will spend just a few minutes here with an overview. And I believe you'll have access to the material, so I really don't want to go through the slide presentation. I'd very much think that I really want to keep it, Mike, for and what's on your mind, what's on their mind, et cetera.

So relevant to this slide because I'm going to glance to simply to remind everybody that we celebrated our seventh anniversary as a stand-alone company last week. I've been here now as CFO for about 4.5 years. And it's amazing how time flies, but seven years is not a long time. And many investors ask me why it is that I still say that we have a fair amount of self-health opportunity on the margin side. It's because there's still some of the residual complexity in the organization. So I'll talk about that with respect to margin expansion.

Here's our vision, and again, really the key here in my view is that the water sector and certainly, the wastewater and the clean water side of the water sector is the one that I think has long needed a definitive leader in this space, and one that can put capital to work in a smart, efficient way to solve some of the grand challenges that our customers are facing, whether that be the utilities, which were about 50% of the spending in water is the utility, the after-producer of water. They also represent half of our revenue.

The other third – another third is the industrial uses of water. And then the remainder is commercial buildings, residential and agricultural. But really, here in our view is we want to be a true thought leader in this space and really demonstrate and show that there is a good set of return on capital opportunities here in this market.

As I talked about some of the grand challenges, again, many of you have seen me, these are clearly the macro drivers that we've seen for a number of years. And whether it happens tomorrow or the next day or next year or next decade, these challenges are not going away. The three that really stand out predominantly to me are the issues of water scarcity; secondly, the issue of the resilience of our infrastructure to weather-related and water-related events; and third, the affordability of water, not only affordability to the utility but also the affordability to the export users of water, given the increase in cost of water infrastructure around the world.

One of the unique things about Xylem is we arguably have the broadest portfolio of solutions and technology in the water sector. And we do play across the entire water cycle, whether that be from getting water at its source to a treatment plant, treatment water, producing clean water, distributing that to the end users of water and then moving that wastewater back to the treatment plant to be reprocessed, recycled and reused. And we have arguably the broadest portfolio there. I don’t think there’s any other company that has this kind of breadth across the entire water cycle than Xylem.

Again, though, as we’ve said many times, you don’t invest in Xylem just because you want to invest in a water company. At the end of the day, you invest in us as a company because we think we have a really strong value-creation proposition here. We do focus very much on accelerating our rate of profitable growth but at very good returns and margins. We are still early in the phase of driving continuous improvement across the organization, things like Lean, Six Sigma, Kaizen, we’ve been at this now for about 4.5 years. And we’ve been investing heavily in developing not only this generation of leaders but also generations to come.

But at the same time, as you look at our balance sheet and you look at our cash generation, one of the things I’m most proud of over the last couple of years is not just the improved growth rate and margin expansion, but we’ve been converting our earnings at well above 100% the last couple of years, and that is generating a lot of attractive cash flow. And as a result of that, we’ve been able to deploy that cash against some very smart, disciplined acquisitions that have further built out the portfolio.

Couple of examples here. Again, most of you are probably familiar with this, but our acquisition generally really began about two years ago, when we acquired Sensus, which was a metrology company. We bought that not only to get into the metrology side of the business, but we really wanted to build out our capabilities across the clean water side of the utility, whereas the rest of our businesses have a long history in the wastewater side of the utility. And we believe having that relationship around the utility is a very powerful opportunity.

Next acquisitions really were a handful of technology acquisitions, like Pure, whether it be leak detection, whether it be storm water overflow, the pain points that the utilities are facing in managing their CapEx and improving their operational efficiency have informed what we’ve added to our portfolio, and we will continue to build out this part of our portfolio.

Again, here are our targets for 2020. I know, Mike, you’ll certainly have a question on margins, so I’ll hold my answers to them. But we feel – we remain very confident about our ability to stand these growth rates as well as to get to our 2020 margin target of 17% to 18%. And again, we believe, over that time frame, we will continue to build out a cash arsenal to be able to go do other smart acquisitions to really be value accretive.

So again, this is the last slide. I think I have maybe one more here. These are really the things that we believe support our investment thesis. I've touched on some of them already. But again, can take any questions that you might have on this slide here in a moment.

But there's something that I don't want to spend too much time on here that I really also think differentiates us as a company, and that is, if you heard me talking to our customers, or my colleagues in the company, I talk a lot about the role that we have as a company to not just create economic value but to create social value. And whether that be through our philanthropy programs, whether it be through the various products and technologies that we bring to market to help people at the base, the poorest areas in the world, we are actively involved in that to help solve water. We are getting involved in educating youth.

