

Xylem Inc.
Form 10-Q
April 30, 2015

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q
(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2015

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number: 1-35229

Xylem Inc.

(Exact name of registrant as specified in its charter)

Indiana
(State or other jurisdiction of incorporation or
organization)

45-2080495

(I.R.S. Employer Identification No.)

1 International Drive, Rye Brook, NY 10573
(Address of principal executive offices) (Zip code)
(914) 323-5700

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of April 24, 2015, there were 181,371,182 outstanding shares of the registrant's common stock, par value \$0.01 per share.

Xylem Inc.

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PART I

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

XYLEM INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED INCOME STATEMENTS (Unaudited)

(in millions, except per share data)

For the three months ended March 31,	2015	2014
Revenue	\$837	\$906
Cost of revenue	522	564
Gross profit	315	342
Selling, general and administrative expenses	206	224
Research and development expenses	23	27
Restructuring charges	3	15
Operating income	83	76
Interest expense	14	14
Other non-operating (expense), net	(1	) (1
Gain from sale of businesses	9	—
Income before taxes	77	61
Income tax expense	13	12
Net income	\$64	\$49
Earnings per share:		
Basic	\$0.35	\$0.27
Diluted	\$0.35	\$0.27
Weighted average number of shares:		
Basic	182.1	184.5
Diluted	183.1	185.8
Dividends declared per share	\$0.1408	\$0.1280
See accompanying notes to condensed consolidated financial statements.		

XYLEM INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

(in millions)

For the three months ended March 31,	2015	2014
Net income	\$64	\$49
Other comprehensive loss, before tax:		
Foreign currency translation adjustment	(129	) (2
Foreign currency gain reclassified into net income	(8) —
Net change in cash flow hedges:		
Unrealized losses	(5	) (1
Amount of loss reclassified into net income	5	—
Net change in postretirement benefit plans:		
Amortization of net actuarial loss into net income	4	3
Other comprehensive loss, before tax	(133) —
Income tax impact related to items of other comprehensive loss	1	1
Other comprehensive loss, net of tax	(134	) (1
Comprehensive (loss) income	\$(70	) \$48

See accompanying notes to condensed consolidated financial statements.

XYLEM INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(in millions, except per share amounts)

	March 31, 2015	December 31, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	\$554	\$663
Receivables, less allowances for discounts and doubtful accounts of \$28 and \$34 in 2015 and 2014, respectively	738	771
Inventories	502	486
Prepaid and other current assets	141	144
Deferred income tax assets	38	38
Total current assets	1,973	2,102
Property, plant and equipment, net	434	461
Goodwill	1,582	1,635
Other intangible assets, net	446	470
Other non-current assets	185	192
Total assets	\$4,620	\$4,860
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$311	\$338
Accrued and other current liabilities	441	481
Short-term borrowings and current maturities of long-term debt	81	89
Total current liabilities	833	908
Long-term debt	1,195	1,195
Accrued postretirement benefits	374	388
Deferred income tax liabilities	152	158
Other non-current accrued liabilities	77	84
Total liabilities	2,631	2,733
Commitments and contingencies (Note 17)		
Stockholders' equity:		
Common Stock – par value \$0.01 per share:		
Authorized 750.0 shares, issued 189.4 shares and 188.9 shares in 2015 and 2014, respectively	2	2
Capital in excess of par value	1,807	1,796
Retained earnings	686	648
Treasury stock – at cost 8.1 shares and 6.6 shares in 2015 and 2014, respectively	(273	) (220
Accumulated other comprehensive loss	(233	) (99
Total stockholders' equity	1,989	2,127
Total liabilities and stockholders' equity	\$4,620	\$4,860

See accompanying notes to condensed consolidated financial statements.

XYLEM INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(in millions)

For the three months ended March 31,	2015	2014	
Operating Activities			
Net income	\$64	\$49	
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	24	23	
Amortization	11	13	
Share-based compensation	4	4	
Restructuring charges	3	15	
Gain from sale of businesses	(9) —	
Other, net	1	4	
Payments for restructuring	(6	) (9)
Changes in assets and liabilities (net of acquisitions):			
Changes in receivables	4	(5)
Changes in inventories	(33	) (42)
Changes in accounts payable	4	(2)
Other, net	(28	) (28)
Net Cash – Operating activities	39	22	
Investing Activities			
Capital expenditures	(37	) (25)
Proceeds from sale of businesses	1	—	
Proceeds from the sale of property, plant and equipment	—	1	
Net Cash – Investing activities	(36	) (24)
Financing Activities			
Issuance of short-term debt	—	2	
Repurchase of common stock	(53	) (51)
Proceeds from exercise of employee stock options	6	11	
Dividends paid	(26	) (24)
Other, net	2	—	
Net Cash – Financing activities	(71	) (62)
Effect of exchange rate changes on cash	(41	) (3)
Net change in cash and cash equivalents	(109	) (67)
Cash and cash equivalents at beginning of year	663	533	
Cash and cash equivalents at end of period	\$554	\$466	
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Interest	\$11	\$11	
Income taxes (net of refunds received)	\$8	\$18	

See accompanying notes to condensed consolidated financial statements.

XYLEM INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1. Background and Basis of Presentation

Background

Xylem Inc. ("Xylem" or the "Company") is a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. Xylem was incorporated in Indiana on May 4, 2011. Xylem has two reportable segments, Water Infrastructure and Applied Water. The Water Infrastructure segment focuses on the transportation, treatment and testing of water, offering a range of products including water and wastewater pumps, treatment and testing equipment, and controls and systems. The Applied Water segment serves many of the primary uses of water and focuses on the residential, commercial, industrial and agricultural markets. The Applied Water segment's major products include pumps, valves, heat exchangers, controls and dispensing equipment. Hereinafter, except as otherwise indicated or unless the context otherwise requires, "Xylem," "we," "us," "our" and the "Company" refer to Xylem Inc. and its subsidiaries.

Basis of Presentation

The interim condensed consolidated financial statements reflect our financial position and results of operations in conformity with accounting principles generally accepted in the United States of America ("GAAP"). All transactions between our businesses have been eliminated.

The unaudited interim condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") and, in the opinion of management, reflect all adjustments (which include normal recurring adjustments) considered necessary for a fair presentation of the financial position and results of operations for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such SEC rules. We believe that the disclosures made are adequate to make the information presented not misleading. We consistently applied the accounting policies described in our Annual Report on Form 10-K for the year ended December 31, 2014 ("2014 Annual Report") in preparing these unaudited condensed consolidated financial statements, with the exception of accounting standard updates described in Note 2. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in our 2014 Annual Report. Certain prior year amounts have been reclassified to conform to the current year presentation.

In 2014, we began implementing an organizational redesign to integrate our commercial teams within geographical regions. While this organizational redesign did not change our reportable segments, it had implications on how we manage our business. These changes and the related measurement system were effective in the fourth quarter 2014 and as a result, we commenced reporting our financial performance at such time based on the new organizational design. First quarter 2014 segment information presented herein has been recast from amounts previously reported to reflect these changes. The recast financial information does not represent a restatement of previously issued financial statements and the changes had no impact on our historical consolidated financial position or results of operations. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Estimates are revised as additional information becomes available.

Estimates and assumptions are used for, but not limited to, postretirement obligations and assets, revenue recognition, income tax contingency accruals and valuation allowances, goodwill impairment testing and contingent liabilities. Actual results could differ from these estimates. Additionally, our interim condensed consolidated financial statements may not be indicative of our future performance.

Our quarterly financial periods end on the Saturday closest to the last day of the calendar quarter, except for the fourth quarter which ends on December 31. For ease of presentation, the condensed consolidated financial statements included herein are described as ending on the last day of the calendar quarter.

