Xylem Inc.
Form 10-Q
July 31, 2018

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2018

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	**45-2080495**
(State or other jurisdiction of incorporation or organization)	*(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 þ 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 þ 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 þ		Accelerated filer	¨
Non-accelerated filer ¨	(Do not check if a smaller reporting company)	Smaller reporting company	¨
		Emerging growth company	¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.¨

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

As of July 27, 2018, there were 179,617,701 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)

	Three Months		Six Months	
For the period ended June 30,	**2018**	2017	**2018**	2017
Revenue	**$1,317**	$1,164	**$2,534**	$2,235
Cost of revenue	**798**	707	**1,555**	1,366
Gross profit	**519**	457	**979**	869
Selling, general and administrative expenses	**293**	270	**589**	542
Research and development expenses	**50**	44	**91**	86
Restructuring and asset impairment charges, net	**5**	6	**15**	18
Operating income	**171**	137	**284**	223
Interest expense	**21**	21	**42**	41
Other non-operating income (expense), net	**2**	5	**5**	4
(Loss) gain from sale of business	**(2)**	—	**(2)**	5
Income before taxes	**150**	121	**245**	191
Income tax expense	**35**	21	**51**	35
Net income	**115**	100	**194**	156
Less: Net income attributable to non-controlling interests	**—**	1	**—**	1
Net income attributable to Xylem	**$115**	$99	**$194**	$155
Earnings per share:				
Basic	**$0.64**	$0.55	**$1.08**	$0.87
Diluted	**$0.64**	$0.55	**$1.07**	$0.86
Weighted average number of shares:				
Basic	**179.8**	179.6	**179.8**	179.6
Diluted	**181.0**	180.6	**181.2**	180.6
Dividends declared per share	**$0.2100**	$0.1800	**$0.4200**	$0.3600

See accompanying notes to condensed consolidated financial statements.

XYLEM INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)
(in millions)

	Three Months		**Six Months**	
For the period ended June 30,	**2018**	2017	**2018**	2017
Net income	**$115**	$100	**$194**	$156
Other comprehensive income, before tax:				
Foreign currency translation adjustment	**(60)**	30	**(52)**	59
Net change in derivative hedge agreements:				
Unrealized (losses) gains	**(9)**	3	**(9)**	5
Amount of gain reclassified into net income	**(1)**	(1)	**(2)**	—
Net change in postretirement benefit plans:				
Amortization of prior service credit	**(1)**	—	**(2)**	—
Amortization of net actuarial loss into net income	**4**	2	**7**	5
Settlement/Curtailment	**—**	—	**1**	—
Other comprehensive (loss) income, before tax	**(67)**	34	**(57)**	69
Income tax expense (benefit) related to items of other comprehensive income	**20**	(22)	**10**	(29)
Other comprehensive (loss) income, net of tax	**(87)**	56	**(67)**	98
Comprehensive income	**$28**	$156	**$127**	$254

See accompanying notes to condensed consolidated financial statements.

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

	June 30, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	**$ 321**	$ 414
Receivables, less allowances for discounts and doubtful accounts of $31 and $35 in 2018 and 2017, respectively	**1,019**	956
Inventories	**598**	524
Prepaid and other current assets	**168**	177
Total current assets	**2,106**	2,071
Property, plant and equipment, net	**643**	643
Goodwill	**2,996**	2,768
Other intangible assets, net	**1,269**	1,168
Other non-current assets	**218**	210
Total assets	**$ 7,232**	$ 6,860
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	**$ 580**	$ 549
Accrued and other current liabilities	**536**	551
Short-term borrowings and current maturities of long-term debt	**361**	—
Total current liabilities	**1,477**	1,100
Long-term debt	**2,179**	2,200
Accrued postretirement benefits	**426**	442
Deferred income tax liabilities	**288**	252
Other non-current accrued liabilities	**333**	347
Total liabilities	**4,703**	4,341
Commitments and contingencies (Note 18)		
Stockholders' equity:		
Common Stock – par value $0.01 per share:		
Authorized 750.0 shares, issued 192.8 shares and 192.3 shares in 2018 and 2017, respectively	**2**	2
Capital in excess of par value	**1,932**	1,912
Retained earnings	**1,359**	1,227
Treasury stock – at cost 13.2 shares and 12.4 shares in 2018 and 2017, respectively	**(486)**	(428)
Accumulated other comprehensive loss	**(294)**	(210)
Total stockholders' equity	**2,513**	2,503
Non-controlling interests	**16**	16
Total equity	**2,529**	2,519
Total liabilities and stockholders' equity	**$ 7,232**	$ 6,860

See accompanying notes to condensed consolidated financial statements.

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XYLEM INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(in millions)

For the six months ended June 30,	**2018**	2017
Operating Activities		
Net income	**$194**	$156
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	**58**	55
Amortization	**74**	61
Share-based compensation	**16**	11
Restructuring and asset impairment charges	**15**	18
Loss (gain) from sale of business	**2**	(5)
Other, net	**(7)**	4
Payments for restructuring	**(12)**	(17)
Changes in assets and liabilities (net of acquisitions):		
Changes in receivables	**(68)**	(70)
Changes in inventories	**(87)**	(13)
Changes in accounts payable	**54**	(19)
Other, net	**(38)**	(30)
Net Cash – Operating activities	**201**	151
Investing Activities		
Capital expenditures	**(111)**	(77)
Acquisitions of businesses, net of cash acquired	**(430)**	(6)
Proceeds from sale of business	**—**	11
Other, net	**4**	3
Net Cash – Investing activities	**(537)**	(69)
Financing Activities		
Short-term debt issued, net	**437**	33
Short-term debt repaid	**(54)**	(65)
Repurchase of common stock	**(58)**	(25)
Proceeds from exercise of employee stock options	**4**	7
Dividends paid	**(76)**	(65)
Other, net	**(1)**	—
Net Cash – Financing activities	**252**	(115)
Effect of exchange rate changes on cash	**(9)**	13
Net change in cash and cash equivalents	**(93)**	(20)
Cash and cash equivalents at beginning of year	**414**	308
Cash and cash equivalents at end of period	**$321**	$288
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	**$46**	$46
Income taxes (net of refunds received)	**$51**	$47

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 operates in three segments, Water Infrastructure, Applied Water and Measurement & Control Solutions. The Water Infrastructure segment focuses on the transportation and treatment of water, offering a range of products including water and wastewater pumps, treatment equipment, and controls and systems. The Applied Water segment serves many of the primary uses of water and focuses on the residential, commercial and industrial markets. The Applied Water segment's major products include pumps, valves, heat exchangers, controls and dispensing equipment. The Measurement & Control Solutions segment focuses on developing advanced technology solutions that enable intelligent use and conservation of critical water and energy resources as well as analytical instrumentation used in the testing of water. The Measurement & Control Solutions segment's major products include smart metering, networked communications, measurement and control technologies, critical infrastructure technologies, software and services including cloud-based analytics, remote monitoring and data management, leak detection and pressure monitoring solutions and testing equipment.

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 intercompany 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, 2017 ("2017 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 included in our 2017 Annual Report.

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 and indefinite lived intangible impairment testing and contingent liabilities. Actual results could differ from these estimates.

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.

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Note 2. Recently Issued Accounting Pronouncements

Pronouncements Not Yet Adopted

In August 2017, the Financial Accounting Standards Board ("FASB") issued amended guidance on hedging activities. The amendment better aligns a company's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying for hedging relationships and the presentation of hedge results. Specifically, the guidance:

(1)Eliminates the concept of recognizing periodic hedge ineffectiveness for cash flow and net investment hedges;

(2)Eliminates the benchmark interest rate concept of variable - rate instruments in cash flow hedges and allows companies to designate the contractually specified interest rate as the hedged risk;

(3)Requires a company to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported; and

(4)Provides the ability to perform subsequent hedge effectiveness tests qualitatively.

This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those annual periods. Early adoption is permitted with the effect of adoption reflected as of the beginning of the fiscal year of adoption. For cash flow and net investment hedges existing at the date of adoption, a cumulative-effect adjustment related to eliminating the separate measurement of ineffectiveness is required. Other presentation and disclosure guidance is required only prospectively. We are evaluating the impact of the guidance on our financial condition and results of operations.

In June 2016, the FASB issued guidance amending the accounting for the impairment of financial instruments, including trade receivables. Under current guidance, credit losses are recognized when the applicable losses are probable of occurring and this assessment is based on past events and current conditions. The amended guidance eliminates the "probable" threshold and requires an entity to use a broader range of information, including forecast information when estimating expected credit losses. Generally, this should result in a more timely recognition of credit losses. This guidance is effective for interim and annual periods beginning after December 15, 2019 with early adoption permitted for interim and annual periods beginning after December 15, 2018. The requirements of the amended guidance should be applied using a modified retrospective approach except for debt securities, which require a prospective transition approach. We are evaluating the impact of the guidance on our financial condition and results of operations.

In February 2016, the FASB issued guidance amending the accounting for leases. Specifically, the amended guidance requires all lessees to record a lease liability at lease inception, with a corresponding right of use asset, except for short-term leases. Lessor accounting is not fundamentally changed. This amended guidance is effective for interim and annual periods beginning after December 15, 2018 using a modified retrospective approach. Early adoption is permitted. We are evaluating the impact of the guidance on our financial condition and results of operations.

Recently Adopted Pronouncements

In February 2018, the FASB issued new guidance on the reclassification of certain tax effects in Accumulated Other Comprehensive Income ("AOCI"). The guidance allows a reclassification from AOCI to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act (the "Tax Act"). This guidance is effective for fiscal years beginning after December 15, 2018, including interim periods within those annual periods. Early adoption is permitted. The guidance may be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Act is recognized. We early adopted this guidance effective the first quarter of 2018, and elected to reclassify the income tax effects of the Tax Act from AOCI to retained earnings. As a result of adopting the guidance, AOCI was reduced by $17 million and retained earnings increased by $17 million. This amount includes the effect of the change in the US federal corporate income tax rate.

In March 2017, the FASB issued amended guidance on the presentation of net periodic benefit costs. The amendment requires that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components are required to be presented in the income statement separately and outside a subtotal of income from operations, if one is presented. The amendment also requires entities to disclose the income statement lines

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that contain the other components if they are not appropriately described. This guidance is effective retrospectively for periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted. We adopted this guidance effective the first quarter of 2018. The prior period consolidated income statements and segment results have been retrospectively adjusted in accordance with the new guidance. The impact to the presentation between operating income and other non-operating income within Xylem's Consolidated Income Statements was $2 million or less for each of the quarters of 2017 and 2016 and approximately $4 million for the year ended December 31, 2017.
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, 2017 and may be applied retrospectively to each prior period presented or using a modified retrospective approach with the cumulative effect recognized as of the date of initial application. Early adoption is permitted for interim and annual reporting periods beginning after December 15, 2016. We adopted this guidance as of January 1, 2018 using the modified retrospective transition method. The adoption of the guidance did not have a material impact on our financial condition and results of operations. See Note 4, "Revenue", for further details.

Note 3. Acquisitions and Divestitures

2018 Acquisitions and Divestitures

Pure Technologies Ltd.

On January 31, 2018, we acquired all the issued and outstanding shares of Pure Technologies Ltd. (“Pure”), a leader in intelligent leak detection and condition assessment solutions for water distribution networks for approximately $420 million, net of cash received. Acquisition costs of $4 million were reflected as a component of selling, general and administrative expenses in our Condensed Consolidated Income Statement.

Pure’s results of operations were consolidated with the Company effective February 1, 2018 and are reflected in the Measurement & Control Solutions segment.

The preliminary Pure purchase price allocation as of January 31, 2018 is shown in the following table.

(in millions)	Amount
Cash	$ 14
Receivables	23
Inventories	5
Prepaid and other current assets	2
Property, plant and equipment	22
Intangible assets	149
Other long-term assets	1
Accounts payable	(3)
Accrued and other current liabilities	(12)
Deferred income tax liabilities	(27)
Other non-current accrued liabilities	(2)
Total identifiable net assets	172
Goodwill	262
Total consideration	$ 434

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The fair values of Pure's assets and liabilities were determined based on preliminary estimates and assumptions which management believes are reasonable. The preliminary purchase price allocation is subject to further refinement and may require significant adjustments to arrive at the final purchase price allocation. These adjustments will primarily relate to certain short term assets, property, plant and equipment, intangible assets, certain liabilities, and income tax related items. The final determination of the fair value of certain assets and liabilities will be completed as soon as the necessary information is available but no later than one year from the acquisition date.

Goodwill arising from the acquisition consists largely of synergies and economies of scale expected from combining the operations of Pure and Xylem. All of the goodwill was assigned to the Measurement & Control Solutions segment and is not deductible for tax purposes.

The preliminary estimate of the fair value of Pure identifiable intangible assets was determined primarily using the “income approach,” which requires a forecast of all of the expected future cash flows either through the use of the multi-period excess earnings method or the relief-from-royalty method. Some of the more significant assumptions inherent in the development of intangible asset values include: the amount and timing of projected future cash flows, the discount rate selected to measure the risks inherent in the future cash flows, the assessment of the intangible asset’s life cycle, as well as other factors. The following table summarizes key information underlying identifiable intangible assets related to the Pure acquisition:

Category	**Life**	**Amount (in millions)**
Customer Relationships	17 - 18 years	$ 84
Technology	3 - 10 years	38
Tradenames	17 years	21
Internally Developed Software	3 years	6
Total		$ 149

The following table summarizes, on an unaudited pro forma basis, the condensed combined results of operations of the Company for the three and six month periods ended June 30, 2018 and June 30, 2017, respectively, assuming the acquisition of Pure was made on January 1, 2017.