But also most recently we have been heavily involved in national disasters relief, whether that was the cave rescue in Thailand, dewatering the cave, whether it be disasters in Indonesia or India or right here in the U.S. with all the weather events that have been going on. And this is a great rallying cry for anybody that chooses to come to work with Xylem.

So I'll end it on that, Mike, and hand it over to you.

Q&A

<Q – Michael Halloran>: Great. We'll start with the open Q&A here. Again, if you have any questions, either e-mail me or just raise your hand. Let's start strategically. If I think about the vision prior, it was quite a bit different in – the focus today is technology leadership within the water space. And Sensus, Pure, the big pieces, which you also had the Analytics platform before that. So a multi-full question here. First, talk about how that platform development is going as you're trying to blend all these things together and have more for a cohesive market strategy.

<A – Patrick Decker>: Sure. So I think it's important that as people think about technology between the hardware, kind of, software. It's important that investors, our own people and customers recognize that what we're not looking to do is to completely convert Xylem into a software development company or a data analytics company.

What we find in speaking with utility CEOs, whether they be the most progressive utilities or those that may be at the beginning of the journey and don't have the resources available, is that the reason they need data on the utility operations is to be smarter about where they allocate the next dollar of capital to address their biggest challenges, whether that be water loss through nonrevenue water, whether it be conforming with ETA, consecrate on storm water overflow, whether it'd be reducing their operating costs around energy consumption.

All of these pains differ by utility, but they need more than just data. They need data that someone can educate them and convert that into – the problem they're trying to solve, typically manifest themselves in the very hardware of the network, whether that be the distribution pipeline that has leaks, whether it be the meters that have been deployed and are they accurate and billing effectively or it could very well be the wastewater pumping network or the treatment plant.

So what we find and how the journey is going is we have a lot of really exciting conversations right now with utilities where they're willing to sit down with us and say, we want to deal with someone who not only can get the data, but you can actually tell us what do we actually need to go do to address the very equipment that you're also providing or that your competitors are providing.

So it's early on. We are focused on pilots with some of the most progressive utilities, not always the largest ones, that certainly believe in this. And what we hear from them is what they enjoyed about it, Mike, early on is, they had known these technologies, had existed for some time, but they don't have the time to go through and do the due diligence on label claims that various people in the States are making. But they know that we at Xylem are not going to stake our reputation both as a public company but also as a long-standing provider without having done the diligence on these companies to make sure that we're bringing the best solutions into the portfolio.

<Q – Michael Halloran>: And one question I often get is why you – right, why, as a historically product manufacturer, are you entitled to have the data management plus the product management because there's a lot of other IoT companies who are a layer higher, who maybe have broader software capabilities they can bring in. And what's the pushback that you give to that?

<A – Patrick Decker>: Sure. Yes, so I think the first one is, at the end of the day, not every utility but many of them, again, especially the water utility. Water utilities by definition are risk adverse. That is not a bad thing. They get criticized unfairly for that. There's no upside to taking risks that are not controlled and doing them in partnership with someone who's a trusted partner with you. And so at the end of the day, they are willing to do these things. But it start with a pilot, and it scales from there.

You're right, we are finding that especially in the area of nonrevenue water or building a smart distribution network. We are not finding in many cases that its traditional competitors that are showing up. In one of our competitions in Australia just a few months ago that we won on the nonrevenue water side with one of the large utilities, the competitors were Google, Amazon, IBM, Microsoft and a local telco company. And the reason we won that bid from the mouth of the utility operator was because it wasn't an issue of getting the data. What they needed was the insight on what – how do we use that to make our network, not the communication network, the physical network, operate more effectively.

But I would say, Mike, we're going to have to partner with them in many cases as well. I mean, we're not so arrogant to think we're going to own this space, and that's the early stage that we're going through in some of the pilots.

<Q – Michael Halloran>: So it's basically a fine line between having the content but being able to layer in with that next level higher?

<A – Patrick Decker>: That's correct. I mean, what people will ask me all the time is what is the biggest competitive differentiator Xylem has. Every company can say this, and we're not perfect by any means, but it's our applications knowledge. It's the applications expertise that we have around the very equipment that we have designed, built and manufactured.

<Q – Michael Halloran>: And I think it was the last conference call, but certainly recently above-expected, call it, cross-selling ability, taking some of that technology, tech connectivity that Sensus has, the Analytics piece has that's broader and into the platform. Maybe talk about longer term where you see this going with things like Flygt, your Flygt depending where you are. How that brand can be – how that brand can leverage some of the capabilities elsewhere?

<A – Patrick Decker>: Yes. So the Flygt or Flygt of Sweden is our market-leading submersible wastewater pump. We have by far the largest share position around the world, great install base. We've been betting a lot of Systems Intelligence into that product for a number of years now.