Note 2. Recently Issued Accounting Pronouncements

Pronouncements Not Yet Adopted

In April 2015, the Financial Accounting Standards Board (“FASB”) issued guidance regarding whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license then the software license element of the arrangement should be accounted for in a manner that is consistent with accounting for the acquisition of other software licenses. If a cloud computing arrangement does not include a software license then the arrangement should be accounted for as a service contract. This guidance is effective for interim and annual periods beginning after December 15, 2015. The guidance may be applied (1) retrospectively or (2) prospectively to arrangements entered into, or materially modified after the effective date. Early adoption is permitted. We are evaluating the impact of the guidance on our financial condition and results of operations.

In February 2015, FASB issued guidance which amends the requirements to determine whether a company needs to consolidate certain legal entities into its reported financial statements. Specifically, the amendment: (1) modifies the evaluation of whether limited partnerships and similar legal entities are variable interest entities (“VIEs”) or voting interest entities, (2) eliminates the presumption that a general partner should consolidate a limited partnership and (3) affects the consolidation analysis of reporting entities that are involved with VIEs. This guidance is effective for interim and annual reporting periods beginning after December 15, 2015 and may be applied retrospectively to each prior period presented or with the cumulative effect recognized as of the date of initial application. Early adoption is permitted. We are evaluating the impact of the guidance on our financial condition and results of operations.

In May 2014, the FASB issued guidance on recognizing revenue from contracts with customers. The guidance outlines a single comprehensive model to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the model is that an entity recognizes revenue to portray the transfer of goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard also expands disclosure requirements regarding revenue recognition. This guidance is effective for interim and annual reporting periods beginning after December 15, 2016 and may be applied retrospectively to each prior period presented or with the cumulative effect recognized as of the date of initial application. Early adoption is not permitted. We are evaluating the impact of the guidance on our financial condition and results of operations.

Recently Adopted Pronouncements

In April 2015, the FASB issued guidance which changes the presentation of debt issuance costs in the balance sheet. Under existing GAAP, debt issuance costs are reflected on the balance sheet as an asset. This amendment requires such costs to be reflected as a direct deduction to the related debt liability, with retrospective application upon adoption. We elected to early adopt this standard effective in the first quarter of 2015. Accordingly, \$4 million of debt issuance costs are now reflected within long-term debt as

of March 31, 2015 and December 31, 2014. These costs were previously recorded within other non-current assets. In January 2015, the FASB issued guidance which eliminates from GAAP the concept of an extraordinary item. Under existing GAAP, an event or transaction must be unusual in nature and must occur infrequently to be considered an extraordinary item. Additionally, under current GAAP extraordinary items are separately presented in a company's income statement and disclosed in the footnotes to the company's financial statements. As a result of the new guidance regarding extraordinary items, a company will no longer (1) segregate an extraordinary item from the results of ordinary operations, (2) separately present an extraordinary item on its income statement, and (3) disclose income taxes and earnings-per-share data applicable to an extraordinary item. We elected to early adopt this standard effective in the first quarter of 2015 with retrospective application. Our adoption of this guidance did not have any impact on our financial condition or results of operations.

In June 2014, as a result of inconsistency in practice, the FASB issued guidance related to the recognition of compensation on employee share-based payments in which the terms of the award provide that a performance target that affects vesting could be achieved after the requisite service period. The standard states that the performance target should not be reflected in estimating the grant date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the periods for which the service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. We elected to early adopt this standard effective in the first quarter of 2015 with retrospective application. Our adoption of this guidance did not have any impact on our financial condition or results of operations as we were using the accounting prescribed in the new guidance.

In April 2014, the FASB issued guidance related to the reporting of discontinued operations. The guidance states that the disposal of a business or operation is required to be reported as discontinued operations if the disposal represents a strategic shift that will have a major effect on an entity's operations and financial results. The guidance also expands disclosures about discontinued operations and the disposal of significant businesses that did not qualify for discontinued operations presentation. This standard is effective prospectively, for disposals (or businesses that qualify as "held for sale") that occur within annual periods beginning on or after December 15, 2014 and interim periods within those years. Our adoption of this guidance effective in the first quarter of 2015 did not have any impact on our financial condition or results of operations.

In January 2014, the FASB issued guidance related to service concession arrangements. A service concession arrangement is an arrangement between a public-sector entity grantor and an operating entity under which the operating entity operates the grantor's infrastructure (for example, airports, roads and bridges). The guidance states that service concession arrangements should not be accounted for under the guidance of Accounting Standards Codification Topic 840, Leases, but rather other guidance as deemed appropriate. This guidance is effective for interim and reporting periods beginning on or after December 15, 2014. The guidance requires opening retained earnings in the year of adoption to reflect the cumulative historical impact of any arrangements existing at the date of adoption, and the new guidance to be applied to the financial statements on a prospective basis. Our adoption of this guidance effective in the first quarter of 2015 did not have any impact on our financial condition or results of operations.

Note 3. Divestitures

For the three months ended March 31, 2015, we divested two businesses for \$1 million of cash, which were not material, individually or in the aggregate, to our results of operations or financial position. The sale resulted in a gain of \$9 million, reflected in gain from sale of businesses in our Condensed Consolidated Income Statement.

Note 4. Restructuring Charges

During the three months ended March 31, 2015, we recognized restructuring charges of \$3 million. We incurred these charges primarily in an effort to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges include the elimination of headcount and consolidation of facilities within our Water Infrastructure segment.

During the three months ended March 31, 2014, we recognized restructuring charges of \$15 million within both our Water Infrastructure and Applied Water segments for the same aforementioned purposes for which we incurred the 2015 charges.

The following table presents the components of restructuring expense for the three months ended March 31, 2015 and 2014.

(in millions)	Three Months Ended	
	March 31, 2015	2014
By component:		
Severance and other charges	\$4	\$15
Reversal of restructuring accruals	(1) —
Total restructuring charges	\$3	\$15
By segment:		
Water Infrastructure	\$3	\$10
Applied Water	—	5

The following table displays a rollforward of the restructuring accruals, presented on our Condensed Consolidated Balance Sheets within accrued and other current liabilities, for the three months ended March 31, 2015 and 2014.

(in millions)	2015	2014
Restructuring accruals - January 1	\$12	\$13
Restructuring charges	3	15
Cash payments	(6	) (9
Foreign currency and other	(1) —
Restructuring accruals - March 31	\$8	\$19
By segment:		
Water Infrastructure	\$4	\$10
Applied Water	—	5
Regional selling locations (a)	3	4
Corporate and other	1	—

Regional selling locations consist primarily of selling and marketing organizations that incurred restructuring (a) expense which was allocated to the segments. The liabilities associated with restructuring expense were not allocated to the segments.

The following is a rollforward for the three months ended March 31, 2015 and 2014 of employee position eliminations associated with restructuring activities.

	2015	2014
Planned reductions - January 1	133	51
Additional planned reductions	74	170
Actual reductions	(92	) (109
Planned reductions - March 31	115	112

Total expected costs associated with actions that commenced during the three months ended March 31, 2015 are approximately \$3 million for Water Infrastructure. These costs primarily consist of severance charges. Related to these actions, we incurred \$2 million during the three months ended March 31, 2015. We currently expect activity related to these actions to continue through the third quarter of 2015.

Total expected costs associated with actions that commenced during 2014 are approximately \$19 million for Water Infrastructure. Approximately \$18 million of the expected cost was incurred in 2014 and \$1 million was incurred during the three months ended March 31, 2015. The Water Infrastructure actions commenced in 2014 are substantially complete. Total expected costs associated with actions that commenced during 2014 are approximately \$9 million for Applied Water. Approximately \$6 million of the expected cost was incurred in 2014, and \$3 million is expected to be incurred through early 2016.

