

Deane: ...Xylem here at the RBC Industrial Conference. To my left we have Patrick Decker, CEO. He's held this position since March of 2014. Joined Xylem from Harsco, where he was CEO and prior to that had a number of leadership positions at Tyco, eventually serving as the President of Tyco Flow Control. Patrick, thanks for being here.

Patrick: Thanks, Deane.

Deane: Everyone is getting asked right at the start to discuss the impact of the hurricanes, plural, both in the context of near-term business disruptions, a role in restoration, and most importantly, your folks and your team.

Patrick: Sure. So thanks, Deane. We've been, first of all, what's most important is we were very fortunate. We've got five different locations in and around the southern Texas area and a number of branches across southern Florida, and other than a few of our colleagues who have lost their homes -- and we're taking care of getting them back on their feet at this point in time -- our operations, service branches were down a couple of days, but really should not have any meaningful impact on our financial results and operations for the quarter.

As many of you know, we actually largely stand to benefit from these unfortunate natural disasters, vis-à-vis the work that we do around helping cities build resilient infrastructure. So the first order of merit is our de-watering business, which is our emergency pump rental business. We've got five branches in the southern Texas area and several across Florida. We are in touch with each one of the cities in the area that are being affected. Right now probably not much impact here in the month of September and the quarter, given that they're still involved heavily in search-and-recovery efforts and it will be a little while before we'll see a full deployment of our rental pumps. It will be more of a Q4 story and probably into 2018.

To put it in perspective, I think when we had Hurricane Sandy some years ago, we benefited -- I think we had roughly \$10 million over the course of the two quarters subsequent to the disaster. This is certainly similar in terms of the extent of devastation. We don't necessarily believe right now it's going to be that large of a benefit, just given the fact that you think about in the City of New York, a lot of that water damage was in underground tunnels where you had to get the water out immediately, whereas in the Houston area, it's flat land, dry arid area, a lot of water runs off naturally. So there will be a tailwind for us, but we'll be in a position, Deane, by our next earnings call to be able to size up what the impact not only was in the quarter, but more importantly for Q4, Q1.

And I think it remains to be seen what level of infrastructure has been damaged in the south Texas area, whether it be storm water overflow, infrastructure that needs

to be built, whether there were any wastewater pumping stations that were damaged. We certainly got some of that benefit after Sandy, but again, too early to tell until we get out there and kind of assess the situation.

Deane: How about Florida?

Patrick: Florida, again, too early to tell. I think it will be a smaller scale than obviously what we're seeing in Texas. At the same time, we're probably even better positioned in terms of our branch presence and our rental fleet in Florida than we are in Texas.

Deane: Let's switch over to a topic you and I have discussed from your earliest days as CEO is, I asked a trick question to you right at the start and you gave the right answer. I said, are you in the business of selling pumps?

Patrick: No. We do sell pumps.

Deane: So, on that point, take us through the transformation, the change in the business model, the change in the mindset on going from being a pump seller to a water solutions provider and all that went into it.

Patrick: Sure. So whenever I joined a little less than three and a half years ago, we spent the better part of the first year doing some very deep-value mapping of the water sector to really understand what were the areas that have the best growth as well as the best margin profile. And from my experience, the best way to do that is to start with really understanding who are the customers along different lines of the water network, going from source water, leading into the treatment of water, the clean water distribution network, the users of water, and then taking that water back to the treatment plant. And there are different pain points along the way that we've put kind of value-at-stake estimates, as well as margin and return profiles on each one of those, depending upon the level of technology involved and who the payer is.

And in doing that, clearly we pride ourselves on having market-leading pump offerings, market-leading treatment offerings, market-leading analytics offerings. But what we clearly quickly realized was that we needed to move beyond simply selling equipment into an application and focusing on really developing solutions to broader problems, and so looking at outcomes. And so what that led us to do is to really recognize that the digitization of the water utilities world is happening rapidly, and there really was no player at scale in the industry that was really putting a foot forward and prepared to write a check to go move beyond a pump provider or a treatment provider.