(in millions)	Three Months		Six Months	
For the period ended June 30,	2018	2017	2018	2017
Revenue	N/A	$1,189	$2,539	$2,282
Net income	N/A	$98	$191	$152

The foregoing unaudited pro forma results are for informational purposes only and are not necessarily indicative of the actual results of operations that might have occurred had the acquisition occurred on January 1, 2017, nor are they necessarily indicative of future results. The pro forma financial information includes the impact of purchase accounting and other nonrecurring items directly attributable to the acquisition, which include:

- Amortization expense of acquired intangibles
- Adjustments to the depreciation of property, plant and equipment reflecting the impact of the calculated fair value of those assets in accordance with purchase accounting
- Adjustments to interest expense to remove historical Pure interest costs and reflect Xylem's current debt profile

- The related tax impact of the above referenced adjustments

The pro forma results do not include any cost savings or operational synergies that may be generated or realized due to the acquisition of Pure.

During the three months ended June 30, 2018 Pure had operating income of less than $1 million. During the six months ended June 30, 2018 Pure had an operating loss of $2 million.

Other Acquisition Activity
During the three months ended June 30, 2018 we had no acquisition activity. During the six months ended June 30, 2018 we spent approximately $10 million on other acquisition activity.

2017 Acquisitions and Divestitures

On February 17, 2017, we divested our United Kingdom and Poland based membranes business for approximately $11 million. The sale resulted in a gain of $5 million, which is reflected in gain from sale of business in our Condensed Consolidated Income Statement. The business, which was part of our Applied Water segment, provided membrane filtration products primarily to customers in the municipal water and industrial sectors. The business reported 2016 annual revenue of approximately $8 million.

Note 4. Revenue

As discussed in Note 2, "Recently Issued Accounting Pronouncements", Xylem adopted the new guidance on recognizing revenue from contracts with customers as of January 1, 2018.

Xylem recognizes revenue in a manner that depicts the transfer of promised goods and services to customers in an amount that reflects the consideration to which it expects to be entitled to for providing those goods and services. For each arrangement with a customer, we identify the contract, the associated performance obligations within the contract, determine the transaction price of that contract, allocate the transaction price to each performance obligation and recognize revenue as each performance obligation is satisfied.

The satisfaction of performance obligations in a contract is based upon when the customer obtains control over the asset. Depending on the nature of the performance obligation, control transfers either at a particular point in time, or over time which determines the recognition pattern of revenue.

For product sales, other than long-term construction-type contracts, we recognize revenue once control has passed at a point in time, which is generally when products are shipped. In instances where contractual terms include a provision for customer acceptance, revenue is recognized when either (i) we have previously demonstrated that the product meets the specified criteria based on either seller or customer specified objective criteria or (ii) upon formal acceptance received from the customer where the product has not been previously demonstrated to meet customer specified objective criteria. We recognize revenue on product sales to channel partners, including resellers, distributors or value-added solution providers at the point in time when the risks and rewards, possession, and title have transferred to the customer, which usually occurs at the point of delivery.

Revenue from performance obligations related to services is recognized over time, as the performance obligations are satisfied. In these instances, the customer consumes the benefit of the service as Xylem performs.

Certain businesses also enter into long-term construction-type sales contracts where revenue is recognized over time. In these instances, revenue is recognized using a measure of progress that applies an input method based on costs incurred in relation to total estimated costs.

If shipping and handling activities are performed after a customer obtains control of a good we account for the shipping and handling activities as activities to fulfill a promise to transfer a good. Shipping and handling related costs are accrued as revenue is recognized.

For all contracts with customers, we determine the transaction price in the arrangement and allocate the transaction price to each performance obligation identified in the contract. Judgment is required to determine the appropriate unit of account, and we separate out the performance obligations if they are capable of being distinct and if they are distinct within the context of the contract. We base our allocation of the transaction price to the performance obligations on the relative standalone selling prices for the goods or services contained in a particular performance obligation. The standalone selling prices are determined first by reference to observable prices. In the event observable prices are not available, we estimate the stand-alone selling price by maximizing observable inputs and apply an adjusted market assessment approach, expected cost plus margin approach, or a residual approach in limited situations. Revenue in these instances is recognized on individual performance obligations within the same contract as they are satisfied.

The transaction price is adjusted for our estimate of variable consideration which may include a right of return, discounts, rebates, penalties and retainage. To estimate variable consideration, we apply the expected value or the most likely amount method, based on whichever method most appropriately predicts the amount of consideration we expect to be entitled to. The method applied is typically based on historical experience and known trends. We constrain the amounts of variable consideration that are included in the transaction price, to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur or when uncertainties around the variable consideration are resolved.

We exclude from the measurement of the transaction price all taxes assessed by a governmental authority that are both imposed on and concurrent with specific revenue-producing transaction and collected from a customer, for example sales, use value added and some excise taxes.

For all contracts with customers, payment received for our products and services may not necessarily follow the same pattern of revenue recognition to which it relates and are dictated by the terms and conditions of our contracts with customers. Payments received for product sales typically occur following delivery and the satisfaction of the performance obligation based upon the terms outlined in the contracts. Payments received for services typically occur following the services being rendered. For long-term construction-type projects, payments are typically made throughout the contract as progress is made.

In limited situations contracts with customers include financing components where payment terms exceed one year, however, we believe that the financing effects are not significant to Xylem. In addition, we apply a practical expedient and do not adjust the promised amount of consideration in a contract for the effects of significant financing components when we expect payment terms to be one year or less from the time the goods or services are transferred until ultimate payment.

Product Warranties

We offer standard warranties for our products to ensure that our products comply with agreed-upon specifications in our contracts. For standard warranties, these do not give rise to performance obligations and represent assurance-type warranties. In certain instances, product warranty terms are adjusted to account for the specific nature of the contract. In these instances, we assess the warranties to determine whether they represent service-type warranties, and should be accounted for as a separate performance obligation in the contract.

For assurance-type warranties, we accrue for the estimated cost of product warranties at the time revenue is recognized and record it as a component of cost of revenue. Our product warranty liability reflects our best estimate of probable liability under the terms and conditions of our product warranties offered to customers. We estimate the liability based on our standard warranty terms, the historical frequency of claims and the cost to replace or repair our products under warranty. Factors that impact our warranty liability include the number of units sold, the length of warranty term, historical and anticipated rates of warranty claims and cost per claim. We also record a warranty liability for specific matters. We assess the adequacy of our recorded warranty liabilities quarterly and adjust amounts as necessary.

Disaggregation of Revenue

The following table illustrates the sources of revenue:

(in millions)	**Three Months Ended June 30, 2018**	**Six Months Ended June 30, 2018**
Revenue from contracts with customers	$1,258	$2,420
Other	59	114
Total	$1,317	$2,534

The following table reflects revenue from contracts with customers by application:

(in millions)	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Water Infrastructure		
Transport	$387	$734
Treatment	100	178
Applied Water		
Commercial Building Services	150	287
Residential Building Services	56	113
Industrial Water	182	354
Measurement and Control Solutions		
Water	175	347
Electric	37	74
Gas	47	90
Software and Services/Other	35	69
Test	89	174
Total	$1,258	$2,420

The following table reflects revenue from contracts with customers by geographical region:

(in millions)	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Water Infrastructure		
United States	$135	$248
Europe	191	368
Emerging Markets & Other	161	296
Applied Water		
United States	198	386
Europe	100	198
Emerging Markets & Other	90	170
Measurement and Control Solutions		
United States	230	436
Europe	71	155
Emerging Markets & Other	82	163
Total	$1,258	$2,420

Contract Balances

We receive payments from customers based on a billing schedule as established in our contracts. Contract assets relate to costs incurred to perform in advance of scheduled billings. Contract liabilities relate to payments received in advance of performance under the contracts. Change in contract assets and liabilities are due to our performance under the contract.

The table below provides contract assets, contract liabilities, and significant changes in contract assets and liabilities.

(in millions)	Contract Assets (a)	Contract Liabilities
Balance at 1/1/2018	$ 89	$ 107
Additions, net	51	86
Revenue recognized from opening balance	—	(74)
Billings	(54)	—
Other	(3)	(5)
Balance at 6/30/2018	$ 83	$ 114

(a) Excludes receivable balances which are disclosed on the balance sheet

Performance obligations

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. As of June 30, 2018, the aggregate amount of the transaction price allocated to performance obligations that are unsatisfied or partially unsatisfied for contracts with performance obligations, amount to $233 million. We expect to recognize revenue upon the completion of satisfying these performance obligations in the following 12 to 60 months. The Company elects to apply the practical expedient to exclude from this disclosure revenue related to performance obligations that are part of a contract whose original expected duration is less than one year.

Contract Costs

Costs to obtain a contract include incremental costs that the Company has incurred which it expects to recover. Incremental costs only include costs that the Company would not have incurred had the contract not been obtained. Costs that would have been incurred regardless of whether or not the contract was obtained are expensed as incurred, unless they are explicitly chargeable to the customer whether or not the contract is obtained.

The amortization of costs to obtain contracts is consistent with the pattern of transfer of the related goods or services provided in the contract. The Company elects to apply the practical expedient to expense costs to obtain contracts when the associated amortization period of those costs would be one year or less.

Note 5. Restructuring Charges

From time to time, the Company will incur costs related to restructuring actions in order to optimize our cost base and more strategically position ourselves based on the economic environment and customer demand. During the three and six months ended June 30, 2018, we recognized restructuring charges of $5 million and $15 million, respectively. We incurred these charges primarily as a continuation of our efforts to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges included the reduction of headcount and consolidation of facilities within our Measurement & Control Solutions and Water Infrastructure segments, as well as headcount reductions within our Applied Water segment.

During the three and six months ended June 30, 2017, we recognized restructuring charges of $6 million and $13 million. We incurred these charges primarily as a continuation of our efforts to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges included the reduction of headcount and consolidation of facilities within our Applied Water and Water Infrastructure segments, as well as headcount reductions within our Measurement and Control Solutions segment.

The following table presents the components of restructuring expense and asset impairment charges.

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions)	**2018**	2017	**2018**	2017
By component:				
Severance and other charges	**$5**	$ 6	**$14**	$14
Lease related charges	**—**	—	**1**	—
Reversal of restructuring accruals	**—**	—	**—**	(1)
Total restructuring charges	**$5**	$ 6	**$15**	$13
Asset impairment	**—**	—	—	5
Total restructuring and asset impairment charges	**$5**	$ 6	$15	$18
By segment:				
Water Infrastructure	**$3**	$ 3	**$6**	$5
Applied Water	**—**	2	**1**	10
Measurement & Control Solutions	**2**	1	**8**	3
Corporate and other	**—**	—	**—**	—

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 six months ended June 30, 2018 and 2017.

(in millions)	**2018**	2017
Restructuring accruals - January 1	**$7**	$15
Restructuring charges	**15**	13
Cash payments	**(12)**	(17)
Foreign currency and other	**—**	—
Restructuring accruals - June 30	**$10**	$11
By segment:		
Water Infrastructure	**$2**	$1
Applied Water	**1**	4
Measurement & Control Solutions	**4**	3
Regional selling locations (a)	**2**	3
Corporate and other	**1**	—

(a) Regional selling locations consist primarily of selling and marketing organizations that incurred restructuring 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 six months ended June 30, 2018 and 2017 of employee position eliminations associated with restructuring activities.

	2018	2017
Planned reductions - January 1	**47**	188
Additional planned reductions	**155**	105
Actual reductions and reversals	**(103)**	(185)
Planned reductions - June 30	**99**	108

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The following table presents expected restructuring spend:

(in millions)	Water Infrastructure	Applied Water	Measurement & Control Solutions	Corporate	Total
Actions Commenced in 2018:					
Total expected costs	$ 8	$ 1	$ 8	$ —	$17
Costs incurred during Q1 2018	2	1	5	—	8
Costs incurred during Q2 2018	2	—	2	—	4
Total expected costs remaining	**$ 4**	**$ —**	**$ 1**	**$ —**	**$5**
Actions Commenced in 2017:					
Total expected costs	$ 19	$ 12	$ 2	$ —	$33
Costs incurred during 2017	5	4	2	—	11
Costs incurred during Q1 2018	1	—	—	—	1
Costs incurred during Q2 2018	1	—	—	—	1
Total expected costs remaining	**$ 12**	**$ 8**	**$ —**	**$ —**	**$20**
Actions Commenced in 2016:					
Total expected costs	$ 13	$ 14	$ 11	$ 2	$40
Costs incurred during 2016	11	10	6	2	29
Costs incurred during 2017	2	4	3	—	9
Costs incurred during Q1 2018	—	—	1	—	1
Costs incurred during Q2 2018	—	—	—	—	—
Total expected costs remaining	**$ —**	**$ —**	**$ 1**	**$ —**	**$1**

The Water Infrastructure, Applied Water, and Measurement & Control Solutions actions commenced in 2018 consist primarily of severance charges and are expected to continue through the end of 2018. The Water Infrastructure, Applied Water, and Measurement & Control Solutions actions commenced in 2017 consist primarily of severance charges and are expected to continue through the end of 2019. The Measurement & Control Solutions actions commenced in 2016 are expected to continue through the end of 2018.

Asset Impairment Charges

During the first quarter of 2017 we determined that certain assets within our Applied Water segment, including a tradename, were impaired. Accordingly we recognized an impairment charge of $5 million. Refer to Note 10, "Goodwill and Other Intangible Assets," for additional information.

Note 6. 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 discrete items.

The income tax provision for the three months ended June 30, 2018 was $35 million resulting in an effective tax rate of 23.2%, compared to $21 million resulting in an effective tax rate of 16.8% for the same period in 2017. The income tax provision for the six months ended June 30, 2018 was $51 million resulting in an effective tax rate of 20.8%, compared to $35 million resulting in an effective tax rate of 18.1% for the same period in 2017. The effective tax rate for the three month period ended June 30, 2018 was higher than the U.S. federal statutory rate primarily due to the settlement of tax examinations in various jurisdictions and the Global Intangible Low-Taxed Income ("GILTI") inclusion, partially offset by the mix of earnings in jurisdictions. The effective tax rate for the six month period ended June 30, 2018 was lower than the U.S. federal statutory rate primarily due to the mix of earnings in jurisdictions. Additionally, the effective tax rate for the three and six month periods ended June 30, 2018 is higher than the same periods of 2017 primarily due to the settlement of tax examinations and the GILTI inclusion, partially offset by the reduction of the U.S. federal corporate tax rate.