Note 5. Income Taxes

Our quarterly provision for income taxes is measured using an estimated annual effective tax rate, adjusted for discrete items within periods presented. The comparison of our effective tax rate between periods is significantly impacted by the level and mix of earnings and losses by tax jurisdiction, foreign income tax rate differentials and amount of permanent book-to-tax differences.

The income tax provision for the three months ended March 31, 2015 was \$13 million resulting in an effective tax rate of 17.3%, compared to \$12 million resulting in an effective tax rate of 19.1% for the same period in 2014. The effective tax rate was lower than the United States federal statutory rate in each period primarily due to geographic mix of earnings.

Unrecognized Tax Benefits

We recognize tax benefits from uncertain tax positions only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized from such positions are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

The amount of unrecognized tax benefits at March 31, 2015 was \$41 million which, if ultimately recognized, will reduce our annual effective tax rate. We do not believe that the unrecognized tax benefits will significantly change within the next twelve months.

We classify interest expense relating to unrecognized tax benefits as a component of other non-operating expense, net and tax penalties as a component of income tax expense in our Condensed Consolidated Income Statements. As of March 31, 2015, we had less than \$1 million of interest accrued for unrecognized tax benefits.

Note 6. Earnings Per Share

The following is a reconciliation of the shares used in calculating basic and diluted net earnings per share.

	Three Months Ended March 31,	
	2015	2014
Net income (in millions)	\$64	\$49
Shares (in thousands):		
Weighted average common shares outstanding	182,049	184,505
Add: Participating securities (a)	46	42
Weighted average common shares outstanding — Basic	182,095	184,547
Plus incremental shares from assumed conversions: (b)		
Dilutive effect of stock options	532	659
Dilutive effect of restricted stock	437	563
Weighted average common shares outstanding — Diluted	183,064	185,769
Basic earnings per share	\$0.35	\$0.27
Diluted earnings per share	\$0.35	\$0.27

(a) Restricted stock awards containing rights to non-forfeitable dividends that participate in undistributed earnings with common shareholders are considered participating securities for purposes of computing earnings per share.

(b) Incremental shares from stock options, restricted stock and performance share units are computed by the treasury stock method. The weighted average shares listed below were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the periods presented or were otherwise excluded under the treasury stock method. The treasury stock method calculates dilution assuming the exercise of all in-the-money options and vesting of restricted stock and performance share awards, reduced by the repurchase of shares with the proceeds from the assumed exercises, unrecognized compensation expense for outstanding awards and the estimated tax benefit of the assumed exercises. Performance share units will be included in the treasury stock calculation of diluted earnings per share upon achievement of underlying performance conditions. See Note 14, "Share-Based Compensation Plans" for further detail on the performance share units.

	Three Months Ended March 31,	
(in thousands)	2015	2014
Stock options	2,634	2,746
Restricted stock	590	449
Performance shares	158	69

Note 7. Inventories

The components of total inventories are summarized as follows:

(in millions)	March 31, 2015	December 31, 2014
Finished goods	\$209	\$194
Work in process	49	42
Raw materials	244	250
Total inventories	\$502	\$486

Note 8. Property, Plant and Equipment

The components of total property, plant and equipment, net are as follows:

(in millions)	March 31, 2015	December 31, 2014
Land, buildings and improvements	\$243	\$252
Machinery and equipment	633	655
Equipment held for lease or rental	207	207
Furniture and fixtures	84	87
Construction work in progress	36	41
Other	22	23
Total property, plant and equipment, gross	1,225	1,265
Less accumulated depreciation	791	804
Total property, plant and equipment, net	\$434	\$461

Depreciation expense of \$24 million and \$23 million was recognized in the three months ended March 31, 2015 and 2014, respectively.

Note 9. Goodwill and Other Intangible Assets

Changes in the carrying value of goodwill by reportable segment for the three months ended March 31, 2015 are as follows:

(in millions)	Water Infrastructure	Applied Water	Total
Balance as of January 1, 2015	\$1,098	\$537	\$1,635
Activity in 2015			
Foreign currency and other	(36	) (17	) (53
Balance as of March 31, 2015	\$1,062	\$520	\$1,582

Based on the results of our latest annual impairment tests, we determined that no impairment of goodwill existed as of the measurement date in 2014. However, future goodwill impairment tests could result in a charge to earnings. We will continue to evaluate goodwill on an annual basis as of the beginning of our fourth quarter and whenever events and changes in circumstances indicate there may be a potential impairment.

Other Intangible Assets

Information regarding our other intangible assets is as follows:

(in millions)	March 31, 2015			December 31, 2014		
	Carrying Amount	Accumulated Amortization	Net Intangibles	Carrying Amount	Accumulated Amortization	Net Intangibles
Customer and distributor relationships	\$317	\$(122)	) \$195	\$331	\$(122)	) \$209
Proprietary technology and patents	113	(50)	) 63	116	(49)	) 67
Trademarks	34	(17)	) 17	36	(17)	) 19
Software (a)	125	(87)	) 38	131	(92)	) 39
Other	8	(8)	) —	9	(9)) —
Indefinite-lived intangibles	133	—	) 133	136	—	) 136
	\$730	\$(284)	) \$446	\$759	\$(289)	) \$470

The December 31, 2014 carrying amount of software was previously included within Other non-current assets on (a) the Condensed Consolidated Balance Sheets and is now being reflected within Other intangible assets to conform to a current period change in balance sheet presentation.

Amortization expense related to finite-lived intangible assets was \$11 million and \$13 million for the three months ended March 31, 2015 and 2014, respectively.

Note 10. Derivative Financial Instruments

Risk Management Objective of Using Derivatives

We are exposed to certain risks arising from both our business operations and economic conditions and principally manage our exposures to these risks through management of our core business activities. Certain of our foreign operations expose us to fluctuations of foreign interest rates and exchange rates that may impact revenues, expenses, cash receipts and payments. We enter into derivative financial instruments to protect the value or fix the amount of certain cash flows in terms of the functional currency of the business unit with that exposure.

Cash Flow Hedges of Foreign Exchange Risk

We are exposed to fluctuations in various foreign currencies against our functional currencies. We use foreign currency derivatives including currency forward agreements to manage our exposure to fluctuations in the various exchange rates. Currency forward agreements involve fixing the foreign currency exchange rate for delivery of a specified amount of foreign currency on a specified date.

Certain business units with exposure to foreign currency exchange risks have designated certain currency forward agreements as cash flow hedges of forecasted intercompany inventory purchases and sales. Our principal currency exposures relate to the Euro, Swedish Krona, British Pound, Canadian Dollar, Polish Zloty, Australian Dollar and Hungarian Forint. We held forward foreign exchange contracts with purchase notional amounts totaling \$219 million and \$355 million as of March 31, 2015 and December 31, 2014, respectively. As of March 31, 2015, our most significant foreign currency derivatives include contracts to purchase Swedish Krona and sell Euro, sell US Dollar and purchase Euro, and sell British Pound and purchase Euro. The purchased notional amounts associated with these currency derivatives are \$92 million, \$50 million and \$31 million, respectively. As of December 31, 2014, our most significant foreign currency derivatives include

contracts to purchase Swedish Krona and sell Euro, sell US Dollar and purchase Euro, and sell British Pound and purchase Euro. The purchased notional amounts associated with these currency derivatives are \$140 million, \$85 million and \$51 million, respectively.

The table below presents the effect of our derivative financial instruments on the Condensed Consolidated Income Statements and Statements of Comprehensive Income.