When we saw the opportunity with Sensus, we weren't looking at Sensus as a metering company, although it certainly is a very good metering company. We're really looking at them more from the telecommunications capability and the data analytics overlay that they're now bringing to bear in the utilities space, both water, gas, and electric. And the synergies that are there -- which I'm sure you're going to ask me about here in a moment, so I'll give people a chance to breathe -- is really the opportunity to bring data to bear to a utility to help them manage not only their metering deployment, their wastewater network where we'll be able to connect our wastewater pumping stations and network to give them data to look at energy consumption, energy efficiency, optimization of the entire network, rather than a single pumping station, helping them look at things like smart watershed management. So they oftentimes care deeply about the quality and other aspects of source water before it actually comes to the treatment plant, so they can optimize the way in which they spend their money getting that water ready for use along the distribution network.

And then third, something that I know you're very attuned to, Deane, is I'd say probably the single biggest challenge that water utilities face today around the world is non-revenue water. And today, the only aspect of that that the utilities can really focus on heavily has been the metering side of things. There are three drivers to non-revenue water. One is...

Deane: I want to interrupt just for a sec. For the uninitiated, the term non-revenue water is the kind of polite way water utilities say the water that they lose in the transmission because of leaks. And the statistics are scary, but the biggest one, whether it's in the US -- in fact, you've got it down to the decimal point -- but just let's just say 25% of all water pumped from a water utility in the US is lost through leaks. That's like saying that -- and people don't seem to care -- but if 25% of all iPhone Xs that were being shipped somehow fell off the truck, there would be all kinds of outrage.

Patrick: People would care.

Deane: So non-revenue water, the fact that it leaks into the ground doesn't seem to be a big concern because there's water going back. But anyway, make sure people know what non-revenue water is.

Patrick: No, that's terrific, and the reason it matters to them is it's a big source of potential funding. Those that have followed the water sector for a long time know that one of the biggest constraints to investment in water infrastructure that we know is badly needed is funding. And so this is an opportunity where they already have rates approved by the regulators. All they have to do is be able to capture and minimize what those leaks are and have more effective billing around that. So it's a big emerging focus area. It's been there for a long time. The technologies have

been developed recently to address that in various ways, but they oftentimes tend to be startup companies that don't have scale, don't have channels to market globally, and therefore, the utilities are kind not – they're risk averse in terms of taking on a new technology partner.

And so we certainly have, I think, a first-mover advantage there, given our scale and our deep domain expertise with the utility on the water side of the equation. So that's another example where we think the digitization of the water sector is coming to life and we really want to be the first mover in that space.

So, the last thing I'd wrap on your question, Deane, I want to be clear to everyone, especially those folks back home in the company, we love our equipment pieces of our business and I've long felt – and the utilities will tell you this – they have little interest in dealing with purely a software overlay or a data analytics company, if they don't bring the domain expertise behind that to back it up; and they do want to deal with one solution provider, not three or four of them solving the problem. So it's really important that we continue to bring innovations in and around the equipment that we're connecting to those devices as well.

Deane: So you answered about five of the questions we had teed up there, which is perfectly fine and just the last one on the differentiation between how Xylem's positioned in the smart water networks versus potential competitors. You're seeing some interlopers, IBM, Cisco, that are software driven, say we can handle analytics, but you have the domain expertise.

Patrick: Yeah, I think that's the differentiator and I think there's clearly a role for those providers to play in different situations. But what we've found in our discussions with the utilities is they do care deeply about somebody having real domain expertise around the various aspects of the network that they're trying to optimize. Getting access to the data, anybody can do that for them. It's what do you do to turn that into actionable information based upon what it is you're monitoring? And unless they're willing to partner with someone like that along with our sales or other providers, which they will do in certain cases, they would be prone to come with ourselves. We do have proprietary telecommunications capability and data analytics.

Sometimes customers don't want to go to bed with a proprietary solution, and so we work against that on occasions, but we also sell to the customer that we can also work an open source. We can use open Wi-Fi, mesh technology, we can play both ways. We prefer to play the flex-net card and do the dedicated proprietary network.