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 or litigation, based on the technical merits of the position. The tax benefits recognized in the condensed consolidated financial statements 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 June 30, 2018 was $126 million, as compared to $130 million at December 31, 2017, which if ultimately recognized will reduce our 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 June 30, 2018, we had $5 million of interest accrued for unrecognized tax benefits.

Tax Act

On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”). The Tax Act makes broad and complex changes to the U.S. tax code. The SEC staff issued SAB 118, which provides guidance on accounting for the tax effects of the Tax Act. SAB 118 provides a measurement period that should not extend beyond one year from the Tax Act enactment date for companies to complete the accounting under ASC 740. In accordance with SAB 118, a company must reflect the income tax effects of those aspects of the Tax Act for which the accounting under ASC 740 is complete. To the extent that a company’s accounting for certain income tax effects of the Tax Act is incomplete but it is able to determine a reasonable estimate, it must record a provisional estimate in the financial statements. If a company cannot determine a provisional estimate to be included in the financial statements, it should continue to apply ASC 740 on the basis of the provisions of the tax laws that were in effect immediately before the enactment of the Tax Act.

Our accounting for the following elements of the Tax Act is incomplete: reduction of U.S. federal corporate tax rate and Deemed Repatriation Transition Tax ("Transition Tax"). As noted at year end, however, we were able to reasonably estimate certain effects and, therefore, recorded provisional adjustments for reduction of U.S. federal corporate tax rate and Transition Tax as of December 31, 2017. We have not made additional measurement-period adjustments related to the reduction of U.S. federal corporate tax rate during the quarter as we are continuing to perform additional analysis of our deferred tax assets and liabilities. We have not made additional measurement-period adjustments related to the Transition Tax as we are still completing a more detailed analysis of our accumulated and current earnings and profits ("E&P") as well as awaiting additional regulatory guidance. We are evaluating new guidance issued during the period and expect to complete our accounting within the prescribed measurement period.

Because of the complexity of the GILTI tax rules, we are continuing to evaluate this provision of the Act and the application of ASC 740. As noted at year-end, we were not yet able to reasonably estimate the effect of the new GILTI rules. Therefore, no provisional adjustments were recorded as of December 31, 2017. Under U.S. GAAP, we are allowed to make an accounting policy choice of either (1) treating taxes due on future

U.S. inclusions in taxable income related to GILTI as a current-period expense when incurred (the “period cost method”) or (2) factoring such amounts into a company’s measurement of its deferred taxes (the “deferred method”). Our selection of an accounting policy related to the new GILTI tax rules will depend, in part, on analyzing our global income to determine whether we expect to have future U.S. inclusions in taxable income related to GILTI and, if so, what the impact is expected to be. Because whether we expect to have future U.S. inclusions in taxable income related to GILTI depends on a number of different aspects of our estimated future results of global operations, we are not yet able to reasonably estimate the long-term effects of this provision of the Tax Act. Therefore, we have not recorded any potential deferred tax effects related to GILTI in our financial statements and have not made a policy decision regarding whether to record deferred taxes on GILTI or use the period cost method. Our accounting for the effects related to GILTI is not complete and we expect to complete our accounting within the prescribed measurement period.

Note 7. Earnings Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	**2018**	2017
Net income attributable to Xylem (in millions)	**$115**	$ 99	**$194**	$ 155
Shares (in thousands):				
Weighted average common shares outstanding	**179,770**	179,571	**179,814**	179,557
Add: Participating securities (a)	**35**	28	**29**	31
Weighted average common shares outstanding — Basic	**179,805**	179,599	**179,843**	179,588
Plus incremental shares from assumed conversions: (b)				
Dilutive effect of stock options	**886**	640	**907**	600
Dilutive effect of restricted stock units and performance share units	**351**	362	**453**	438
Weighted average common shares outstanding — Diluted	**181,042**	180,601	**181,203**	180,626
Basic earnings per share	**$0.64**	$ 0.55	**$1.08**	$ 0.87
Diluted earnings per share	**$0.64**	$ 0.55	**$1.07**	$ 0.86

(a) Restricted stock unit 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 units 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 units and performance share units, reduced by the repurchase of shares with the proceeds from the assumed exercises and unrecognized compensation expense for outstanding awards. Performance share units will be included in the treasury stock calculation of diluted earnings per share upon achievement of underlying performance or market conditions at the end of the reporting period. See Note 15, "Share-Based Compensation Plans" to the condensed consolidated financial statements for further detail on the performance share units.

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	**2018**	2017	**2018**	2017
Stock options	**1,360**	1,854	**1,289**	1,813
Restricted stock units	**385**	464	**339**	427
Performance share units	**517**	530	**527**	467

Note 8. Inventories

The components of total inventories are summarized as follows:

(in millions)	**June 30, 2018**	December 31, 2017
Finished goods	**$ 253**	$ 223
Work in process	**56**	42
Raw materials	**289**	259
Total inventories	**$ 598**	$ 524

Note 9. Property, Plant and Equipment

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

(in millions)	**June 30, 2018**	December 31, 2017
Land, buildings and improvements	**$ 327**	$ 329
Machinery and equipment	**810**	799
Equipment held for lease or rental	**246**	241
Furniture and fixtures	**108**	101
Construction work in progress	**82**	85
Other	**21**	21
Total property, plant and equipment, gross	**1,594**	1,576
Less accumulated depreciation	**951**	933
Total property, plant and equipment, net	**$ 643**	$ 643

Depreciation expense of $29 million and $58 million was recognized in the three and six months ended June 30, 2018, respectively, and $27 million and $55 million for the three and six months ended June 30, 2017.

Note 10. Goodwill and Other Intangible Assets

Goodwill

Changes in the carrying value of goodwill by reportable segment for the six months ended June 30, 2018 are as follows:

(in millions)	**Water Infrastructure**	**Applied Water**	**Measurement & Control Solutions**	**Total**
Balance as of January 1, 2018	$ 667	$ 526	$ 1,575	$2,768
Activity in 2018				
Divested/Acquired	—	—	277	277
Foreign currency and other	(9)	(8)	(32)	(49)
Balance as of June 30, 2018	**$ 658**	**$ 518**	**$ 1,820**	**$2,996**

Other Intangible Assets

Information regarding our other intangible assets is as follows:

	June 30, 2018			December 31, 2017		
(in millions)	**Carrying Amount**	**Accumulated Amortization**	**Net Intangibles**	Carrying Amount	Accumulated Amortization	Net Intangibles
Customer and distributor relationships	**$974**	**$ (272)**	**$ 702**	$906	$ (241)	$ 665
Proprietary technology and patents	**200**	**(84)**	**116**	163	(75)	88
Trademarks	**150**	**(36)**	**114**	138	(37)	101
Software	**320**	**(147)**	**173**	277	(130)	147
Other	**25**	**(20)**	**5**	26	(20)	6
Indefinite-lived intangibles	**159**	**—**	**159**	161	—	161
Other Intangibles	**$1,828**	**$ (559)**	**$ 1,269**	$1,671	$ (503)	$ 1,168

Amortization expense related to finite-lived intangible assets was $36 million and $74 million for the three and six months ended June 30, 2018, respectively, and $30 million and $61 million for the three and six months ended June 30, 2017, respectively.

During the first quarter of 2017 we determined that the intended use of a finite lived trade name within our Applied Water segment had changed. Accordingly we recorded a $4 million impairment charge. The charge was calculated using income approach, which is considered a Level 3 input for fair value measurement, and is reflected in “Restructuring and asset impairment charges” in our Condensed Consolidated Income Statements.

Note 11. 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 revenue, expenses, cash receipts, cash payments, and the value of our stockholders' equity. 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 and reduce the volatility in stockholders' equity.

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 and Australian Dollar. We had foreign exchange contracts with purchase notional amounts totaling $226 million and $455 million as of June 30, 2018 and December 31, 2017, respectively. As of June 30, 2018, our most significant foreign currency derivatives included contracts to sell U.S. Dollar and purchase Euro, purchase Swedish Krona and sell Euro, sell British Pound and purchase Euro, purchase Polish Zloty and sell Euro, purchase US Dollar and sell Canadian Dollar, and to sell Canadian Dollar and Purchase Euro. The purchased notional amounts associated with these currency derivatives are $75 million, $68 million, $33 million, $18 million, $15 million and $13 million, respectively. As of December 31, 2017, the purchase notional amounts associated with these currency derivatives were $147 million, $149 million, $66 million, $34 million, $28 million and $25 million, respectively.

Hedges of Net Investments in Foreign Operations

We are exposed to changes in foreign currencies impacting our net investments held in foreign subsidiaries.

Cross Currency Swaps

Beginning in 2015, we entered into cross currency swaps to manage our exposure to fluctuations in the Euro-U.S. Dollar exchange rate. The total notional amount of derivative instruments designated as net investment hedges was $432 million and $446 million as of June 30, 2018 and December 31, 2017, respectively.

Foreign Currency Denominated Debt

On March 11, 2016, we issued 2.250% Senior Notes of €500 million aggregate principal amount due March 2023. We designated the entirety of the outstanding balance, or $574 million and $592 million as of June 30, 2018 and December 31, 2017, respectively, net of unamortized discount, as a hedge of a net investment in certain foreign subsidiaries.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions)	**2018**	2017	**2018**	2017
Cash Flow Hedges				
Foreign Exchange Contracts				
Amount of gain (loss) recognized in OCI (a)	**$(9)**	$3	**$(9)**	$5
Amount of (gain) reclassified from OCI into revenue (a)	**(1)**	(1)	**(2)**	(1)
Amount of loss reclassified from OCI into cost of revenue (a)	**—**	—	**—**	1
Net Investment Hedges				
Cross Currency Swaps				
Amount of gain (loss) recognized in OCI (a)	**$36**	$(23)	**$13**	$(31)
Foreign Currency Denominated Debt				
Amount of gain (loss) recognized in OCI (a)	**$42**	$(34)	**$19**	$(48)

(a) Effective portion

As of June 30, 2018, $8 million of net losses on cash flow hedges are expected to be reclassified into earnings in the next 12 months. The ineffective portion of a cash flow hedge is recognized immediately in selling, general and administrative expenses in the Condensed Consolidated Income Statements and was not material for the three and six months ended June 30, 2018 and 2017.

As of June 30, 2018, no gains or losses on the net investment hedges are expected to be reclassified into earnings over their duration. The net investment hedges did not experience any ineffectiveness for the three and six months ended June 30, 2018.

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The fair values of our derivative assets and liabilities are measured on a recurring basis using Level 2 inputs and are determined through the use of models the at consider various assumptions including yield curves, time value and other measurements.
The fair values of our foreign exchange contracts currently included in our hedging program designated as hedging instruments were as follows:

(in millions)	**June 30, 2018**	December 31, 2017
Derivatives designated as hedging instruments		
Assets		
Cash Flow Hedges		
Other current assets	**$ 1**	$ 3
Liabilities		
Cash Flow Hedges		
Other current liabilities	**$ (7)**	$ (1)
Net Investment Hedges		
Other non-current liabilities	**$ (54)**	$ (64)

The fair value of our long-term debt, due in 2023, designated as a net investment hedge was $620 million and $638 million as of June 30, 2018 and December 31, 2017, respectively.

Note 12. Accrued and Other Current Liabilities

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

(in millions)	**June 30, 2018**	December 31, 2017
Compensation and other employee benefits	**$ 187**	$ 203
Customer-related liabilities	**132**	119
Accrued taxes	**68**	75
Accrued warranty costs	**48**	55
Other accrued liabilities	**101**	99
Total accrued and other current liabilities	**$ 536**	$ 551

Note 13. Credit Facilities and Debt

Total debt outstanding is summarized as follows:

(in millions)	**June 30, 2018**	December 31, 2017
4.875% Senior Notes due 2021 (a)	**$600**	$ 600
2.250% Senior Notes due 2023 (a)	**578**	597
3.250% Senior Notes due 2026 (a)	**500**	500
4.375% Senior Notes due 2046 (a)	**400**	400
Commercial paper	**98**	—
Research and development finance contract	**121**	125
Term loan	**261**	—
Other	**3**	—
Debt issuance costs and unamortized discount (b)	**(21)**	(22)
Total debt	**2,540**	2,200
Less: short-term borrowings and current maturities of long-term debt	**361**	—
Total long-term debt	**$2,179**	$ 2,200

(a) The fair value of our Senior Notes 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 2021 was $627 million and $648 million as of June 30, 2018 and December 31, 2017, respectively. The fair value of our Senior Notes due 2023 was $620 million and $638 million as of June 30, 2018 and December 31, 2017, respectively. The fair value of our Senior Notes due 2026 was $471 million and $498 million as of June 30, 2018 and December 31, 2017, respectively. The fair value of our Senior Notes due 2046 was $389 million and $431 million as of June 30, 2018 and December 31, 2017, respectively.

(b) The debt issuance costs and unamortized discount are recognized as a reduction in the carrying value of the Senior Notes in the Condensed Consolidated Balance Sheets and are 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 4.875% Senior Notes of $600 million aggregate principal amount due October 2021 (the "Senior Notes due 2021"). On March 11, 2016, we issued 2.250% Senior Notes of €500 million aggregate principal amount due March 2023 (the "Senior Notes due 2023"). On October 11, 2016, we issued 3.250% Senior Notes of $500 million aggregate principal amount due October 2026 (the “Senior Notes due 2026”) and4.375% Senior Notes of $400 million aggregate principal amount due October 2046 (the “Senior Notes due 2046” and, together with the Senior Notes due 2021, the Senior Notes due 2023 and the Senior Notes due 2026, the “Senior Notes”).