(in millions)	Three Months Ended	
	March 31, 2015	2014
Derivatives in Cash Flow Hedges		
Foreign Exchange Contracts		
Amount of loss recognized in Other Comprehensive Income (a)	\$(5	) \$(1
Amount of loss (gain) reclassified from Other Comprehensive Income into revenue (a)	4	(1
Amount of loss reclassified from Other Comprehensive Income into cost of revenue (a)	1	1

(a) Effective portion

As of March 31, 2015, \$14 million of the net unrealized losses on cash flow hedges is expected to be reclassified into earnings in the next 12 months. The ineffective portion of the change in fair value of a cash flow hedge is excluded from effectiveness testing and is recognized immediately in selling, general and administrative expenses in the Condensed Consolidated Income Statements. For the three months ended March 31, 2015 and 2014, the amounts were not material.

The fair values of our foreign exchange contracts currently included in our hedging program were as follows:

(in millions)	March 31, 2015	December 31, 2014
Derivatives designated as hedging instruments		
Assets		
Other current assets	\$2	\$1
Liabilities		
Other current liabilities	(12	) (13
Total fair value	\$(10	) \$(12

Note 11. Accrued and Other Current Liabilities

The components of total accrued and other current liabilities are as follows:

(in millions)	March 31, 2015	December 31, 2014
Compensation and other employee benefits	\$158	\$186
Customer-related liabilities	65	66
Accrued warranty costs	30	31
Accrued taxes	76	77
Other accrued liabilities	112	121
Total accrued and other current liabilities	\$441	\$481

Note 12. Credit Facilities and Long-Term Debt

Total debt outstanding is summarized as follows:

(in millions)	March 31, 2015	December 31, 2014
Short-term borrowings and current maturities of long-term debt	\$81	\$89
Long-term debt		
3.550% Senior Notes due 2016 (a)	\$600	\$600
4.875% Senior Notes due 2021 (a)	600	600
Debt issuance costs	(4	) (4
Unamortized discount (b)	(1	) (1
Long-term debt	\$1,195	\$1,195
Total debt	\$1,276	\$1,284

The fair value of our Senior Notes (as defined below) was determined using quoted prices in active markets for identical securities, which are considered Level 1 inputs. The fair value of our Senior Notes due 2016 (as defined (a)below) was \$620 million and \$621 million as of March 31, 2015 and December 31, 2014, respectively. The fair value of our Senior Notes due 2021 (as defined below) was \$659 million and \$653 million as of March 31, 2015 and December 31, 2014, respectively.

The unamortized discount is recognized as a reduction in the carrying value of the Senior Notes in the Condensed (b)Consolidated Balance Sheets and is being amortized to interest expense in our Condensed Consolidated Income Statements over the expected remaining terms of the Senior Notes.

Senior Notes

On September 20, 2011, we issued 3.550% Senior Notes of \$600 million aggregate principal amount due September 2016 (the "Senior Notes due 2016") and 4.875% Senior Notes of \$600 million aggregate principal amount due October 2021 (the "Senior Notes due 2021" and together with the Senior Notes due 2016 the "Senior Notes"). The Senior Notes include covenants which restrict our ability, subject to exceptions, to incur debt secured by liens and engage in sale and leaseback transactions, as well as provide for customary events of default (subject, in certain cases, to receipt of notice of default and/or customary grace and cure periods). We may redeem the Senior Notes, as applicable, in whole or in part, at any time at a redemption price equal to the principal amount of the Senior Notes to be redeemed, plus a make-whole premium. If a change of control triggering event (as defined in the Senior Notes indenture) occurs, we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase. As of March 31, 2015, we were in compliance with all covenants.

Interest on the Senior Notes due 2016 is payable on March 20 and September 20 of each year. Interest on the Senior Notes due 2021 is payable on April 1 and October 1 of each year.

Five-Year Revolving Credit Facility

Effective March 27, 2015, Xylem entered into a Five-Year Revolving Credit Facility (the "Credit Facility") with Citibank, N.A., as administrative agent, and a syndicate of lenders. The Credit Facility provides for an aggregate principal amount of up to \$600 million of: (i) revolving extensions of credit (the "revolving loans") outstanding at any time and (ii) the issuance of letters of credit in a face amount not in excess of \$100 million outstanding at any time. The Credit Facility provides for increases of up to \$200 million for a

possible maximum total of \$800 million in aggregate principal amount at our request and with the consent of the institutions providing such increased commitments.

At our election, the interest rate per annum applicable to the revolving loans will be based on either (i) a Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, plus an applicable margin or (ii) a fluctuating rate of interest determined by reference to the greatest of: (a) the prime rate of Citibank, N.A., (b) the U.S. Federal funds effective rate plus half of 1% or (c) the Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, in each case, plus an applicable margin.

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The Credit Facility also contains limitations on, among other things, incurring secured debt, granting liens, entering into sale and leaseback transactions, mergers, consolidations, liquidations, dissolutions and sales of assets. In addition, the Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default. As of March 31, 2015, we were in compliance with all covenants.

As of March 31, 2015, the Credit Facility was undrawn.

Research and Development Facility Agreement

On December 4, 2013, the Company amended and restated its Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank (the "EIB") to add an additional borrower under the facility. The facility provides an aggregate principal amount of up to €120 million (approximately \$132 million) to finance research projects and infrastructure development in the European Union. The Company's wholly owned subsidiaries in Luxembourg, Xylem Holdings S.á r.l. and Xylem International S.á r.l., are the borrowers under the R&D Facility Agreement. The obligations of the borrowers under the R&D Facility Agreement are guaranteed by the Company under an Amended and Restated Deed of Guarantee, dated as of December 4, 2013, in favor of the EIB. The funds are available to finance research and development projects during the period from 2013 through 2016 at the Company's R&D facilities in Sweden, Germany, Italy, the United Kingdom, Austria, Norway and Hungary.

Under the R&D Facility Agreement, the borrower can draw loans on or before June 14, 2015 with a maturity of no longer than 12 years. The R&D Facility Agreement provides for Fixed Rate loans and Floating Rate loans. The interest rate per annum applicable to Fixed Rate loans is at a fixed percentage rate per annum specified by the EIB which includes the applicable margin. The interest rate per annum applicable to Floating Rate loans is at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Pounds Sterling or U.S. Dollars, plus an applicable spread specified by the EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans is determined by reference to the credit rating of the Company.

In accordance with the terms of the R&D Facility Agreement, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The R&D Facility Agreement also contains limitations on, among other things, incurring debt, granting liens, and entering into sale and leaseback transactions. In addition, the R&D Facility Agreement contains other terms and conditions, such as customary representations and warranties, additional covenants and customary events of default. As of March 31, 2015, we were in compliance with all covenants.

As of March 31, 2015, \$76 million was outstanding under the R&D Facility Agreement. Although the borrowing term for this arrangement is for five years, we have classified it as short-term debt on our Condensed Consolidated Balance Sheet since we intend to repay this obligation in less than one year.

Note 13. Postretirement Benefit Plans

The following table provides the components of net periodic benefit cost for our defined benefit pension plans, disaggregated by domestic and international plans.

(in millions)	Three Months Ended	
	March 31, 2015	2014
Domestic defined benefit pension plans:		
Interest cost	\$1	\$1
Expected return on plan assets	(1	) (1
Amortization of net actuarial loss	1	1
Net periodic benefit cost	\$1	\$1
International defined benefit pension plans:		
Service cost	\$3	\$4
Interest cost	6	7
Expected return on plan assets	(8	) (8
Amortization of net actuarial loss	3	2
Net periodic benefit cost	\$4	\$5
Total net periodic benefit cost	\$5	\$6

The total net periodic benefit cost for other postretirement employee benefit plans was \$1 million for the three months ended March 31, 2015 and 2014.

We contributed \$6 million and \$11 million to our defined benefit plans during the three months ended March 31, 2015 and 2014, respectively. Additional contributions ranging between approximately \$18 million and \$28 million are expected during the remainder of 2015.