Deane: That tends to be more robust in big weather events.

Patrick: That's correct. Yeah, both a redundancy.

Deane: So look, you and I could go further down this higher up the technology curve path that you're on, but what I always find important is that's only part of the investment theme. You still have to prove to investors that you are solid on cash flow, that there's margin improvement story. So my point is always you're a self-help story, still 400 or 500 basis points of margin upside. So take us through your priorities on the fundamental side of Xylem and where it stands today.

Patrick: I would look at it and say our priority areas right now are to successfully integrate and leverage the investment that we made in Sensus and building out a new platform that really does help us digitize the water sector. There's a lot of work that we're doing from an engineering, technology, stack development, and getting our commercial teams up to speed on how to sell that value proposition. That's one big domain.

But that's really an overlay from a growth standpoint to the opportunities on the core business or our legacy Xylem business. So there, it really has been a significant increase over the past few years in investments and innovation and technology and strengthening our channels to market, integrating our commercial teams to sell the portfolio, rather than being specifically just product expertise. And so that certainly has begun to yield benefits in terms of faster to market growth organically.

Then you have the self-help margin story. There really are four big drivers there behind that. The first is we've committed to about \$50 million or 100 basis points of margin expansion from the Sensus cost synergies, mainly procurement, and we feel very good about that. Secondly, it's in the area of global procurement and Lean deployment across the company. We're going to be doing about \$135 million a year this year in total savings there, up about 15 to 20% from last year, which was up 15, 20 versus the previous year, and still see were probably in the early innings on that deployment.

Third is simplifying our back offices. We still have a lot of fragmentation. We have a lot of entities around the world, kind of overhang from our ITT days, where the businesses were managed separately and independently. So we're in the early stages of consolidating those back offices and support functions, combination of shared service and outsourcing. That's a longer term play, kind of the next three to four years. And then lastly, we have attractive incremental margins on our volume, on our organic growth, which we've built into our model going forward as well.

So those are the four things that drive that. Now in the midst of all that, that's covering some level of inflation and a reinvestment in the business, mainly in

R&D and engineering, and some sales investments; very confident about the margin expansion targets.

Deane: Okay, how about cash flow, because there was a time that Xylem was underachieving below 90% conversion. You're now comfortably above 110 with aspirations higher, so take us through what has gone well there.

Patrick: I'd say what's gone well and where there's still big areas of opportunity to improve, whenever I came onboard back in '14, I think our working capital ratio as a percentage of revenue was about 26, 26.5% of revenue. Quite frankly, kind of in line with the rest of a kind of crappy sector, in terms of how the supply chains have been put together and how we manage our working capital. So we moved from having an annual free cash flow target, which can also incentivize people to wait until December to do certain things that are not healthy for the business. And we imbedded a third of our annual incentive plan metric for our top few hundred people is working capital ratio.

So we've gotten that down now to just around 22%, with a long way to go to get down to what we believe is more of a mid to high teens to be more in line with the broader industrial sector. Now, with the acquisition of Sensus, Sensus actually has more like a 10% working capital ratio. So we're learning a lot from what they've put in place; and we've actually moved the young lady who was leading that effort over to lead the Xylem wide effort now with Tony Milando, our Head of Continuous Improvement. So we're seeing good progress there.

So that's certainly helped with the conversion. And then I think also just being more efficient on our other investments around capex, etcetera. This is not a capital-intensive business and don't envision that changing over time. So we're very comfortable committing to that kind of 110+% conversion.

Deane: Good. And that enables you to pay debt down faster...

Patrick: Yes.

Deane: ... after Sensus. M&A aspirations, I get asked this a lot, do you need to go after another big Sensus acquisition or what's that pool -- water pun intended -- of smaller bolt-on technology businesses like Visenti?