The Senior Notes include covenants that 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. We may also redeem the Senior Notes in certain other circumstances, as set forth in the applicable Senior Notes indenture.

If a change of control triggering event (as defined in the applicable 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.

Interest on the Senior Notes due 2021 is payable on April 1 and October 1 of each year. Interest on the Senior Notes due 2023 is payable on March 11 of each year. Interest on the Senior Notes due 2026 and the Senior Notes due 2046 is payable on May 1 and November 1 of each year beginning on May 1, 2017. As of June 30, 2018, we were in compliance with all covenants for the Senior Notes.

Credit Facilities

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 of an amendment to the Credit Facility dated August 30, 2016, we may not exceed a maximum leverage ratio of 4.00 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) for a period of four full fiscal quarters following the Sensus acquisition and a maximum leverage ratio of 3.50 to 1.00 through the rest of 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 June 30, 2018 the Credit Facility was undrawn and we are in compliance with all covenants.

European Investment Bank - R&D Finance Contract

On October 28, 2016, the Company entered into a Finance Contract (the “Finance Contract”) with the European Investment Bank (the “EIB”). 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 Finance Contract and Xylem Inc. is the Guarantor. The Finance Contract provides for up to €105 million (approximately $121 million) to finance research, development and innovation projects in the field of sustainable water and wastewater solutions during the period from 2017 through 2019 in Sweden, Germany, Italy, UK, Hungary and Austria. The Company has unconditionally guaranteed the performance of the borrowers under the Finance Contract. Under the Finance Contract, the borrowers are able to draw loans on or before April 28, 2018, with a maturity of no longer than 11 years.

Both the Finance Contract and the R&D Facility Agreement (described below) are subject to the same leverage ratio as the Credit Facility. Both agreements also contain limitations on, among other things, incurring debt, granting liens, and entering into sale and leaseback transactions, as well as other terms and conditions, such as customary representations and warranties, additional covenants and customary events of default.

Both the Finance Contract and the R&D Facility Agreement provide for fixed rate loans and floating rate loans. Under the Finance Contract, 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 is 59 basis points (0.59%). As of June 30, 2018 and December 31, 2017, $121 million and $125 million were outstanding under the Finance Contract, respectively.

Term Loan Facility

On January 26, 2018, the Company’s subsidiary, Xylem Europe GmbH (the “borrower”) entered into a 12-month €225 million (approximately $261 million) term loan facility (the “Term Facility”) the terms of which are set forth in a term loan agreement, among the borrower, the Company, as parent guarantor and ING Bank. The Company has entered into a parent guarantee in favor of ING Bank also dated January 26, 2018 to secure all present and future obligations of the borrower under the Term Loan Agreement. The Term Facility was used to partially fund the acquisition of Pure Technologies.

Commercial Paper

Our commercial paper program generally serves as a means of short-term funding and has a combined outstanding limit of $600 million inclusive of the Five-Year Revolving Credit Facility. As of June 30, 2018 and December 31, 2017 $98 million and $0 million of the Company's$600 million commercial paper program was outstanding at a weighted average interest rate of 2.29% and 0%, respectively. We will periodically borrow under this program and may borrow under it in future periods.

Other Borrowings

Effective October 20, 2016, Xylem entered into a revolving line of credit with SEB Bank. The line of credit provides for an aggregate principal amount of up €65 million (approximately$75 million) with a maturity date of September 30, 2018. The line of credit was used to partially fund the acquisition of Pure Technologies in the first quarter of 2018. As of June 30, 2018 the revolving line of credit was undrawn.

During the second quarter of 2018, Xylem was funded CNY 20 million (approximately $3 million) from a revolving line of credit held with the China Construction Bank. The line of credit was used for cash needs associated with Xylem's PDC China business in 2018. As of June 30, 2018 and December 31, 2017, $3 million and $0 million were outstanding under the revolving line of credit, respectively. The remaining outstanding balance was paid off in July 2018 and the revolving line of credit was terminated.

Note 14. Postretirement Benefit Plans

The components of net periodic benefit cost for our defined benefit pension plans are as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions)	**2018**	2017	**2018**	2017
Domestic defined benefit pension plans:				
Service cost	**$1**	$1	**$2**	$2
Interest cost	**1**	1	**2**	2
Expected return on plan assets	**(1)**	(1)	**(3)**	(3)
Amortization of net actuarial loss	**—**	—	**1**	1
Net periodic benefit cost	**$1**	$1	**$2**	$2
International defined benefit pension plans:				
Service cost	**$3**	$3	**$5**	$6
Interest cost	**5**	5	**10**	10
Expected return on plan assets	**(10)**	(8)	**(19)**	(16)
Amortization of net actuarial loss	**3**	2	**5**	4
Settlement/Curtailment	**—**	—	**1**	—
Net periodic benefit cost	**$1**	$2	**$2**	$4
Total net periodic benefit cost	**$2**	$3	**$4**	$6

The components of net periodic benefit cost other than the service cost component are included in the line item "other non-operating income (expense), net" in the Condensed Consolidated Income Statements.

The total net periodic benefit cost for other postretirement employee benefit plans was less than $1 million for both the three and six months ended June 30, 2018, including amounts recognized in other comprehensive income ("OCI") of less than $1 million and $1 million for both the three and six months ended June 30, 2018. The total net periodic benefit cost for other postretirement employee benefit plans was less than $1 million and $1 million, including amounts recognized in OCI of less than $1 million, for both the three and six months ended June 30, 2017.

We contributed $12 million and $13 million to our defined benefit plans during the six months ended June 30, 2018 and 2017, respectively. Additional contributions ranging between approximately $10 million and $16 million are expected during the remainder of 2018.

Note 15. Share-Based Compensation Plans

Share-based compensation expense was $7 million and $16 million during the three and six months ended June 30, 2018, respectively, and $5 million and $11 million during the three and six months ended June 30, 2017, respectively. The unrecognized compensation expense related to our stock options, restricted stock units and performance share units was $8 million, $27 million and $22 million, respectively, at June 30, 2018 and is expected to be recognized over a weighted average period of 2.1, 2.2 and 2.0 years, respectively. The amount of cash received from the exercise of stock options was $4 million and $7 million for the six months ended June 30, 2018 and 2017, respectively.

Stock Option Grants

The following is a summary of the changes in outstanding stock options for the six months ended June 30, 2018.

	Share units (in thousands)	**Weighted Average Exercise Price / Share**	**Weighted Average Remaining Contractual Term (Years)**	**Aggregate Intrinsic Value** (in millions)
Outstanding at January 1, 2018	2,076	$37.44	7.0	
Granted	309	75.18		
Exercised	(118)	34.30		
Forfeited and expired	(40)	47.03		
Outstanding at June 30, 2018	**2,227**	**$42.66**	**6.9**	**$ 58**
Options exercisable at June 30, 2018	**1,497**	**$35.34**	**6.0**	**$ 48**
Vested and expected to vest as of June 30, 2018	**2,135**	**$41.66**	**6.8**	**$ 57**

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 six months ended June 30, 2018 was $4.7 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 2018 grants.

Volatility	**23.40 %**
Risk-free interest rate	**2.76 %**
Dividend yield	**1.12 %**
Expected term (in years)	**5.1**
Weighted-average fair value / share	**$17.81**

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 Unit Grants

The following is a summary of restricted stock unit activity for the six months ended June 30, 2018. The fair value of the restricted stock units is equal to the closing share price on the date of the grant.

	Share units (in thousands)	**Weighted Average Grant Date Fair Value /Share**
Outstanding at January 1, 2018	779	$ 35.39
Granted	243	74.93
Vested	(433)	40.17
Forfeited	(32)	46.61
Outstanding at June 30, 2018	**557**	**$ 58.03**

ROIC Performance Share Unit Grants

The following is a summary of Return on Invested Capital ("ROIC") performance share unit grants for the six months ended June 30, 2018. The fair value of the ROIC performance share units is equal to the closing share price on the date of the grant.

	Share units (in thousands)	**Weighted Average Grant Date Fair Value /Share**
Outstanding at January 1, 2018	298	$ 41.48
Granted	76	75.18
Forfeited	(95)	37.12
Outstanding at June 30, 2018	**279**	**$ 52.14**

TSR Performance Share Units Grants

The following is a summary of our Total Shareholder Return ("TSR") performance share unit grants for the six months ended June 30, 2018.

	Share units (in thousands)	**Weighted Average Grant Date Fair Value /Share**
Outstanding at January 1, 2018	213	$ 47.04
Granted	76	99.24
Forfeited	(10)	47.14
Outstanding at June 30, 2018	**279**	**$ 61.17**

The fair value of TSR performance share units was calculated on the date of grant using a Monte Carlo simulation model utilizing several key assumptions, including expected Company and peer company share price volatility, correlation coefficients between peers, the risk-free rate of return, the expected dividend yield and other award design features. The following are weighted-average assumptions for 2018 grants.

Volatility	**26.8%**
Risk-free interest rate	**2.44%**

Note 16. Capital Stock

For the three and six months ended June 30, 2018 the Company repurchased approximately 0.4 million shares for $25 million and 0.8 million shares for $58 million of common stock, respectively. Repurchases include both share repurchase programs approved by the Board of Directors and repurchases in relation to settlement of employee tax withholding obligations due as a result of the vesting of restricted stock units. The details of repurchases by each program are as follows:

On August 24, 2015, our Board of Directors authorized the repurchase of up to $500 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. For the three and six months ended June 30, 2018, we repurchased approximately 0.4 million shares for $25 million and 0.7 million shares for $50 million, respectively. For the three and six months ended June 30, 2017, we repurchased 0.1 million shares for $7 million. There are up to $363 million in shares that may still be purchased under this plan as of June 30, 2018.

Aside from the aforementioned repurchase programs, we repurchased less than 0.1 million shares and approximately 0.1 million shares for less than $1 million and approximately $8 million for the three and six months ended June 30, 2018, respectively, in relation to settlement of employee tax withholding obligations due as a result of the vesting of restricted stock units. Likewise, we repurchased less than 0.1 million shares and 0.1 million shares for less than $1 million and $5 million for the three and six months ended June 30, 2017, respectively.

Note 17. Accumulated Other Comprehensive Income (Loss)

The following table provides the components of accumulated other comprehensive income (loss) for the three months ended June 30, 2018:

(in millions)	Foreign Currency Translation	Postretirement Benefit Plans	Derivative Instruments	Total
Balance at April 1, 2018	$ (7)	$ (202)	$ 2	$ (207)
Foreign currency translation adjustment	(60)	—	—	(60)
Tax on foreign currency translation adjustment	(19)	—	—	(19)
Amortization of prior service cost and net actuarial loss on postretirement benefit plans into other non-operating income (expense), net		—		
Other non-operating income	—	3	—	3
Income tax impact on amortization of postretirement benefit plan items	—	(1)	—	(1)
Unrealized loss on derivative hedge agreements	—	—	(9)	(9)
Reclassification of unrealized gain on derivative hedge agreements into revenue	—	—	(1)	(1)
Balance at June 30, 2018	**$ (86)**	**$ (200)**	**$ (8)**	**$ (294)**

The following table provides the components of accumulated other comprehensive income (loss) for the six months ended June 30, 2018:

(in millions)	Foreign Currency Translation	Postretirement Benefit Plans	Derivative Instruments	Total
Balance at January 1, 2018	$ (15)	$ (198)	$ 3	$ (210)
Cumulative effect of change in accounting principle	(11)	(6)	—	(17)
Foreign currency translation adjustment	(52)	—	—	(52)
Tax on foreign currency translation adjustment	(8)	—	—	(8)
Changes in postretirement benefit plans	—	1	—	1
Amortization of prior service cost and net actuarial loss on postretirement benefit plans into other non-operating income (expense), net	—		—	
Other non-operating income		5		5
Income tax impact on amortization of postretirement benefit plan items	—	(2)	—	(2)
Unrealized loss on derivative hedge agreements	—	—	(9)	(9)
Reclassification of unrealized gain on derivative hedge agreements into revenue	—	—	(2)	(2)
Balance at June 30, 2018	**$ (86)**	**$ (200)**	**$ (8)**	**$ (294)**

Note 18 Commitments and Contingencies

Legal Proceedings

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. 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 among ITT Corporation (now ITT LLC), Exelis and Xylem, ITT Corporation (now ITT LLC) 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 ITT's legacy products. We believe ITT Corporation (now ITT LLC) 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 $10 million and $10 million as of June 30, 2018 and December 31, 2017, respectively, for these general litigation matters.

Indemnifications

As part of our 2011 spin-off from our former parent, ITT Corporation (now ITT LLC), 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. On May 29, 2015, Harris Inc. acquired Exelis. As the parent of Exelis, Harris Inc. is responsible for Exelis's indemnification obligations under the Distribution Agreement.

Guarantees

We obtain certain stand-by letters of credit, bank guarantees and surety bonds from third-party financial institutions in the ordinary course of business when required under contracts or to satisfy insurance related requirements. As of June 30, 2018 and December 31, 2017, the amount of stand-by letters of credit, bank guarantees and surety bonds was $251 million and $240 million, respectively.

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 $4 million and $4 million as of June 30, 2018 and December 31, 2017, respectively, 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)	**2018**	2017
Warranty accrual – January 1	**$82**	$99
Net charges for product warranties in the period	**13**	17
Settlement of warranty claims	**(24)**	(24)
Foreign currency and other	**1**	2
Warranty accrual - June 30	**$72**	$94

Note 19. Segment Information

Our business has three reportable segments: Water Infrastructure, Applied Water and Measurement & Control Solutions. When determining the reportable segments, the Company aggregated operating segments based on their similar economic and operating characteristics. The Water Infrastructure segment focuses on the transportation and treatment of water, offering a range of products including water and wastewater pumps, treatment equipment, and controls and systems. The Applied Water segment serves many of the primary uses of water and focuses on the residential, commercial and industrial markets. The Applied Water segment's major products include pumps, valves, heat exchangers, controls and dispensing equipment. The Measurement & Control Solutions segment focuses on developing advanced technology solutions that enable intelligent use and conservation of critical water and energy resources as well as analytical instrumentation used in the testing of water. The Measurement & Control Solutions segment's major products include smart metering, networked communications, measurement and control technologies, critical infrastructure technologies, software and services including cloud-based analytics, remote monitoring and data management, leak detection and pressure monitoring solutions and testing equipment.