Note 14. Share-Based Compensation Plans

Share-based compensation expense was \$4 million during the three months ended March 31, 2015 and 2014. The unrecognized compensation expense related to our stock options, restricted stock and performance based shares was \$9 million, \$28 million and \$6 million, respectively, at March 31, 2015 and is expected to be recognized over a weighted average period of 2.4, 2.3 and 2.4 years, respectively. The amount of cash received from the exercise of stock options was \$6 million and \$11 million for the three months ended March 31, 2015 and 2014, respectively.

Stock Option Grants

The following is a summary of the changes in outstanding stock options for the three months ended March 31, 2015:

(shares in thousands)	Shares	Weighted Average Exercise Price / Share	Weighted Average Remaining Contractual Term (Years)
Outstanding at January 1, 2015	2,989	\$28.60	6.5
Granted	645	\$35.96	10.0
Exercised	(239)	) \$27.41	5.1
Forfeited	(4)	) \$24.60	6.7
Outstanding at March 31, 2015	3,391	\$30.09	7.0
Options exercisable at March 31, 2015	2,243	\$27.36	5.9
Vested and expected to vest as of March 31, 2015	3,223	\$29.80	6.9

The aggregate intrinsic value of the outstanding, exercisable, and vested and expected to vest stock options as of March 31, 2015 was \$19 million, \$18 million and \$19 million, respectively. The total intrinsic value of options exercised (which is the amount by which the stock price exceeded the exercise price of the options on the date of exercise) during the three months ended March 31, 2015 was \$2 million.

Stock Option Fair Value

The fair value of each option grant was estimated on the date of grant using the binomial lattice pricing model which incorporates multiple and variable assumptions over time, including assumptions such as employee exercise patterns, stock price volatility and changes in dividends. The following are weighted-average assumptions for 2015 grants:

Dividend yield	1.57	%
Volatility	27.80	%
Risk-free interest rate	1.63	%
Expected term (in years)	5.60	
Weighted-average fair value / share	\$8.53	

Expected volatility is calculated based on a weighted analysis of historic and implied volatility measures for a set of peer companies and Xylem. We use historical data to estimate option exercise and employee termination behavior within the valuation model. Employee groups and option characteristics are considered separately for valuation purposes. The expected term represents an estimate of the period of time options are expected to remain outstanding. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of option grant.

Restricted Stock Grants

The following is a summary of restricted stock activity for the three months ended March 31, 2015:

(shares in thousands)	Shares	Weighted Average Grant Date Fair Value /Share
Outstanding at January 1, 2015	1,171	\$ 31.80
Granted	333	\$ 35.96
Vested	(289	) \$ 26.73
Forfeited	(3	) \$ 29.27
Outstanding at March 31, 2015	1,212	\$ 34.17

Performance-Based Share Grants

The following is a summary of performance-based share grants for the three months ended March 31, 2015:

(shares in thousands)	Shares	Weighted Average Grant Date Fair Value /Share
Outstanding at January 1, 2015	124	\$ 33.95
Granted	91	\$ 35.96
Vested	—	\$ —
Forfeited	—	\$ —
Outstanding at March 31, 2015	215	\$ 34.80

Note 15. Capital Stock

On August 20, 2013, the Board of Directors authorized the repurchase of up to \$250 million in shares with no expiration date. The program's objective is to deploy our capital in a manner that benefits our shareholders and maintains our focus on growth. During the three months ended March 31, 2015, we repurchased 1.4 million shares for \$50 million under this program. There are up to \$20 million in shares that may still be purchased under this plan as of March 31, 2015. For the three months ended March 31, 2014, we repurchased 1.3 million shares for \$50 million under this program.

On August 18, 2012, the Board of Directors authorized the repurchase of up to 2.0 million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem employee stock plans by acquiring shares in the open market from time to time. There were no shares repurchased under this program during the three months ended March 31, 2015 and 2014. There are up to 1.0 million shares that may still be purchased under this plan as of March 31, 2015.

Aside from the aforementioned repurchase programs, we repurchased 0.1 million shares for \$3 million during the three months ended March 31, 2015 in relation to settlement of employee tax withholding obligations due as a result of the vesting of restricted stock. Likewise, during the three months ended March 31, 2014, we repurchased less than 0.1 million shares for \$1 million.

Note 16. Accumulated Other Comprehensive Income (Loss)

The following table provides the components of accumulated other comprehensive income (loss) for the three months ended March 31, 2015:

(in millions)	Foreign Currency Translation	Postretirement Benefit Plans	Derivative Instruments	Total
Balance at January 1, 2015	\$145	\$(231)	\$(13)	\$(99)
Foreign currency translation adjustment	(129)	—	—	(129)
Foreign currency gain reclassified into gain on sale of businesses	(8)	—	—	(8)
Amortization of net actuarial loss on postretirement benefit plans into:				
Cost of revenue	—	1	—	1
Selling, general and administrative expenses	—	3	—	3
Income tax impact on amortization of postretirement benefit plan items	—	(1)	—	(1)
Unrealized loss on foreign exchange agreements	—	—	(5)	(5)
Reclassification of unrealized loss on foreign exchange agreements into revenue	—	—	4	4
Reclassification of unrealized loss on foreign exchange agreements into cost of revenue	—	—	1	1
Balance at March 31, 2015	\$8	\$(228)	\$(13)	\$(233)

Note 17. Commitments and Contingencies

General

From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses, including acquisitions and divestitures, intellectual property matters, product liability and personal injury claims, employment and pension matters, government and commercial contract disputes.

On December 17, 2014, the Korea Fair Trade Commission (“KFTC”) issued a written decision regarding an investigation into bid-rigging allegations against Xylem Water Solutions South Korea Co., Ltd. (“Xylem South Korea”), a subsidiary of Xylem Inc. The KFTC found that certain employees of Xylem South Korea had participated in activities that violated Korea’s antitrust laws. Xylem South Korea was assessed a fine of approximately \$1.6 million, and following criminal prosecution a minimal criminal penalty was imposed. In January 2015, Xylem South Korea paid the fine and filed an appeal of the KFTC’s decision with the Seoul High Court.

In connection with the KFTC matter, the Company commenced an internal investigation relating to the allegations against Xylem South Korea. In late 2014, the Company broadened this internal investigation to assess related allegations made by certain employees of Xylem South Korea during the investigation into the KFTC matter. The broadened investigation includes a review of compliance by Xylem South Korea and its employees with the requirements of the Foreign Corrupt Practices Act. The Company engaged independent outside counsel to assist with its investigation and an independent professional services firm to provide forensic accounting assistance. In late January 2015, the Company voluntarily contacted the SEC and the Department of Justice (“DOJ”) to advise both agencies of this internal

investigation. The Company is fully cooperating with any government investigation. Xylem South Korea's revenue is less than one percent of the Company's total revenue. Although the Company currently cannot reasonably estimate the potential liability, if any, related to the investigation, we currently believe that these matters will not have a material adverse effect on the Company's business, financial condition or results of operations.

From time to time, claims may be asserted against Xylem alleging injury caused by any of our products resulting from asbestos exposure. We believe there are numerous legal defenses available for such claims and would defend ourselves vigorously. Pursuant to the Distribution Agreement ("Distribution Agreement") dated October 25, 2011 among ITT Corporation ("ITT" or "former parent"), Exelis Inc. and Xylem, the former parent has an obligation to indemnify, defend and hold Xylem harmless for asbestos product liability matters, including settlements, judgments, and legal defense costs associated with all pending and future claims that may arise from past sales of the former parent's legacy products. We believe the former parent remains a substantial entity with sufficient financial resources to honor its obligations to us.