Patrick: So as I look at the three areas that I communicated at Investor Day are -- comes out of that value mapping work that I talked about before -- the first priority was the whole digitization or build out of the water utility space. I would say there we don't really need to go do any big chunky acquisitions. I think there you'll be looking at more tuck-ins, bolt-ons, probably nothing any bigger than a few hundred million dollars and most of them being well, well below that. And we

certainly have the capacity, both management and financial, to do a number of those. I think you'll see a steady string of pearls there.

The other two areas were treatment and the industrial space. We play there today, but smaller scale. It's a very attractive market. And various aspects of water services, de-watering, some other things that are out there. There I would say we certainly have the financial bandwidth and we have the management bandwidth to do anything of scale if we chose to do so, but we don't have to. And so we'll continue to be very disciplined in our valuation approach, much like we did with Sensus. I think we earned a lot of respect and credibility with that acquisition; and I certainly wouldn't look to blow that chasing something that didn't make sense for us in terms of the right time.

Deane: Good to hear. Let's switch to China as one of the growth drivers. We saw some pretty impressive uptick in orders and revenues in the second quarter. There's also been a sea change in China five-year plan in terms of how their addressing their water issues. What's your opportunity?

Patrick: China, prior to – in China, our exposure there is about two-thirds of our revenue is in the utility space and about a third is in the commercial building, industrial space. And even when China went south for a period of time, a little more than a year ago, we didn't really feel much of that within the utility play. Where we saw it was in that third of our business that's tied to industrial commercial. So we did see a drop in revenue there through '16, but at a much smaller scale than other peer companies did because of the exposure.

We've lapped that now and because of what you just spoke to, the Chinese government has extended – the Chinese government in the last five-year plan had prioritized water quality and environmental quality as a top policy mandate, and we've seen that fueling our orders growth there for the last year. We've had orders growth of 30% plus in the first half of the year. Secondly, they've extended that five-year plan mandate to now include non-revenue water. So they've mandated that. The utilities across China reduced their non-revenue water from 27% down below 10% over the next handful of years. That's a tall task. Hope they get there, but nevertheless, it's certainly going to fuel funding and spending going into that space and we certainly think that we're well-positioned to be able to do that.

India continues to be a high, high growth market for us; triple-digit growth in orders the last quarter or two and really strong revenue growth. And we're now beginning to see a recovery in Middle East. So we had high single-digit orders in the first half of the year. Expect that to turn to revenue growth in the back half.

Deane: Got it. Look, we're being gypped on time today, but I still got to squeeze one last question into overtime here. I'm always impressed with any time the government of Singapore makes specific calls on technology. There's no other city/state in the world that is more advanced in terms of water treatment, and anyone they partner with must have something unique going on. You've got a number of relationships in Singapore. What are they and why does that matter?

Patrick: Absolute great question. So as Deane well knows, the reason why Singapore Public Utility Board is arguably "the" definitive thought leader in the water space is because they have a water treaty with Malaysia that's set to run out within the next kind of 30 plus years, and so it really drives them as a national security issue to make sure they have a full handle on their water consumption, sources of water, reuse of water, but also managing non-revenue water. They've got one of the lowest non-revenue water ratios now in the globe, down around 5% or so.

And part of the way they got there was they had asked us, because of our analytics instrumentation capabilities around YSI, but also the trust that we had built with them on our wastewater pumping capabilities and treatment capabilities with them, they had asked us to form a partnership with Visenti, which is a leak-detection company that was formed out of MIT, the MIT Startup Program. So we partnered with them about six years ago and worked with them. We provided the hardware, they the software, to develop a leak-detection opportunity for Singapore.

And as a result of that, Singapore had asked us to perhaps purchase them at some point in time; and we ended up doing that about two weeks before we closed the Sensus transaction. The beauty of this was they were actually the number one, they were the number one priority in the M&A pipeline of Sensus. Sensus had been going after them for a while. So we're building a really neat relationship with Singapore PUB, I think at a level we haven't seen before; and I'm really excited about the possibilities of that being a reference account for us in other parts of the globe.

Deane: All right. Patrick, on that note, we'll call it a wrap, and I appreciate you being here today.

Patrick: Thanks Deane, thank you.

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