But the piece that we were missing up to this point in time were two things. One, we were building in 12 different areas around the world, skunk work on how do you build out remote networking capability to monitor that equipment real time. And that's one of the biggest advantages of us having acquired Sensus is their telecommunications platform and capability, already in existence, allows us to immediately plug and play. And that's one of the first things we introduced to the market as part of those synergies.

The second is being able to gather the data off of the entire network, and to now be able to use the AI and machine learning capabilities that we've been acquired, vis-à-vis, Pure as well as a couple on the startups to apply that same data mining capability across the wastewater part of the network. That is a generic skill set that we've now acquired and are able to scale in a pretty significant way.

<Q – Michael Halloran>: How leverageable do you find the relationships are within the public utility space to add those next layers and basically increment off that install base?

<A – Patrick Decker>: It is powerful. I think we're in the early stages. I would say that the approach we're taking there is we're focused very much on a select set of utilities right now to really build out that reference case, as you well know Mike, the – because of the conservative nature of the industry, you have progressive utilities that typically make the first move, but others are watching to see whether it can be proven out and works. And then it's a trusted relationship because, again, of the risk aversion.

Two, I think it's the fact that they know that when we are there as a technology provider, we're trying to sell them something. And so the credibility that you get when you have a utility operator being the one who is singing the praise. That goes a lot further along than neither one of my folks in there trying to convince them of something. And so we've got a small advisory group, a combination of ex-water utility CEO, but also ex-engineering consulting firm CEO that are fully retained by us right now. They help me and the team work through what is the best way to drive accelerated adoption in the utility space.

<Q – Michael Halloran>: Makes sense. And maybe just anything end market-wise that has you – up and down right now? I mean, the utility side has been very healthy for a while. You obviously get some regional variability depending on the quarter. Some of the things can just push a little bit one way or another, but the end market seemed pretty good.

<A – Patrick Decker>: Yes, they do. Oops, might have turned the volume up. Yes, they do. I think the – I don't want to belabor too much of the education on our profile, but it does help people get their heads wrapped around. But why they continue to be not so much bullish but doesn't seem to be kind of too flustered by what people are kind of expressing right now in terms of worry.

First of all, 50% of our revenue is utility. And in that, it's third Europe, it's third North America, it's third emerging markets. And that part of our business has historically grown healthy way in that low to mid-single digits, even in some of the worst of times with maybe one or two exceptions. And right now, we continue to see record levels of bidding and long-lead time treatment projects, which were typically a forbearer of further investments after that. You don't build a treatment plant for the [indiscernible] (0:17:07) treatment plant. You build it as part of an overall system and network, but it's the first thing that a utility breaks around them. So we feel very positive about that.

I think certainly the other end markets, we've been running hot here through the first three quarters of the year, whether that be industrial, whether that be commercial buildings, those together are another 45% – 40%, I should say, of our revenues. That we believe will moderate. We're working with some easier comps right now. That's maybe the not downside but keep it all in check kind of use on organic growth. We think that will moderate.

<Q – Michael Halloran>: That's good. More peak growth than peak cycle, thus, from your perspective?

<A – Patrick Decker>: that's right. Yes. I think the – it's not peak cycle, and I think, we are – we would say we guide long-term in that business to always be basically the 3% kind of range of organic growth. Sometimes a little harder, sometimes a little softer, but that's kind of the read-through over the course of the cycle.

I think the piece that we really have been prone to be exposed to, historically, was about 10% of our revenue was in oil and gas and mining. And a few years back, that dropped off precipitously and took about two points of organic revenue growth away from the total company. That exposure now is roughly 5% of our total revenue, and we've diversified the business that we sum to that to be more construction and general industrial. So I think we've shifted some of the risk there, Mike, that we feel pretty immune and recession proof if in event we saw that kind of global softness.

<Q – Michael Halloran>: So I've gotten a series of margin questions in the audience coming in, and I'll give a shot. So why don't we frame where we are today in the context of your long-term targets, 17%, 18%, we're a few hundred basis point away from that. You got some inflationary pressures in the short-term. You've added peer, you've added some other acquisitions that are

going to pressure that. On top it, it certainly feels backend loaded relative to what we would have expect, when those targets were first laid out.

So maybe talk about how that march happens. How do we get from A to B? And what are the levers? And maybe some budgets around that.

<A – Patrick Decker>: Sure. So I'll stop short of giving guidance for 2019, what the layers are. We'll do that in our next call. But it's really driven by a few things here. First is we began a little more than a year ago planning for a pretty significant simplification of our backlogs. We called that Global Business Services.

And if you look at our G&A, whenever we spun out of ITT, seven years ago, I think we were running nearly 11% of revenue was in G&A. That's just crazy. We've had a lot of basic blocking and tackling, but it's been through basic overhead reduction, eliminating layers, kind of chipping away at it, we're down now just above 8%.