Although the ultimate outcome of any legal matter cannot be predicted with certainty, based on present information, including our assessment of the merits of the particular claims, we do not expect that any asserted or unasserted legal claims or proceedings, individually or in aggregate, will have a material adverse effect on our results of operations or financial condition. We have estimated and accrued \$6 million and \$9 million for these general legal matters as of March 31, 2015 and December 31, 2014.

Indemnifications

As part of our 2011 spin-off from our former parent, ITT, Exelis Inc. and Xylem will indemnify, defend and hold harmless each of the other parties with respect to such parties' assumed or retained liabilities under the Distribution Agreement and breaches of the Distribution Agreement or related spin agreements. The former parent's indemnification obligations include asserted and unasserted asbestos and silica liability claims that relate to the presence or alleged presence of asbestos or silica in products manufactured, repaired or sold prior to October 31, 2011, the Distribution Date, subject to limited exceptions with respect to certain employee claims, or in the structure or material of any building or facility, subject to exceptions with respect to employee claims relating to Xylem buildings or facilities. The indemnification associated with pending and future asbestos claims does not expire. Xylem has not recorded a liability for material matters for which we expect to be indemnified by the former parent or Exelis Inc. through the Distribution Agreement and we are not aware of any claims or other circumstances that would give rise to material payments from us under such indemnifications.

Environmental

In the ordinary course of business, we are subject to federal, state, local, and foreign environmental laws and regulations. We are responsible, or are alleged to be responsible, for ongoing environmental investigation and remediation of sites in various countries. These sites are in various stages of investigation and/or remediation and in many of these proceedings our liability is considered de minimis. We have received notification from the U.S. Environmental Protection Agency, and from similar state and foreign environmental agencies, that a number of sites formerly or currently owned and/or operated by Xylem or for which we are responsible under the Distribution Agreement, and other properties or water supplies that may be or have been impacted from those operations, contain disposed or recycled materials or wastes and require environmental investigation and/or remediation. These sites include instances where we have been identified as a potentially responsible party under federal and state environmental laws and regulations.

Accruals for environmental matters are recorded on a site-by-site basis when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated, based on current law and existing technologies. Our accrued liabilities for these environmental matters represent the best estimates related to the investigation and remediation of environmental media such as water, soil, soil vapor, air and

structures, as well as related legal fees. These estimates, and related accruals, are reviewed quarterly and updated for progress of investigation and remediation efforts and changes in facts and legal circumstances. Liabilities for these environmental expenditures are recorded on an undiscounted basis. We have estimated and accrued \$5 million as of March 31, 2015 and December 31, 2014 for environmental matters.

It is difficult to estimate the final costs of investigation and remediation due to various factors, including incomplete information regarding particular sites and other potentially responsible parties, uncertainty regarding the extent of investigation or remediation and our share, if any, of liability for such conditions, the selection of alternative remedial approaches, and changes in environmental standards and regulatory requirements. We believe the total amount accrued is reasonable based on existing facts and circumstances.

Warranties

We warrant numerous products, the terms of which vary widely. In general, we warrant products against defect and specific non-performance. The table below provides the changes in our product warranty accrual.

(in millions)	2015	2014
Warranty accrual – January 1	\$31	\$37
Net changes for product warranties in the period	6	5
Settlement of warranty claims	(6	) (8
Foreign currency and other	(1) —
Warranty accrual - March 31	\$30	\$34

Note 18. Segment Information

Our business has two reportable segments: Water Infrastructure and Applied Water. The Water Infrastructure segment, focuses on the transportation, treatment and testing of water, offering a range of products including water and wastewater pumps, treatment and testing equipment, and controls and systems. The Applied Water segment encompasses the uses of water and focuses on the residential, commercial, industrial and agricultural markets offering a wide range of products, including pumps, valves and heat exchangers.

Additionally, we have Regional selling locations which consist primarily of selling and marketing organizations and related support that offer products and services across both of our reportable segments. Corporate and other consists of corporate office expenses including compensation, benefits, occupancy, depreciation, and other administrative costs, as well as charges related to certain matters, such as environmental matters that are managed at a corporate level and are not included in the business segments in evaluating performance or allocating resources.

The accounting policies of each segment are the same as those described in the summary of significant accounting policies (see Note 1 in the 2014 Annual Report). The following tables contain financial information for each reportable segment.

(in millions)	Three Months Ended	
	March 31, 2015	2014
Revenue:		
Water Infrastructure	\$500	\$552
Applied Water	337	354
Total	\$837	\$906
Operating Income:		
Water Infrastructure	\$47	\$46
Applied Water	46	41
Corporate and other	(10	) (11
Total	\$83	\$76
Depreciation and Amortization:		
Water Infrastructure	\$25	\$25
Applied Water	6	6
Regional selling locations (a)	2	3
Corporate and other	2	2
Total	\$35	\$36
Capital Expenditures:		
Water Infrastructure	\$25	\$13
Applied Water	7	5
Regional selling locations (b)	2	2
Corporate and other	3	5
Total	\$37	\$25

Depreciation and amortization expense incurred by the Regional selling locations was included in an overall (a) allocation of Regional selling location costs to the segments; however, a certain portion of that expense was not specifically identified to a segment. That expense is captured in this Regional selling location line.

(b) Represents capital expenditures incurred by the Regional selling locations not allocated to the segments.

The following table contains the total assets for each reportable segment.

(in millions)	Total Assets	
	March 31, 2015	December 31, 2014
Water Infrastructure	\$2,067	\$2,128
Applied Water	1,103	1,114
Regional selling location (a)	902	961
Corporate and other (b)	548	657
Total	\$4,620	\$4,860

(a) The Regional selling locations have assets that consist primarily of cash, accounts receivable and inventory which are not allocated to the segments.

(b) Corporate and other consists of items pertaining to our corporate headquarters function, which principally consist of cash, deferred tax assets, pension assets and certain property, plant and equipment.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the condensed consolidated financial statements, including the notes thereto, included elsewhere in this report on Form 10-Q (this "Report"). Except as otherwise indicated or unless the context otherwise requires, "Xylem," "we," "us," "our" and the "Company" refer to Xylem Inc. and its subsidiaries. References in the condensed consolidated financial statements to "ITT" or the "former parent" refer to ITT Corporation and its consolidated subsidiaries (other than Xylem Inc.).

This Report contains information that may constitute "forward-looking statements" within the meaning of the Private Securities Litigation Act of 1995. Forward-looking statements by their nature address matters that are, to different degrees, uncertain. Generally, the words "anticipate," "estimate," "expect," "project," "intend," "plan," "forecast," "believe," "will," "could," "would," "should" and similar expressions identify forward-looking statements, which generally are not historical in nature. However, the absence of these words or similar expressions does not mean that a statement is not forward-looking. These forward-looking statements include statements about the capitalization of the Company, the Company's restructuring and realignment, future strategic plans and other statements that describe the Company's business strategy, outlook, objectives, plans, intentions or goals. All statements that address operating or financial performance, events or developments that we expect or anticipate will occur in the future - including statements relating to orders, revenue, operating margins and earnings per share growth, and statements expressing general views about future operating results - are forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause actual results to differ materially from those expressed or implied in, or reasonably inferred from, such forward-looking statements.

Factors that could cause results to differ materially from those anticipated include: economic, political and other risks associated with our international operations, including military actions, economic sanctions or trade embargoes that could affect customer markets, and non-compliance with laws, including foreign corrupt practice laws, export and import laws and competition laws; potential for unexpected cancellations or delays of customer orders in our reported backlog; our exposure to fluctuations in foreign currency exchange rates; competition and pricing pressures in the markets we serve; the strength of housing and related markets; weather conditions; ability to retain and attract key members of management; our relationship with and the performance of our channel partners; our ability to borrow or to refinance our existing indebtedness and availability of liquidity sufficient to meet our needs; changes in the value of goodwill or intangible assets; risks relating to product defects, product liability and recalls; governmental investigations; security breaches or other disruptions of our information technology systems; litigation and contingent liabilities; and other factors set forth under "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2014 ("2014 Annual Report") and with subsequent filings we make with the Securities and Exchange Commission ("SEC").