Additionally, we have Regional selling locations, which consist primarily of selling and marketing organizations and related support services, that offer products and services across 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 2017 Annual Report). The following tables contain financial information for each reportable segment:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions)	**2018**	2017	**2018**	2017
Revenue:				
Water Infrastructure	**$546**	$482	**$1,026**	$901
Applied Water	**388**	361	**754**	694
Measurement & Control Solutions	**383**	321	**754**	640
Total	**$1,317**	$1,164	**$2,534**	$2,235
Operating Income:				
Water Infrastructure	**$92**	$74	**$141**	$115
Applied Water	**61**	48	**111**	84
Measurement & Control Solutions	**31**	29	**64**	54
Corporate and other	**(13)**	(14)	**(32)**	(30)
Total operating income	**$171**	$137	**$284**	$223
Interest expense	**$21**	21	**$42**	$41
Other non-operating expense, net	**2**	5	**5**	4
(Loss) gain from sale of business	**(2)**	—	**(2)**	5
Income before taxes	**$150**	$121	**$245**	$191
Depreciation and Amortization:				
Water Infrastructure	**$16**	$15	**$33**	$31
Applied Water	**6**	6	**11**	12
Measurement & Control Solutions	**36**	30	**73**	61
Regional selling locations (a)	**5**	4	**10**	8
Corporate and other	**2**	2	**5**	4
Total	**$65**	$57	**$132**	$116
Capital Expenditures:				
Water Infrastructure	**$17**	$13	**$40**	$27
Applied Water	**5**	3	**14**	10
Measurement & Control Solutions	**22**	15	**46**	32
Regional selling locations (b)	**3**	3	**8**	8
Corporate and other	**3**	—	**3**	—
Total	**$50**	$34	**$111**	$77

(a) Depreciation and amortization expense incurred by the Regional selling locations was included in an overall 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)	**June 30, 2018**	December 31, 2017
Water Infrastructure	**$1,227**	$ 1,232
Applied Water	**1,053**	1,002
Measurement & Control Solutions	**3,664**	3,198
Regional selling locations (a)	**1,146**	1,119
Corporate and other (b)	**142**	309
Total	**$7,232**	$ 6,860

(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, 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.

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,” “target,” “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: overall economic and business conditions, political and other risks associated with our international operations, including military actions, economic sanctions or trade barriers and 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 successfully identify, complete and integrate acquisitions; 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, 2017 ("2017 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 global water technology company. We design, manufacture and service highly engineered solutions ranging across a wide variety of critical applications. Our broad portfolio of solutions addresses customer needs across the water cycle, from the delivery, measurement and use of drinking water to the collection, test and treatment of wastewater to the return of water to the environment. Our product and service offerings are organized into three reportable segments that are aligned around the critical market applications they provide: Water Infrastructure, Applied Water and Measurement & Control

Solutions.

- *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 also provide sales and rental of specialty dewatering pumps and related equipment and services. In the Water Infrastructure segment, we provide the majority of our sales

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directly to customers with strong applications 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, 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. In the Applied Water segment, we provide the majority of our sales through long-standing relationships with many of the leading independent distributors in the markets we serve, with the remainder going directly to customers.
- *Measurement & Control Solutions* primarily serves the utility infrastructure solutions and services sector by delivering communications, smart metering, critical infrastructure technologies, measurement and control technologies and services that allow customers to more effectively use their distribution networks for the delivery of critical resources such as water, electricity and natural gas. In the Measurement & Control Solutions segment, we also provide analytical instrumentation used to measure water quality, flow and level in wastewater, surface water and coastal environments. Additionally, we sell software and services including cloud-based analytics, remote monitoring and data management, leak detection and pressure monitoring solutions. We also sell smart lighting products and solutions that improve efficiency and public safety efforts across communities. In the Measurement & Control Solutions segment, we generate our sales through a combination of long-standing relationships with leading distributors and dedicated channel partners as well as direct sales depending on the regional availability of distribution channels and the type of product.

Executive Summary

Xylem reported revenue for the second quarter of 2018 of $1,317 million, an increase of 13.1% compared to $1,164 million reported in the second quarter of 2017. On a constant currency basis, revenue increased by $124 million, or 10.7%, primarily consisting of organic revenue growth of $98 million, or 8.4%, driven by growth in the utility, industrial and commercial end markets, which was marginally offset by a slight decline in the residential end market. Acquisition revenue of $29 million also contributed to the increase, partially offset by lost revenue related to divestitures of $3 million.

We generated operating income of $171 million (margin of 13.0%) during the second quarter of 2018, a $34 million increase compared to $137 million (margin of 11.8%) in 2017. The increase in operating income and margin included favorable impacts from decreased Sensus acquisition related costs of $4 million and decreased restructuring and realignment costs of $2 million, partially offset by an increase in special charges of $1 million. Excluding the impact of these items, adjusted operating income was $182 million (adjusted margin of 13.8%) during the second quarter of 2018 as compared to $153 million (adjusted margin of 13.1%) in 2017. The increase in adjusted operating margin was primarily due to cost reductions from our global procurement and productivity initiatives, favorable volume impacts and price gains, which were partially offset by cost inflation, increased spending on strategic investments and unfavorable mix. Purchase accounting impacts also negatively affected operating margin.

Additional financial highlights for the quarter ended June 30, 2018 include the following:

- Orders of $1,378 million, up 13.7% from $1,212 million in the prior year, up 8.4% on an organic basis
- Earnings per share of $0.64, up 16.4% from the prior year ($0.73, up 23.7% on an adjusted basis)
- Cash flow from operating activities of $201 million for the six months ended June 30, 2018, up 33.1% from the prior year. Free cash flow, excluding Sensus acquisition related costs, of $91 million as compared to $96 million in the prior year, as higher operating cash flows were offset by the timing of capital spending and increased investing activity.

Key Performance Indicators and Non-GAAP Measures

Management reviews key performance indicators including revenue, gross margins, segment operating income and margins, orders growth, working capital and backlog, among others. In addition, we consider certain non-GAAP (or "adjusted") 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. Excluding revenue, Xylem provides guidance only on a non-GAAP basis due to the inherent difficulty in forecasting certain amounts that would be included in GAAP earnings, such as discrete tax items, without unreasonable effort. These adjusted metrics are consistent with how management views our business and are used to make financial, operating and planning decisions. These metrics, however, are not measures of financial performance under GAAP and should not be considered a substitute for revenue, operating income, net income, earnings per share (basic and diluted) or net cash from operating activities 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 fluctuations in foreign currency translation 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 translation impacts is determined by translating current period and prior period activity using the same currency conversion rate.
- "constant currency" defined as financial results adjusted for foreign 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, Sensus acquisition related costs, special charges, tax-related special items and loss/(gain) from sale of business, as applicable. A reconciliation of adjusted net income is provided below.

(In millions, except for per share data)	Three Months Ended June 30, 2018	2017	Six Months Ended June 30, 2018	2017
Net income attributable to Xylem	**$115**	$99	**$194**	$155
Earnings per share - diluted	**$0.64**	$0.55	**$1.07**	$0.86
Restructuring and realignment, net of tax of $3 and $7 for 2018 and net of tax of $5 and $7 for 2017	**7**	7	**19**	16
Sensus acquisition related costs, net of tax of $1 and $5 for 2017	**—**	3	**—**	9
Special charges, net of tax of $0 and $1 for 2018 and net of tax of $0 and $2 for 2017	**1**	—	**6**	3
Tax-related special items	**6**	(3)	**3**	(3)
Loss (gain) from sale of business, net of tax of $0 for 2018 and $2 for 2017	**2**	—	**2**	(3)
Adjusted net income	**$131**	$106	**$224**	$177
Adjusted earnings per share	**$0.73**	$0.59	**$1.24**	$0.98

- "operating expenses excluding restructuring and realignment costs, Sensus acquisition related costs and special charges" defined as operating expenses, adjusted to exclude restructuring and realignment costs, Sensus acquisition related costs and special charges.
- "adjusted operating income" defined as operating income, adjusted to exclude restructuring and realignment costs, Sensus acquisition related costs and special charges, and "adjusted operating margin" defined as adjusted operating income divided by total 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.
- "Sensus acquisition related costs" defined as costs incurred by the Company associated with the acquisition of Sensus that are being reported within operating income. These costs include integration costs, acquisition costs, costs related to the recognition of the backlog intangible asset amortization recorded in purchase accounting.
- "special charges" defined as costs incurred by the Company, such as non-cash impairment charges, acquisition and integration related costs not related to Sensus and other special non-operating items.
- "tax-related special items" defined as tax items, such as tax return versus tax provision adjustments, tax exam impacts, tax law change impacts, significant reserves for cash repatriation, excess tax benefits/losses and other discrete tax adjustments.
- "free cash flow" defined as net cash from operating activities, as reported in the Statement of Cash Flow, less capital expenditures as well as adjustments for other significant items that impact current results which 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)	Six Months Ended June 30, 2018	2017
Net cash provided by operating activities	**$201**	$151
Capital expenditures	**(111)**	(77)
Free cash flow	**$90**	$74
Cash paid for Sensus related acquisition costs	**$(1)**	$(22)
Free cash flow, excluding Sensus acquisition related costs	**$91**	$96

“EBITDA” defined as earnings before interest, taxes, depreciation and amortization expense and "Adjusted EBITDA" reflects the adjustment to EBITDA to exclude share-based compensation, restructuring and realignment costs, Sensus acquisition related costs, special charges and gain from sale of business.

	Three Months Ended June 30,		Six Months Ended June 30,	
(in millions)	**2018**	2017	**2018**	2017
Net Income	**$115**	$100	**$194**	$156
Income tax expense	**35**	21	**51**	35
Interest expense (income), net	**20**	20	**40**	40
Depreciation	**29**	27	**58**	55
Amortization	**36**	30	**74**	61
EBITDA	**$235**	$198	**$417**	$347
Share-based compensation	**$7**	$5	**16**	11
Restructuring and realignment	**9**	12	**25**	23
Sensus acquisition related costs	**—**	2	**—**	9
Special charges	**1**	—	**7**	5
Loss (gain) from sale of business	**2**	—	**2**	(5)
Adjusted EBITDA	**$254**	$217	**$467**	$390

2018 Outlook

We anticipate total revenue growth in the range of 10% to 11% in 2018 with organic revenue growth anticipated to be approximately 6% to 7%. The following is a summary of our organic revenue outlook by end market.

- Utilities revenue increased approximately 10% organically through the first half of the year led by strength in North America and Asia Pacific. In 2018 we expect organic revenue growth in the high-single-digits with stable growth in the U.S. from water and wastewater spending and mixed but stable low-single-digit growth in Europe. We also anticipate high-single-digit growth from the smart meter market and infrastructure analytics along with healthy infrastructure investments and continued focus in emerging markets with projects in China, India and Asia Pacific.
- Industrial revenue increased approximately 6% organically through the first half of the year lead by strength in the U.S. and western Europe. In 2018 we expect organic revenue growth in the mid-single-digits driven by solid industrial conditions in both the U.S. and Europe along with continued recovery in the oil and gas and mining markets in North America. We also anticipate mixed emerging market conditions with strength in China and India offset by softness in the Middle East and Latin America.
- In the commercial markets, organic growth was approximately 6% through the first half of the year driven by strength in the U.S and Asia Pacific. In 2018 we expect organic revenue growth in the low-to-mid-single-digits driven by continued strength in the U.S. and the emerging markets lead by initiatives in the India and China building markets. We expect growth in Europe to stabilize after over 2 years of strong performance.
- In residential markets, organic growth was approximately 1% through the first half of the year driven by strength in western Europe which was partially offset by weakness in the U.S. In 2018 we expect organic revenue growth in the low-single-digits driven by continued competitive market dynamics in the U.S., market share gains from an increased selling focus in Europe and increased demand in China and other Asia Pacific countries for secondary clean water sources.

We will continue to strategically execute restructuring and realignment actions primarily to reposition our European and North American businesses in an effort to optimize our cost structure and improve our operational efficiency and effectiveness. Included in these costs are initial costs to implement our Global Shared Services platform, which will enable us to simplify, standardize and centralize many of our transactional processes. During 2018, we expect to incur $45 million in integration, restructuring and realignment costs. We expect to

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realize approximately $10 million of incremental net savings in 2018 from actions initiated in 2017, and an additional $3 million of net savings from our 2018 actions.

We plan to continue to take actions and focus spending in 2018 on actions that allow us to make progress on our top strategic priorities. The priority of accelerating profitable growth encompasses our initiatives to drive commercial excellence, grow in emerging markets and strengthen innovation and technology through creation of new centers of excellence, a streamlined approach to product development and smart acquisitions. The priority of driving continuous improvement is an area where we will continue to work to create new opportunities to unlock savings by eliminating waste, increasing efficiencies and proactively managing input costs. All of our strategic priorities are supported by efforts to expand and further deepen our talent pool. We plan to continue to deploy capital in smart, disciplined ways to develop and acquire solutions to address our customers' challenges. Finally, we continue to work to improve cash performance, particularly around working capital, to generate increasing cash flows for investments and returns to our shareholders.