The analysis that we've done and all the planning that we've done, we launched this project a little more than a year ago, and we just got through our first wave of execution a couple of months back, where we believe strongly we can get 200 more basis points of G&A out of our cost structure. And that's just because we are heavily loaded in G&A from a transactional – human interaction from a transactional perspective as opposed to using modernized tools to outsource a fair amount of that work.

We believe that we'll still be a bit backend loaded in 2020, just given the timing of the waves that we're rolling out. But you will begin to see a meaningful benefit of that in 2019 as well. So that's the first thing that one needs to believe.

The second piece is we are still relatively early on in the deployment of Continuous Improvement. That would be a combination of global procurement, where we built a new team about three years ago. And we still have a fair amount of our supplier base that's not yet been put out to our queue. We're re-leveraging our combined skill and certainly the acquisitions that helped there because they'd given us more volume leverage to be able to drive. But also the point of Lean, Six Sigma, Kaizen, we've done a good job in the factories. I'm encouraged by the progress beyond the factory, but it is still not consistently employed across the rest of the organization to drive Lean.

The third though is the incremental margins. And obviously right now, we're growing at the upper end of what the original organic revenue guidance was. You're not seeing those incrementals on the Measurement & Control Solutions segment, the new ones that we've acquired. You haven't seen that drop-through yet because it's been masked by growth investments that we've been making over the course of really this year.

And so we've got between 70 to 80 basis points of margin headwind from investments that we're making right now to support two things. One, it's the scalability of the new infrastructure Analytics platform, Pure, EmNet, Valor, bringing those together, scaling that globally, think sales and marketing support. But it's also the money that we're spending on pursuing some large international deals that came out of our integration with Sensus, those we're investing in an upfront engineering business development work, things that are binary in outcome.

So when we expect to get a decision from the customers on those somewhere in the middle to later part of next year, you either wins the big project, which are very attractive margins, pay for those investments or you lose it and you cut off the investment. And so we have through, we would believe, about middle to late 2019 where we will lap that investment, and that will remove some of the headwind that we've been absorbing here in 2018. All by plan, all by design. It's a decision we've made as part of our growth strategy.

<Q – Michael Halloran>: And when you think about volume as a component of that, is that like third of that leverage point I think?

<A – Patrick Decker>: Yes. So we would historically had expected and still would that we would drop incrementals for every dollar of revenue, somewhere between 30% and 35% of that would drop to the bottom line. That's actually a little below history because of the mix of emerging markets and treatment growth, but we still stand behind that.

The piece that we don't have built in to our margin expansion because those targets were put out before we acquired our way into the new Analytics platform is depending upon the growth rates of that part of the business. Those margins are very accretive to our overall margin as Xylem, both gross margin and operating income. And so it's a very small part of our revenue base today.

<Q – Michael Halloran>: Makes sense. And then on the cost inflation side, there was another question, just how are you managing through that? It feels like a little slower recovery process than what you would have hoped about back to where you want to be here. When can we start seeing those incrementals be a little bit more normalized across the pieces?

<A – Patrick Decker>: Yes, so we had – we've been pleased with the pricing realization that's been out there. I think it does take time to build.

<Q – Michael Halloran>: Yes.

<A – Patrick Decker>: Secondly, I would say that the – we had some impact in the third quarter, and we would expect to continue in Q4 for the first half of next year around some extra cost that we had to incur on electronic components mainly in our MCS segment. You probably heard other companies in the space comment on that. That was up $5 million in the quarter. That will continue, obviously. We'll build that into our plans and pricing discussions going forward. But nevertheless, the teams have done a great job of working through that.

I think that the other area that we have been very focused in on is minimizing the impact of tariffs. I think we called out $5 million of impact in the quarter. That's about the run rate, and that's because we, for the most part, are pretty much localized in terms of each one of our country is around the world. So I'm pretty confident that, that margin expansion headwind will hopefully begin to abate based on pricing and cost action.

<<Michael Halloran, Analyst, Robert W. Baird & Co.>>

Makes a lot of sense. Unfortunately, it’s all the time we have. So please join me in thanking Xylem for their time today.

<<Patrick Decker, President and Chief Executive Officer>>

Thank you, Mike.

<<Michael Halloran, Analyst, Robert W. Baird & Co.>>

Management, we’ll be available in downstairs, if you have any further questions in the Walton Room in the seventh floor for breakout session. Presenting next in this room is Acuity Brands; presenting next in the North Ballroom is Littelfuse; Badger Meter is in State Room; Covanta Holding Corporation presenting in the LaSalle Room. Thank you.