All forward-looking statements made herein are based on information available to the Company as of the date of this Report. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

Our quarterly financial periods end on the Saturday closest to the last day of the calendar quarter, except for the fourth quarter which ends on December 31. For ease of presentation, the reporting periods included herein are described as ending on the last day of the calendar quarter.

Overview

Xylem is a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. Our business focuses on providing technology-intensive equipment and services. Our product and service offerings are organized into two reportable segments: Water Infrastructure and Applied Water. Our segments are aligned with each of the sectors in the cycle of water, water infrastructure and usage applications.

Water Infrastructure serves the water infrastructure sector with pump systems that transport water from aquifers, lakes, rivers and seas; with filtration, ultraviolet and ozone systems that provide treatment, making the water fit to use; and pumping solutions that move the wastewater to treatment facilities where our mixers, biological treatment, monitoring and control systems provide the primary functions in the treatment process. We provide analytical instrumentation used to measure water quality, flow and level in wastewater, surface water and coastal environments. In the Water Infrastructure segment, we provide the majority of our sales directly to customers with strong application expertise, while the remaining amount is through distribution partners.

Applied Water serves the usage applications sector with water pressure boosting systems for heating, ventilation and air conditioning and for fire protection systems to the residential and commercial building services markets. In addition, our pumps, heat exchangers, valves and controls provide cooling to power plants and manufacturing facilities, as well as circulation for food and beverage processing. We also provide boosting systems for farming irrigation, pumps for dairy operations and rainwater reuse systems for small scale crop and turf irrigation. In the Applied Water segment, we provide the majority of our sales through long-standing relationships with the world's leading distributors, with the remainder going directly to customers.

In 2014, we began implementing an organizational redesign to integrate our commercial teams within geographical regions. While this organizational redesign did not change our reportable segments, it had implications on how we manage our business. These changes and the related measurement system were effective in the fourth quarter 2014 and as a result, we commenced reporting our financial performance at such time based on the new organizational design. First quarter 2014 segment information presented herein has been recast from amounts previously reported to reflect these changes. The recast financial information does not represent a restatement of previously issued financial statements and the changes had no impact on our historical consolidated financial position or results of operations.

Executive Summary

Xylem reported revenue for the first quarter of 2015 of \$837 million, a decrease of 7.6% compared to \$906 million during the first quarter of 2014. Revenue was flat on a constant currency basis due to organic growth of 1.0% offset by the impact of our divestiture of our Wolverhampton valves business. The organic growth was driven by strength from emerging markets and modest growth in the United States which was largely offset by weakness in Australia and Canada. Operating income for the first quarter of 2015 was \$83 million, reflecting an increase of \$7 million or 9.2% compared to \$76 million in the first quarter of 2014, primarily due to cost saving initiatives and savings from restructuring actions, which more than offset headwinds from cost inflation and unfavorable foreign exchange impacts. Additionally, restructuring and realignment cost actions taken to improve the overall cost base of the business were \$6 million in the first quarter of 2015 as compared to \$18 million in the prior year.

Additional financial highlights for the quarter ended March 31, 2015 include the following:

• Orders of \$915 million, or 7.9% decline from \$993 million in the prior year

• Earnings per share of \$0.35, up 29.6% from the prior year (\$0.33 on an adjusted basis, down 2.9%, though up 8.8% excluding \$0.04 negative impact from currency translation)

• Cash flow from operating activities of \$39 million for the three months ended March 31, 2015, up 77.3% from prior year, and free cash flow of positive \$2 million as compared to negative \$3 million in the prior year.

Key Performance Indicators and Non-GAAP Measures

Management reviews key performance indicators including revenue, gross margin, segment operating income and margins, earnings per share, orders growth, working capital, free cash flow and backlog, among others. In addition, we consider certain measures to be useful to management and investors evaluating our operating performance for the periods presented, and provide a tool for evaluating our ongoing operations, liquidity and management of assets. This information can assist investors in assessing our financial performance and measures our ability to generate capital for deployment among competing strategic alternatives and initiatives, including, but not limited to, dividends, acquisitions, share repurchases and debt repayment. These metrics, however, are not measures of financial performance under accounting principles generally accepted in the United States of America ("GAAP") and should not be considered a substitute for revenue, operating income, net income, earnings per share (basic and diluted) or net cash from operations as determined in accordance with GAAP. We consider the following non-GAAP measures, which may not be comparable to similarly titled measures reported by other companies, to be key performance indicators:

"organic revenue" and "organic orders" defined as revenue and orders, respectively, excluding the impact of foreign currency fluctuations, intercompany transactions and contributions from acquisitions and divestitures. Divestitures include sales of insignificant portions of our business that did not meet the criteria for classification as a discontinued operation. The period-over-period change resulting from foreign currency fluctuations assumes no change in exchange rates from the prior period.

"constant currency" defined as financial results adjusted for currency translation impacts by translating current period and prior period activity using the same currency conversion rate. This approach is used for countries whose functional currency is not the U.S. Dollar.

"adjusted net income" and "adjusted earnings per share" defined as net income and earnings per share, respectively, adjusted to exclude restructuring and realignment costs, and tax-related special items. A reconciliation of adjusted net income is provided below.

(In millions, except for per share data)	Three Months Ended	
	March 31,	
	2015	2014
Net income	\$64	\$49
Restructuring and realignment, net of tax	4	15
Special charges, net of tax	2	—
Tax-related special items	(1	) (1
Gain on sale of businesses, net of tax	(9) —
Adjusted net income	\$60	\$63
Weighted average number of shares - Diluted	183.1	185.8
Adjusted earnings per share	\$0.33	\$0.34

"operating expenses excluding restructuring and realignment costs and special charges" defined as operating expenses, adjusted to exclude restructuring and realignment costs, and special charges.

"adjusted segment operating income" defined as segment operating income, adjusted to exclude restructuring and realignment costs, and special charges, and "adjusted segment operating margin" defined as adjusted segment operating income divided by total segment revenue.

"realignment costs" defined as costs not included in restructuring costs that are incurred as part of actions taken to reposition our business, including items such as professional fees, severance, relocation, travel, facility set-up and other costs.

"special charges" defined as costs incurred by the Company, such as legal and professional fees, associated with the Korea matters, as well as costs incurred for the contractual indemnification of tax obligations to ITT.

"free cash flow" defined as net cash provided by operating activities less capital expenditures, as well as adjustments for other significant items that impact current results that management believes are not related to our ongoing operations and performance. Our definition of free cash flow does not consider certain non-discretionary cash payments, such as debt. The following table provides a reconciliation of free cash flow.

(In millions)	Three Months Ended	
	March 31,	
	2015	2014
Net cash provided by operating activities	\$39	\$22
Capital expenditures	(37	) (25
Free cash flow	\$2	\$(3

2015 Outlook

We continue to anticipate organic revenue growth in the low single digits in 2015. This projected organic growth excludes a continued expected negative foreign exchange translation impact on our growth in the high single digits, primarily driven by a weaker Euro to U.S. dollar. We expect strength in the United States industrial markets excluding oil and gas, partially offset by modest deceleration in emerging market growth, resulting in low single-digit growth overall for the industrial end market. We expect public utilities to also increase at low single digits with emerging market infrastructure investments continuing to bolster growth and with improving market conditions in the United States. In the commercial market, we anticipate growth of low to mid-single digits as the United States appears to continue to slowly recover and emerging markets continue to be strong, which we expect will be partially offset by soft European markets. We believe the residential markets will be flat to down low single digits as the United States markets soften and Europe declines, partially offset by new product launches. Finally, we expect that organic revenue growth in the agriculture markets, which is our smallest end market, will likely be relatively flat compared to 2014 as we are expecting slower growth in the United States as a result of lapping a strong 2014 combined with weakness in Europe and continued strength in emerging markets.