Results of Operations

	Three Months Ended June 30,			**Six Months Ended June 30,**		
(In millions)	**2018**	2017	Change	**2018**	2017	Change
Revenue	**$1,317**	$1,164	13.1 %	**$2,534**	$2,235	13.4 %
Gross profit	**519**	457	13.6 %	**979**	869	12.7 %
Gross margin	**39.4 %**	39.3 %	10 bp	**38.6 %**	38.9 %	(30) bp
Total operating expenses	**348**	320	8.8 %	**695**	646	7.6 %
Expense to revenue ratio	**26.4 %**	27.5 %	(110) bp	**27.4 %**	28.9 %	(150) bp
Restructuring and realignment costs	**10**	12	(16.7)%	**26**	23	13.0 %
Sensus acquisition related charges	**—**	4	NM	**—**	14	NM
Special charges	**1**	—	NM	**7**	5	40.0 %
Operating expenses excluding restructuring and realignment costs, Sensus acquisition related costs and special charges	**337**	304	10.9 %	**662**	604	9.6 %
Expense to revenue ratio	**25.6 %**	26.1 %	(50) bp	**26.1 %**	27.0 %	(90) bp
Operating income	**171**	137	24.8 %	**284**	223	27.4 %
Operating margin	**13.0 %**	11.8 %	120 bp	**11.2 %**	10.0 %	120 bp
Interest and other non-operating expense, net	**19**	16	18.8 %	**37**	37	— %
(Loss) gain on sale of business	**(2)**	—	NM	**(2)**	5	(140.0)%
Income tax expense	**35**	21	66.7 %	**51**	35	45.7 %
Tax rate	**23.2 %**	16.8 %	640 bp	**20.8 %**	18.1 %	270 bp
Net income	**$115**	$100	15.0 %	**$194**	$156	24.4 %

NM - Not meaningful percentage change

Revenue

Revenue generated during the three and six months ended June 30, 2018 was $1,317 million and $2,534 million, reflecting increases of $153 million or 13.1% and $299 million or 13.4%, respectively, compared to the same prior year periods. On a constant currency basis, revenue grew 10.7% and 9.7% for the three and six months ended June 30, 2018. The increases at constant currency were primarily due to increases in organic revenue of $98 million and $175 million, respectively, reflecting strong organic growth in North America as well as strength in the emerging markets, particularly in China, and western Europe. Acquisition revenue of $29 million and $49 million, respectively, also contributed to the increase, partially offset by a $3 million and $8 million reduction in revenue related to divestitures during each respective period.

The following tables illustrate the impact from organic growth, recent acquisitions and divestitures, and foreign currency translation in relation to revenue during the three and six months ended June 30, 2018:

	Water Infrastructure		**Applied Water**		**Measurement & Control Solutions**		**Total Xylem**	
(In millions)	$ Change	% Change	$ Change	% Change	$ Change	% Change	$ Change	% Change
2017 Revenue	$482		$361		$321		$1,164	
Organic growth	51	10.6 %	22	6.1 %	25	7.8 %	98	8.4 %
Acquisitions/Divestitures	—	— %	(3)	(0.8)%	29	9.0 %	26	2.3 %
Constant currency	51	10.6 %	19	5.3 %	54	16.8 %	124	10.7 %
Foreign currency translation (a)	13	2.7 %	8	2.2 %	8	2.5 %	29	2.4 %
Total change in revenue	64	13.3 %	27	7.5 %	62	19.3 %	153	13.1 %
2018 Revenue	**$546**		**$388**		**$383**		**$1,317**	

	Water Infrastructure		**Applied Water**		**Measurement & Control Solutions**		**Total Xylem**	
(In millions)	$ Change	% Change	$ Change	% Change	$ Change	% Change	$ Change	% Change
2017 Revenue	$901		$694		$640		$2,235	
Organic growth	87	9.7 %	46	6.6 %	42	6.6 %	175	7.8 %
Acquisitions/Divestitures	—	— %	(8)	(1.2)%	49	7.7 %	41	1.8 %
Constant currency	87	9.7 %	38	5.5 %	91	14.2 %	216	9.7 %
Foreign currency translation (a)	38	4.2 %	22	3.2 %	23	3.6 %	83	3.7 %
Total change in revenue	125	13.9 %	60	8.6 %	114	17.8 %	299	13.4 %
2018 Revenue	**$1,026**		**$754**		**$754**		**$2,534**	

(a) Foreign currency translation impact primarily due to strength in the value of the Euro, the Chinese Yuan, the British Pound and various other currencies against the U.S. Dollar.

Water Infrastructure

Water Infrastructure revenue increased $64 million, or 13.3%, for the second quarter of 2018 (10.6% increase at constant currency) compared to the respective 2017 period. Revenue benefited from $13 million of foreign currency translation, with the change at constant currency coming entirely from organic growth of $51 million. Organic growth for the quarter was driven by strength in the utility end market across all regions, particularly in the United States, the emerging markets and Europe. The strength in these regions was largely attributable to growth from share gains and market demand. Organic growth for the quarter was also driven by strength in the industrial end market, primarily in western Europe and the United States. From an application perspective, organic revenue growth was driven by both our transport and treatment applications. The transport application had strong revenue growth in North America from modest share gains and continued focus by utility customers on improving infrastructure, as well as strong global dewatering rental sales for the quarter. Organic revenue from our treatment application had strong project deliveries in the emerging markets, particularly in the Middle East, Latin America and China, as well as in Europe.

For the six months ended June 30, 2018, revenue increased $125 million, or 13.9% (9.7% increase at constant currency) compared to the respective 2017 period. Revenue benefited from $38 million of foreign currency translation, with the change at constant currency coming entirely from organic growth of $87 million. Organic growth for the first half was driven by strength in the utility end market across all regions, with particularly strong growth coming from the emerging markets, especially China, and the United States. Organic growth for the first half was also driven by strength in the industrial end market, primarily in Europe and the United States, partially offset by industrial declines in Asia Pacific due to the lapping of a large industrial treatment project delivery in the region in the first quarter of last year. From an application perspective, organic revenue growth was driven primarily by our transport application. The transport application grew due to strength in North America from modest share gains and continued focus by utility customers on improving infrastructure, as well as strong

dewatering rental sales, and product localization in China. Organic revenue from our treatment application also contributed to the segment's growth across all regions, particularly from strong project deliveries in China and the Middle East.

Applied Water

Applied Water revenue increased $27 million, or 7.5%, for the second quarter of 2018 (5.3% increase at constant currency) as compared to the prior year, with revenue benefiting from $8 million of foreign currency translation for the quarter. Revenue growth at constant currency consisted of organic growth of $22 million, or 6.1%, in the second quarter of 2018, which was driven by strength in the industrial and commercial end markets, particularly in the United States and China, partially offset by residential declines in North America. From an application perspective, organic revenue growth in the second quarter was led by growth in the industrial water application, driven primarily by healthy general industrial demand and increased specialty flow business in North America as well as project deliveries in China. Commercial building services revenue also grew organically, primarily driven by distributor strength and growth in commercial building construction in North America and market improvement in project business in China and India. This organic growth was partially offset by a decline in residential building services primarily driven by declines in the North America residential water business due to a difficult compare to last year's 15% growth.

For the six months ended June 30, 2018, revenue increased $60 million, or 8.6% (5.5% increase at constant currency), with revenue benefiting from $22 million of foreign currency translation in the first half. The revenue growth at constant currency consisted of $46 million, or 6.6% organic growth, partially offset by $8 million of reduction in revenue related to divestitures. The organic revenue growth for the first half was driven primarily by strength in the industrial and commercial end markets as well as modest growth in the residential end market. Organic revenue growth in the industrial water application was driven primarily by recovery in large project business and healthy general industrial demand in North America and western Europe as well as strong project deliveries in emerging markets, particularly China. Commercial building services revenue also grew organically, primarily driven by distributor strength in North America and modest market improvement in project business in China. Residential building services also had very modest organic growth, primarily from strength in western Europe, partially offset by declines in North America.

Measurement & Control Solutions

Measurement & Control Solutions revenue increased $62 million, or 19.3%, for the second quarter of 2018 (16.8% at constant currency) as compared to the prior year, with revenue benefiting from $8 million of foreign currency translation for quarter. Revenue growth at constant currency was made up of the revenue contributed by acquisitions of $29 million and organic revenue growth of $25 million, or 7.8%, for the second quarter. Organic revenue growth for the quarter was primarily driven by strength in the utility end market in the United States. From an application perspective, the gas as well as the software as a service & other applications were the leaders of organic growth for the quarter, driven by large project deployments in the United States. The test application also experienced mid-single-digit growth during the quarter, primarily driven by strength in western Europe and the United States

applications deployments in the United States and from water application strength in the United States, partially offset by the lapping of large project shipments in the U.K. in the prior year.

For the six months ended June 30, 2018, revenue increased $114 million, or 17.8% (14.2% at constant currency) as compared to the prior year, with revenue benefiting from $23 million of foreign currency translation. Revenue growth at constant currency was made up of the revenue contributed by acquisitions of $49 million and organic revenue growth of $42 million, or 6.6%, for the first half of 2018. Organic revenue growth for the first half was primarily driven by strength in the utility end market in North America and China. From an application perspective, software as a service & other contributed the most organic revenue for the segment with large deployments in the United States and the U.K. Additional organic revenue growth in North America primarily came from the gas and electric applications. The test application also had modest organic revenue growth, primarily in western Europe in the industrial end market and in

China in the utility end market, due to large shipments. The water application revenue declined organically during the first half of the year, primarily due to lapping prior year project shipments in the U.K., partially offset by strength in North America.

Orders / Backlog

Orders received during the second quarter of 2018 were $1,378 million, an increase of $166 million, or 13.7%, over the second quarter of the prior year (11.2% increase at constant currency). Orders received during the six months ended June 30, 2018 were $2,698 million, an increase of $349 million, or 14.9%, from the prior year (11.2% increase at constant currency). The order growth at constant currency primarily consisted of organic order growth of 8.4% and 9.4% for the three and six months ended June 30, 2018, respectively. For the three and six months ended June 30, 2018, orders from acquisitions of $38 million and $52 million, respectively, also contributed to the growth at constant currency, partially offset by a reduction in orders related to divestitures of $4 million and $10 million, respectively.

Water Infrastructure segment orders increased $59 million, or 11.3%, to $580 million (8.6% increase at constant currency) for the quarter as compared to the prior year. The order increase on a constant currency basis consisted entirely of an increase in organic orders. Organic orders grew in both of the segment applications. Treatment applications had strong order intake, primarily from projects in China, as well as order strength in North America and Europe. The transport growth was primarily driven by increased strength in North America from strong dewatering rental orders for the quarter along with oil and gas order strength. Transport order growth was also driven by order strength in Europe, partially offset by a decline in India due to project timing. For the six months ended June 30, 2018 orders increased $146 million, or 14.8%, to $1,134 million (10.5% increase at constant currency) as compared to the same prior year period. The order increase on a constant currency basis consisted entirely of an increase in organic orders. Organic orders grew in both of the segment applications. The transport growth was driven by increased strength in North America from dewatering rental orders and order strength across most of our product offerings, particularly in North America and Europe. Transport order growth was also driven by order strength in the emerging markets, particularly in China and the Middle East and Africa, and in Europe. Treatment applications had strong order intake, primarily from mixer and filtration orders in China and large projects in North America, as well as order strength in India and Europe.

Applied Water segment orders increased $26 million, or 6.9%, to $401 million (4.5% increase at constant currency) for the second quarter of 2018 as compared to the prior year. The order increase for the second quarter on a constant currency basis included organic order growth of $21 million, or 5.6%, driven by strong commercial and industrial performance in the United States, as well as modest strength in Europe. These increases were partially offset by declines in the emerging markets, particularly in China where we benefited from a large order in the prior year and the reduction of orders from divestitures of $4 million. For the six months ended June 30, 2018 orders increased $56 million, or 7.7%, to $785 million (4.5% increase at constant currency) as compared to the prior year. The order increase on a constant currency basis included organic order growth of $43 million, or 5.9%, driven by strong commercial and industrial performance in the United States, as well as modest strength in Europe and the emerging markets, partially offset by the reduction orders from divestitures of $10 million.

Measurement & Control Solutions segment orders increased $81 million, or 25.6%, to $397 million (23.4% increase at constant currency) for the second quarter of 2018 as compared to the same prior year period. The order increase at constant currency included orders from recent acquisitions of $38 million and organic order growth of $36 million, or 11.4%, primarily from large deployment orders in the United States, primarily in the water and gas applications. For the six months ended June 30, 2018 orders increased $147 million, or 23.3%, to $779 million (19.9% increase at constant currency) as compared to the prior year. The order increase at constant currency included orders from recent acquisitions of $52 million and organic order growth of $74 million, or 11.7%, primarily from large deployment orders in North America and western Europe. These increases in organic orders were primarily from increase in the water, software as a service & other and gas applications, with the electric application orders being flat. The organic order increases were partially offset by slight declines in test application orders in China due to timing as well as the lapping of a large order in the prior year.

Backlog includes orders on hand as well as contractual customer agreements at the end of the period. Delivery schedules vary from customer to customer based on their requirements. Annual or multi-year contracts are subject to rescheduling and cancellation by customers due to the long-term nature of the contracts. As such, beginning total backlog, plus orders, minus revenues, will not equal ending total backlog due to contract adjustments, foreign currency fluctuations, and other factors. Typically, large projects require longer lead production cycles and deployment schedules and delays can occur from time to time. Total backlog was $1,707 million at June 30, 2018, an increase of $176 million or 11.5%, as compared to June 30, 2017 backlog of $1,531 million, and an increase of $194 million or 12.8%, as compared to December 31, 2017 backlog of $1,513 million. The increase in backlog as compared to the prior year amounts includes approximately $69 million of backlog from acquisitions. We anticipate that over 50% of the backlog at June 30, 2018 will be recognized as revenue in the remainder of 2018.