We will continue to execute restructuring and realignment actions to reposition our European and North American business which we expect to optimize our cost structure and improve our operational efficiency and effectiveness. In 2015, we expect to incur approximately \$20 million in restructuring and realignment costs. We expect to realize approximately \$16 million of incremental net savings in 2015 from restructuring actions initiated in 2014, and an additional \$2 million of net savings from our 2015 actions.

Additional strategic actions include strategic initiatives which are expected to drive above-market growth, advance continuous improvement activities to increase productivity, focus on improving cash performance and drive a disciplined capital deployment strategy.

Results of Operations

(In millions)	Three Months Ended		
	March 31,		
	2015	2014	Change
Revenue	\$837	\$906	(7.6) %
Gross Profit	315	342	(7.9) %
Gross Margin	37.6	% 37.7	% (10) bp
Operating expenses excluding restructuring and realignment costs and special charges	225	248	(9.3) %
Expense to revenue ratio	26.9	% 27.4	% (50) bp
Restructuring and realignment costs	6	18	(66.7) %
Special charges	1	—	NM
Total operating expenses	232	266	(12.8) %
Operating Income	83	76	9.2 %
Operating Margin	9.9	% 8.4	% 150 bp
Interest and other non-operating expense, net	15	15	— %
Gain on sale of businesses	9	—	NM
Income tax expense	13	12	8.3 %
Tax rate	17.3	% 19.1	% (180) bp
Net Income	\$64	\$49	30.6 %

Revenue

Revenue generated during the three months ended March 31, 2015 was \$837 million, reflecting a decrease of \$69 million or 7.6%, compared to the same prior year period. On a constant currency basis, revenue increased 0.4% reflecting organic growth within emerging markets and the United States partially offset by the impact of the Wolverhampton valves business divestiture in the third quarter of 2014 and declines in Australia and Canada.

The following table illustrates the impact from organic growth, recent acquisitions and divestitures, and fluctuations in foreign currency in relation to revenue during the three months ended March 31, 2015:

(In millions)	Three Months Ended March 31,			
	Change	% Change		
2014 Revenue	\$906			
Organic growth	9	1.0		%
Acquisitions/(Divestitures)	(5	) (0.6)%
Constant Currency	4	0.4		%
Foreign currency translation (a)	(73	) (8.0)%
Total change in revenue	(69	) (7.6)%
2015 Revenue	\$837			

(a) Foreign currency impact primarily due to fluctuations in the value of the Euro, Swedish Krona, British Pound, Norwegian Krone, Canadian Dollar and Australian Dollar against the U.S. Dollar.

The following table summarizes revenue by segment:

(In millions)	Three Months Ended March 31,		As Reported Change		Constant Currency Change	
	2015	2014				
Water Infrastructure	\$500	\$552	(9.4	)%	0.4	%
Applied Water	337	354	(4.8	)%	0.6	%
Total	\$837	\$906	(7.6	)%	0.4	%

Water Infrastructure

Water Infrastructure revenue decreased \$52 million, or 9.4%, for the three months ended March 31, 2015 (0.4% increase at constant currency) compared to the respective 2014 period. The 0.4% constant currency increase was driven by \$2 million, or 0.4%, organic growth from strength in the public utility end market, partially offset by weakness in the industrial water end market.

From an application perspective for the first quarter of 2015, treatment grew and transport was flat while test applications declined. Revenue from treatment applications grew primarily from the delivery of ozone and filtration projects in China, which was partially offset by project deliveries in Australia in the prior year and weakness in southern Europe. Flat revenue from Transport applications was primarily due to public utility and industrial strength in northern and western Europe combined with increased public utility demand in China, offset by declines in industrial dewatering applications from weakness in the oil and gas market and reduced public utility capital expenditure spending in Canada. Revenue from test applications declined primarily due to lapping prior year strong project shipments in the emerging markets, which was partially offset by strength in India from environmental monitoring projects.

Applied Water

Applied Water revenue declined \$17 million, or 4.8%, for the three months ended March 31, 2015 (0.6% increase at constant currency) compared to the respective 2014 period. The 0.6% increase at constant currency was due to \$7 million, or 2.0%, organic growth in the commercial and residential end markets, partially offset by declines in the agriculture and industrial water end markets, and further offset by a \$5 million reduction in revenue due to the absence of revenue from our Wolverhampton valves business which we divested in the third quarter of 2014.

From an application perspective for the first quarter of 2015, the organic revenue increase was primarily driven by strength in commercial and residential building service applications, partially offset by weakness in the irrigation and industrial water applications. Revenue grew in commercial buildings primarily within the United States due to shipments related to an uptick in orders resulting from distributor restocking at the end of 2014 combined with strength from a recovering institutional building sector. Residential building applications experienced growth within northern Europe from market strength and increased demand for new energy efficient products, partially offset by weakness in the United States from cold weather conditions delaying construction activity and negative price realization. Revenue from irrigation applications declined principally due to lapping of a strong first quarter in 2014 combined with weaker market conditions in 2015. Revenue from industrial applications were down slightly in the quarter due to the lapping of strong oil and gas project shipments for fire protection systems in Asia in the prior year.

Orders / Backlog

Orders received during the first quarter of 2015 of \$915 million decreased by \$78 million, or 7.9%, from the prior year (0.1% decrease at constant currency). Organic order growth increased 0.4% for the three months ended March 31, 2015.

Water Infrastructure segment orders decreased \$35 million, or 5.9%, to \$562 million (3.5% increase at constant currency) for the quarter as compared to the prior year. Organic orders increased 3.5% during the first quarter predominately due to a large custom transport project win in Canada combined with strength in the U.S. distribution channel. Organic growth was further bolstered by treatment and test applications from increased public utility spending in emerging markets. The increases were partially offset in industrial dewatering applications due to weakness in the oil and gas market.

Applied Water segment orders decreased \$43 million, or 10.9% to \$353 million (5.6% decrease at constant currency) for the three months ended March 31, 2015. Organic order volume decreased 4.3% for the three months ended March 31, 2015 as a result of similar market dynamics impacting revenue.

Delivery schedules vary from customer to customer based upon their requirements. Typically, large projects require longer lead production cycles and delays can occur from time to time. Total backlog was \$793 million at March 31, 2015, flat compared to March 31, 2014 and increased \$53 million or 7.2%, as compared to \$740 million at December 31, 2014. We anticipate that approximately 78% of the backlog at March 31, 2015 will be recognized as revenue in the remainder of 2015.

Gross Margin

Gross margin declined slightly to 37.6% for the three months ended March 31, 2015, compared to 37.7% for 2014. Gross margin was impacted by foreign exchange headwinds, negative price impacts and geographic sales mix due to higher volume sold to the emerging markets and lower rental activity from oil and gas market weakness. These declines were partially mitigated by benefits realized from restructuring savings and cost saving initiatives through lean six sigma and global sourcing across both segments.

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Operating Expenses

The following table presents operating expenses for the three months ended March 31, 2015 and 2014:

(In millions)	Three Months Ended		Change
	March 31,		
	2015	2014	
Selling, general and administrative expenses ("SG&A")	\$206	\$224	(8.0)%
SG&A as a % of revenue	24.6	% 24.7	% (10)bp
Research and development expenses ("R&D")	23	27	(14.8)%
R&D as a % of revenue			