Gross Margin

Gross margin as a percentage of revenue increased 10 and decreased 30 basis points to 39.4% and 38.6%, respectively, for the three and six months ended June 30, 2018 as compared to 39.3% and 38.9%, respectively, for comparative 2017 periods. The slight gross margin increase for the quarter was primarily driven by cost reductions from global procurement and productivity improvement initiatives, the decrease in Sensus acquisition related costs included in gross margin and price realization, which were partially offset by cost inflation, unfavorable mix impacts and purchase accounting impacts from new acquisitions. The gross margin decline for the first half was primarily driven by cost inflation, unfavorable mix, purchase accounting impacts and currency impacts, which were partially offset by cost reductions from global procurement and productivity improvement initiatives, as well as a reduction in Sensus related acquisition and realignment costs included in gross margin.

Operating Expenses

The following table presents operating expenses for the three and six months ended June 30, 2018 and 2017:

	Three Months Ended June 30,			Six Months Ended June 30,		
(In millions)	**2018**	2017	Change	**2018**	2017	Change
Selling, general and administrative expenses ("SG&A")	**$293**	$270	8.5 %	**$589**	$542	8.7 %
SG&A as a % of revenue	**22.2 %**	23.2 %	(100)bp	**23.2 %**	24.3 %	(110)bp
Research and development expenses ("R&D")	**50**	44	13.6 %	**91**	86	5.8 %
R&D as a % of revenue	**3.8 %**	3.8 %	— bp	**3.6 %**	3.8 %	(20)bp
Restructuring and asset impairment charges, net	**5**	6	(16.7)%	**15**	18	(16.7)%
Operating expenses	**$348**	$320	8.8 %	**$695**	$646	7.6 %
Expense to revenue ratio	**26.4 %**	27.5 %	(110)bp	**27.4 %**	28.9 %	(150)bp

Selling, General and Administrative Expenses

SG&A increased by $23 million to $293 million or 22.2% of revenue in the second quarter of 2018, as compared to $270 million or 23.2% of revenue in the comparable 2017 period; and increased $47 million to $589 million or 23.2% of revenue in the six months ended June 30, 2018, as compared to $542 million or 24.3% of revenue for the six months ended in 2017. The improvement in SG&A as a percent of revenue for both periods was primarily driven by favorable volume impacts and savings from global procurement and continuous improvement initiatives and restructuring actions, which were partially offset by cost inflation and additional spending on strategic initiatives. Negative currency translation impacts and additional SG&A from recent acquisitions also added to the increase in SG&A expenses as compared to the prior year.

Research and Development Expenses

R&D spending was $50 million or 3.8% of revenue in the second quarter of 2018 as compared to $44 million or 3.8% of revenue in the comparable period of 2017; and was $91 million or 3.6% of revenue in the six months ended June 30, 2018, as compared to $86 million or 3.8% of revenue in the comparable period of 2017. The increased spending on R&D is driven by our continued commitment to innovation and technology development.

Restructuring Charges and Asset Impairment

Restructuring

During the three and six months ended June 30, 2018, we recognized restructuring charges of $5 million and $15 million, respectively. We incurred these charges related to actions taken in 2018 primarily as a continuation of our efforts to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges included the reduction of headcount and consolidation of facilities within our Measurement & Control Solutions and Water Infrastructure segments, as well as headcount reductions within our Applied Water segment. Included in the charges recorded during the three and six months ended June 30, 2018 were $1 million and $3 million, respectively, related to actions commenced in prior years.

During the three and six months ended June 30, 2017, we recognized restructuring charges of $6 million and $13 million. We incurred these charges related to actions taken in 2017 primarily as a continuation of our efforts to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges included the reduction of headcount and consolidation of facilities within our Applied Water and Water Infrastructure segments, as well as headcount reduction within our Measurement & Control Solutions segment. Included in the charges recorded during the three and six months ended June 30, 2017 were $2 million and $7 million, respectively, related to actions commenced in prior years.

The following table presents expected restructuring spend:

(in millions)	Water Infrastructure	Applied Water	Measurement & Control Solutions	Corporate	Total
Actions Commenced in 2018:					
Total expected costs	$ 8	$ 1	$ 8	$ —	$17
Costs incurred during Q1 2018	2	1	5	—	8
Costs incurred during Q2 2018	2	—	2	—	4
Total expected costs remaining	**$ 4**	**$ —**	**$ 1**	**$ —**	**$5**
Actions Commenced in 2017:					
Total expected costs	$ 19	$ 12	$ 2	$ —	$33
Costs incurred during 2017	5	4	2	—	11
Costs incurred during Q1 2018	1	—	—	—	1
Costs incurred during Q2 2018	1	—	—	—	1
Total expected costs remaining	**$ 12**	**$ 8**	**$ —**	**$ —**	**$20**
Actions Commenced in 2016:					
Total expected costs	$ 13	$ 14	$ 11	$ 2	$40
Costs incurred during 2016	11	10	6	2	29
Costs incurred during 2017	2	4	3	—	9
Costs incurred during Q1 2018	—	—	1	—	1
Costs incurred during Q2 2018	—	—	—	—	—
Total expected costs remaining	**$ —**	**$ —**	**$ 1**	**$ —**	**$1**

The Water Infrastructure, Applied Water, and Measurement & Control Solutions actions commenced in 2018 consist primarily of severance charges and are expected to continue through the end of 2018. The Water Infrastructure, Applied Water, Measurement & Control Solutions and Corporate actions commenced in 2017 consist primarily of severance charges and are expected to continue through the end of 2019.

We currently expect to incur approximately $23 million in restructuring costs for the full year. Included in these costs are initial costs to implement our Global Shared Services platform, which will enable us to simplify, standardize and centralize many of our transactional processes.As a result of all of the actions taken and expected to be taken in 2018, we anticipate approximately $2 million of total net savings to be realized during 2018.

Asset Impairment

During the first quarter of 2017 we determined that certain assets within our Applied Water segment, including a trade name were impaired. Accordingly we recognized an impairment charge of $5 million. Refer to Note 10, "Goodwill and Other Intangible Assets," for additional information.

Operating Income

Operating income for the second quarter of 2018 was $171 million, reflecting an increase of 24.8% compared to $137 million in the second quarter of 2017. Operating margin was 13.0% for 2018 versus 11.8% for 2017, an increase of 120 basis points. The increase in operating margin was primarily due to cost reductions resulting from our global procurement and productivity initiatives, favorable volume impacts and price gains and a decrease in Sensus acquisition related costs. These favorable impacts on operating margin were partially offset by cost inflation increases, increased spending on strategic investment and unfavorable mix. Purchase accounting impacts also negatively affected operating margin.

Adjusted operating income was $182 million with an operating margin of 13.8% in 2018 as compared to adjusted operating income of $153 million with an adjusted operating margin of 13.1% in the second quarter of 2017. The increase in adjusted operating margin was mostly due to cost reductions resulting from our global procurement and productivity initiatives and favorable volume impacts and price gains, which were partially offset by cost inflation increases, increased spending on strategic investment and unfavorable mix. Purchase accounting impacts also negatively affected operating margin.

Operating income for the six months ended June 30, 2018 was $284 million, reflecting an increase of 27.4% compared to $223 million in 2017. Operating margin was 11.2% for 2018 versus 10.0% for 2017, an increase of 120 basis points. The increase in operating margin was primarily due to cost reductions resulting from our global procurement and productivity initiatives, favorable volume impacts and price gains and a decrease in Sensus acquisition related costs. These favorable impacts on operating margin were partially offset by cost inflation increases, increased spending on strategic investments and unfavorable mix. Purchase accounting impacts also negatively affected operating margin.

Adjusted operating income was $317 million with an operating margin of 12.5% for the six months ended June 30, 2018 as compared to adjusted operating income of $265 million with an adjusted operating margin of 11.9% in 2017. The increase in adjusted operating margin was mostly due to cost reductions resulting from our global procurement and productivity initiatives and favorable volume impacts and price gains, which were partially offset by cost inflation increases, increased spending on strategic investments and unfavorable mix. Purchase accounting impacts also negatively affected operating margin.

The table below provides a reconciliation of the total and each segment's operating income to adjusted operating income, and a calculation of the corresponding adjusted operating margin:

	Three Months Ended June 30,			Six Months Ended June 30,		
(In millions)	**2018**	2017	Change	**2018**	2017	Change
Water Infrastructure						
Operating income	**$92**	$74	24.3 %	**$141**	$115	22.6 %
Operating margin	***16.8 %***	*15.4 %*	*140 bp*	***13.7 %***	*12.8 %*	*90 bp*
Restructuring and realignment costs	**5**	5	— %	**10**	9	11.1 %
Adjusted operating income	**$97**	$79	22.8 %	**$151**	$124	21.8 %
Adjusted operating margin	***17.8 %***	*16.4 %*	*140 bp*	***14.7 %***	*13.8 %*	*90 bp*
Applied Water						
Operating income	**$61**	$48	27.1 %	**$111**	$84	32.1 %
Operating margin	***15.7 %***	*13.3 %*	*240 bp*	***14.7 %***	*12.1 %*	*260 bp*
Restructuring and realignment costs	**2**	5	(60.0)%	**5**	9	(44.4)%
Special charges	**—**	—	— %	**—**	5	NM
Adjusted operating income	**$63**	$53	18.9 %	**$116**	$98	18.4 %
Adjusted operating margin	***16.2 %***	*14.7 %*	*150 bp*	***15.4 %***	*14.1 %*	*130 bp*
Measurement & Control Solutions						
Operating income	**$31**	$29	6.9 %	**$64**	$54	18.5 %
Operating margin	***8.1 %***	*9.0 %*	*(90)bp*	***8.5 %***	*8.4 %*	*10 bp*
Sensus acquisition related costs	**—**	3	NM	**—**	9	NM
Restructuring and realignment costs	***3***	2	50.0 %	***11***	5	120.0 %
Special charges	***1***	—	NM	***3***	—	NM
Adjusted operating income	***$35***	$34	2.9 %	***$78***	$68	14.7 %
Adjusted operating margin	***9.1 %***	*10.6 %*	*(150)bp*	***10.3 %***	*10.6 %*	*(30)bp*
Corporate and other						
Operating loss	**$(13)**	$(14)	(7.1)%	**$(32)**	$(30)	6.7 %
Sensus acquisition related costs	**—**	1	NM	**—**	5	NM
Special charges	**—**	—	— %	**4**	—	NM
Adjusted operating loss	**$(13)**	$(13)	— %	**$(28)**	$(25)	12.0 %
Total Xylem						
Operating income	**$171**	$137	24.8 %	**$284**	$223	27.4 %
Operating margin	***13.0 %***	*11.8 %*	*120 bp*	***11.2 %***	*10.0 %*	*120 bp*
Restructuring and realignment costs	**10**	12	(16.7)%	**26**	23	13.0 %
Sensus acquisition related costs	**—**	4	NM	**—**	14	NM
Special charges	**1**	—	NM	**7**	5	40.0 %
Adjusted operating income	**$182**	$153	19.0 %	**$317**	$265	19.6 %
Adjusted operating margin	***13.8 %***	*13.1 %*	*70 bp*	***12.5 %***	*11.9 %*	*60 bp*

NM - Not meaningful percentage change

Water Infrastructure

Operating income for our Water Infrastructure segment increased $18 million, or 24.3%, for the second quarter of 2018 compared to the prior year, with operating margin also increasing from 15.4% to 16.8%. Restructuring and realignment costs incurred during the quarter were $5 million for both years. Excluding these restructuring and realignment costs, adjusted operating income increased $18 million, or 22.8%, with adjusted operating margin increasing from 16.4% to 17.8%. The increase in adjusted operating margin for the quarter was primarily due to cost reductions from our global procurement and productivity initiatives, favorable volume and price gains, which were partially offset by cost inflation, unfavorable mix and increased spending on strategic investments.

For the six months ended June 30 2018, operating income increased $26 million, or 22.6%, as compared to the prior year, with operating margin also increasing from 12.8% to 13.7%. Operating margin was negatively impacted by increased restructuring and realignment costs of $1 million in 2018. Excluding these restructuring and realignment costs, adjusted operating income increased $27 million, or 21.8%, with adjusted operating margin increasing from 13.8% to 14.7%. The increase in adjusted operating margin was primarily due to cost reductions from our global procurement and productivity initiatives, favorable volume and improving price realization in the second quarter, which were partially offset by cost inflation, negative currency impacts and unfavorable mix.

Applied Water

Operating income for our Applied Water segment increased $13 million, or 27.1%, for the second quarter of 2018 compared to the prior year, with operating margin also increasing from 13.3% to 15.7%. Operating margin was positively impacted by decreased restructuring and realignment costs of $3 million. Excluding these restructuring and realignment costs, adjusted operating income increased $10 million, or 18.9%, with adjusted operating margin increasing from 14.7% to 16.2%. The increase in adjusted operating margin was primarily due to cost reductions from our global procurement and productivity initiatives and favorable volume and price gains, which were partially offset by cost inflation and unfavorable mix.

For the six months ended June 30, 2018, operating income for increased $27 million, or 32.1%, as compared to the prior year, with operating margin also increasing from 12.1% to 14.7%. Operating margin was positively impacted by special charges of $5 million incurred in 2017 that did not recur and decreased restructuring and realignment costs of $4 million in 2018. Excluding special charges and restructuring and realignment costs, adjusted operating income increased $18 million, or 18.4%, with adjusted operating margin increasing from 14.1% to 15.4%. The increase in adjusted operating margin was primarily due to cost reductions from our global procurement and productivity initiatives, favorable volume and improving price realization in the second quarter, which were partially offset by cost inflation and unfavorable mix.

Measurement & Control Solutions

Operating income for our Measurement & Control Solutions segment increased $2 million, or 6.9%, for the second quarter of 2018 compared to the prior year, with operating margin decreasing from 9.0% to 8.1%. Operating margin was positively impacted by $3 million of Sensus acquisition related costs incurred during the quarter in 2017 that did not recur. This impact was partially offset by an increase in restructuring and realignment costs of $1 million and $1 million of special charges incurred during the quarter in 2018. Excluding these items, adjusted operating income increased $1 million, or 2.9%, with adjusting operating margin decreasing from 10.6% to 9.1%. The decrease in adjusted operating margin was primarily due to increases in cost inflation, spending on strategic investments and unfavorable mix impacts due to a shift to large gas project deployments. Purchase accounting impacts from current acquisitions also negatively affected operating margin. These impacts were partially offset by cost reductions from our global procurement and productivity initiatives and favorable volume impacts.

For the six months ended June 30, 2018, operating income increased $10 million, or 18.5%, as compared to the prior year, with operating margin also increasing from 8.4% to 8.5%. Operating margin was positively impacted by $9 million of Sensus acquisition related costs incurred during the year in 2017 that did not recur. This impact was partially offset by an increase in restructuring and realignment costs of $6 million and $3 million of special charges incurred in 2018. Excluding these items, adjusted operating income increased $10 million, or 14.7%, with adjusting operating margin decreasing from 10.6% to 10.3%. The decrease in adjusted operating margin was primarily due to increases in cost inflation, spending on strategic investments and unfavorable mix impacts due to a shift to large gas project deployments. Purchase accounting impacts also negatively affected operating margin. These impacts were partially offset by cost reductions from our global procurement and productivity initiatives and favorable volume.

Corporate and other
Operating expense for corporate and other decreased $1 million (remained flat on an adjusted basis) for the second quarter of 2018 as compared to the prior year, primarily due to $1 million of Sensus acquisition related costs incurred during the quarter in 2017 that did not recur. For the six months ended June 30, 2018 operating expense for corporate and other increased $2 million (increased $3 million on an adjusted basis) as compared to the prior year. This increase was primarily due to an increase in employee related, non-cash share-based compensation costs, which was partially offset by the net reduction of Sensus acquisition related costs and special charges.

Interest Expense

Interest expense was $21 million and $42 million for the three and six months ended June 30, 2018, and $21 million and $41 million for the three and six months ended June 30, 2017. The increased interest expense for the six month period includes additional interest expense in 2018 related to debt entered into in the first quarter of 2018 to fund our acquisition of Pure Technologies. See Note 13, "Credit Facilities and Debt" of our consolidated financial statements for a description of our credit facilities and long-term debt and related interest.

Income Tax Expense

The income tax provision for the three months ended June 30, 2018 was $35 million resulting in an effective tax rate of 23.2%, compared to $21 million resulting in an effective tax rate of 16.8% for the same period in 2017. The income tax provision for the six months ended June 30, 2018 was $51 million resulting in an effective tax rate of 20.8%, compared to $35 million resulting in and effective tax rate of 18.1% for the same period in 2017. The effective tax rate for the three month period ended June 30, 2018 was higher than the U.S. federal statutory rate primarily due to the settlement of tax examinations in various jurisdictions and the GILTI inclusion, partially offset by the mix of earnings in jurisdictions. The effective tax rate for the six month period ended June 30, 2018 was lower than the U.S. federal statutory rate primarily due to the mix of earnings in jurisdictions. Additionally, the effective tax rate for the three and six month periods ended June 30, 2018 is higher than the same periods of 2017 primarily due to the settlement of tax examinations and the GILTI inclusion, partially offset by the reduction of the U.S. federal corporate tax rate.
On December 22, 2017, the US government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”). The Tax Act makes broad and complex changes to the U.S. tax code. As noted at year end, we were able to reasonably estimate certain effects and, therefore, as permitted by SAB 118, recorded provisional estimates associated with the reduction of U.S. federal corporate tax rate and deemed repatriation transition tax. We have not made additional measurement-period adjustments related to these items during the quarter. See Note 6 “Income Tax Expense” of our consolidated financial statements for further discussion of the Tax Act.

Other Comprehensive Income

Other comprehensive loss was $87 million for the three months ended June 30, 2018 compared to income of $56 million for the same period in 2017. This decrease was primarily driven by unfavorable foreign currency translation impacts due to the weakening of the Euro, the Great British pound, the Chinese yuan, the Polish zloty, the Canadian dollar and the Swedish Krona as compared to the U.S. dollar in the current quarter versus the strengthening of these currencies in the same quarter of 2017. These decreases were partially offset by the favorable impact from movement in our Euro net investment hedges during the quarter. The tax impact on the movement in the net investment hedges also contributed to the year over year decrease.
For the six months ended June 30, 2018 other comprehensive loss was $67 million as compared to income of $98 million for the same period in 2017, a decrease of $165 million. This decrease was primarily driven by unfavorable foreign currency translation impacts due to the weakening of the Euro, the Canadian dollar, the Polish Zloty and the Swedish Krona as compared to the U.S. dollar in the current year versus strengthening for the same period in the prior year. Also contributing to the decrease was the weakening of the Great British Pound as compared to the U.S. Dollar in 2018 even more so than it did during the same

period in 2017. These decreases were partially offset by the favorable impact from movement in our Euro net investment hedges. The tax impact on the movement in the net investment hedges also contributed to the year over year decrease.

Liquidity and Capital

The following table summarizes our sources and (uses) of cash:

(In millions)	**Six Months Ended June 30, 2018**	2017	Change
Operating activities	**$201**	$151	$50
Investing activities	**(537)**	(69)	(468)
Financing activities	**252**	(115)	367
Foreign exchange (a)	**(9)**	13	(22)
Total	**$(93)**	$(20)	$(73)

(a) The impact is primarily due to the weakness of the Argentine Peso, the Chinese Yuan and the Indian Rupee against the U.S. Dollar. These impacts were partially offset by the strengthening of the Euro against the U.S. Dollar.

Sources and Uses of Liquidity

Operating Activities

During the six months ended June 30, 2018, net cash provided by operating activities was $201 million, an increase of $50 million as compared to the same prior year period. This increase was primarily driven by increased cash from earnings during the period and improved working capital efficiency.

Investing Activities

Cash used in investing activities was $537 million for the six months ended June 30, 2018 as compared to $69 million in the comparable prior year period. This increase was mainly driven by the $430 million spent on 2018 acquisitions, primarily the acquisition of Pure Technologies, versus the $6 million spent for acquisition purchase price true-ups in the prior year. Spending on capital projects also increased by $34 million over the prior year, primarily due to increased spending on software development, the purchase of a building, as well as increased spending on other capital investments. Lastly, we did not receive any proceeds from the sale of a business during the six months ended June 30, 2018 as compared to $11 million received in the prior year for a divested business.

Financing Activities

Cash generated by financing activities was $252 million for the six months ended June 30, 2018 as compared to cash used of $115 million in the comparable prior year period. The net increase in cash provided by financing activities during the period was primarily due to the issuance of $437 million in short term debt in the current year, which was largely used for acquisition financing, versus $33 million issued in the prior year. This was partially offset by increases in share repurchase activity of $33 million and dividends paid of $11 million as compared to the prior year.

Funding and Liquidity Strategy

Our ability to fund our capital needs depends on our ongoing ability to generate cash from operations, and access to bank financing and the capital markets. Historically, we have generated operating cash flow sufficient to fund our primary cash needs centered on operating activities, working capital, capital expenditures, strategic investments and dividend payments. If our cash flows from operations are less than we expect, we may need to incur debt or issue equity. From time to time, we may need to access the long-term and short-term capital markets to obtain financing. Our access to, and the availability of, financing on acceptable terms and conditions in the future will be impacted by many factors, including: (i) our credit ratings or absence of a credit rating, (ii) the liquidity of the overall capital markets, and (iii) the current state of the economy. There can be no assurance that such financing will be available to us on acceptable terms or that such financing will be available at all.

We monitor our global funding requirements and seek to meet our liquidity needs on a cost effective basis. Based on our current global cash positions, cash flows from operations and access to the commercial paper markets, we believe there is sufficient liquidity to meet our funding requirements. In addition, our existing committed credit facilities and access to the public debt markets would provide further liquidity if required.

We anticipate that our present sources of funds, including funds from operations and additional borrowings, will provide us with sufficient liquidity and capital resources to meet our liquidity and capital needs both inside and outside of the United States over the next twelve months.

Credit Facilities & Long-Term Contractual Commitments

See Note 13, "Credit Facilities and Debt" of our consolidated financial statements for a description of our credit facilities and long-term debt.

Non-U.S. Operations

We generated approximately 54% and 55% of our revenue from non-U.S. operations for the three and six months ended June 30, 2018 and 54% for the both the three and six months ended June 30, 2017. As we continue to grow our operations in the emerging markets and elsewhere outside of the United States, we expect to continue to generate significant revenue from non-U.S. operations and we expect a substantial portion of our cash will be predominately held by our foreign subsidiaries. We expect to manage our worldwide cash requirements considering available funds among the many subsidiaries through which we conduct business and the cost effectiveness with which those funds can be accessed. We may transfer cash from certain international subsidiaries to the U.S. and other international subsidiaries when we believe it is cost effective to do so. We continually review our domestic and foreign cash profile, expected future cash generation and investment opportunities, and reassess whether there is a demonstrated need to repatriate funds held internationally to support our U.S. operations. As of June 30, 2018, we have provided a deferred tax liability of $20 million for foreign withholding taxes and state income taxes on $769 million expected to be repatriated to the U.S. parent as deemed necessary. As of June 30, 2018, our foreign subsidiaries were holding $293 million in cash or marketable securities.

Critical Accounting Estimates

Our discussion and analysis of our results of operations and capital resources are based on our condensed consolidated financial statements, which have been prepared in conformity with GAAP. The preparation of these condensed consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and the disclosure of contingent assets and liabilities. We believe the most complex and sensitive judgments, because of their significance to the condensed consolidated financial statements, result primarily from the need to make estimates about the effects of matters that are inherently uncertain. Management’s Discussion and Analysis of Financial Condition and Results of Operations in the 2017 Annual Report describes the critical accounting estimates used in preparation of the condensed consolidated financial statements. Actual results in these areas could differ from management’s estimates. There have been no significant changes in the information concerning our critical accounting estimates as stated in our 2017 Annual Report.

New Accounting Pronouncements

See Note 2, "Recently Issued Accounting Pronouncements," to the condensed consolidated financial statements for a complete discussion of recent accounting pronouncements. We are currently evaluating the impact of certain recently issued guidance on our financial condition and results of operations in future periods.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has been no material change in the information concerning market risk as stated in our 2017 Annual Report.

ITEM 4. CONTROLS AND PROCEDURES

Our management, with the Chief Executive Officer and Chief Financial Officer of the Company, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this quarterly report. Any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Based on such evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

There have been no changes in our internal control over financial reporting during the fiscal quarter covered by this quarterly report that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

PART II

ITEM 1. LEGAL PROCEEDINGS

From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses. Some of these proceedings seek remedies relating to environmental matters, intellectual property matters, personal injury claims, employment and pension matters, government contract issues and commercial or contractual disputes, sometimes related to acquisitions or divestitures. See Note 18 "Commitments and Contingencies" to the condensed consolidated financial statements for further information and any updates.

ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors previously disclosed in our 2017 Annual Report on Form 10-K under Item 1A. Risk Factors.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table presents information with respect to purchases of the Company's common stock by the Company during the three months ended June 30, 2018:

(IN MILLIONS, EXCEPT PER SHARE AMOUNTS) PERIOD	TOTAL NUMBER OF SHARES PURCHASED	AVERAGE PRICE PAID PER SHARE (a)	TOTAL NUMBER OF SHARES PURCHASED AS PART OF PUBLICLY ANNOUNCED PLANS OR PROGRAMS (b)	APPROXIMATE DOLLAR VALUE OF SHARES THAT MAY YET BE PURCHASED UNDER THE PLANS OR PROGRAMS (b)
4/1/18 - 4/30/18	—	—	—	**$388**
5/1/18 - 5/31/18	0.3	69.83	0.3	**$369**
6/1/18 - 6/30/18	0.1	71.46	0.1	**$363**

This table does not include shares tendered to satisfy the exercise price in connection with cashless exercises of employee stock options or shares tendered to satisfy tax withholding obligations in connection with employee equity awards.

(a) Average price paid per share is calculated on a settlement basis.

(b) On August 24, 2015, our Board of Directors authorized the repurchase of up to $500 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. For the three months ended June 30, 2018, we repurchased 0.4 million shares for $25 million. There are up to $363 million in shares that may still be purchased under this plan as of June 30, 2018.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

See the Exhibit Index for a list of exhibits filed as part of this report and incorporated herein by reference.

XYLEM INC.
EXHIBIT INDEX

Exhibit Number	Description	Location
3.1	Fourth Amended and Restated Articles of Incorporation of Xylem Inc.	Incorporated by reference to Exhibit 3.1 of Xylem Inc.'s Form 8-K filed on May 15, 2017 (CIK No. 1524472, File No. 1-35229).
3.2	Fourth Amended and Restated By-laws of Xylem Inc.	Incorporated by reference to Exhibit 3.1 of Xylem Inc.'s Form 8-K filed on May 15, 2017 (CIK No. 1524472, File No. 1-35229).
11.0	Statement Re-Computation of Per Share Earnings	Information required to be presented in Exhibit 11 is provided under "Earnings Per Share" in Note 7 to the Condensed Consolidated Financial Statements in Part I, Item 1 "Condensed Consolidated Financial Statements" of this Report in accordance with the provisions of Financial Accounting Standards Board Accounting Standards Codification 260, *Earnings Per Share*.
31.1	Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith.
31.2	Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith.
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b) (32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference.
32.2	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b) (32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as

		shall be expressly set forth by specific reference.
101.0	The following materials from Xylem Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) Condensed Consolidated Income Statements, (ii) Condensed Consolidated Statements of Comprehensive Income, (iii) Condensed Consolidated Balance Sheets, (iv) Condensed Consolidated Statements of Cash Flows and (v) Notes to Condensed Consolidated Financial Statements	The instance document does not appear in the interactive data file because its XBRL tags are embedded within the Inline XBRL document.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

XYLEM INC.
(Registrant)

/s/ Paul A. Stellato
Paul A. Stellato
Vice President, Controller and Chief Accounting Officer

July 31, 2018