

Xylem Inc.  
Form 10-Q  
October 29, 2015

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

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

For the quarterly period ended September 30, 2015

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 1-35229

Xylem Inc.

(Exact name of registrant as specified in its charter)

Indiana

(State or other jurisdiction of incorporation or  
organization)

45-2080495

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

1 International Drive, Rye Brook, NY 10573

(Address of principal executive offices) (Zip code)

(914) 323-5700

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer ☒

Accelerated filer ☐

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

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

As of October 23, 2015, there were 179,366,169 outstanding shares of the registrant's common stock, par value \$0.01 per share.

Xylem Inc.

Table of Contents

| ITEM                                                                                                                                         | PAGE      |
|----------------------------------------------------------------------------------------------------------------------------------------------|-----------|
| PART I – Financial Information                                                                                                               |           |
| Item 1 - <u>Condensed Consolidated Financial Statements:</u>                                                                                 |           |
| <u>Condensed Consolidated Income Statements for the Three and Nine Months Ended September 30, 2015 and 2014 (Unaudited)</u>                  | <u>3</u>  |
| <u>Condensed Consolidated Statements of Comprehensive Income for the Three and Nine Months Ended September 30, 2015 and 2014 (Unaudited)</u> | <u>4</u>  |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2015 and December 31, 2014 (Unaudited)</u>                                      | <u>5</u>  |
| <u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2015 and 2014 (Unaudited)</u>                     | <u>6</u>  |
| <u>Notes to the Condensed Consolidated Financial Statements (Unaudited)</u>                                                                  | <u>7</u>  |
| Item 2 - <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>                                        | <u>28</u> |
| Item 3 - <u>Quantitative and Qualitative Disclosures About Market Risk</u>                                                                   | <u>44</u> |
| Item 4 - <u>Controls and Procedures</u>                                                                                                      | <u>44</u> |
| PART II – Other Information                                                                                                                  |           |
| Item 1 - <u>Legal Proceedings</u>                                                                                                            | <u>45</u> |
| Item 1A - <u>Risk Factors</u>                                                                                                                | <u>45</u> |
| Item 2 - <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>                                                                  | <u>45</u> |
| Item 3 - <u>Defaults Upon Senior Securities</u>                                                                                              | <u>45</u> |
| Item 4 - <u>Mine Safety Disclosures</u>                                                                                                      | <u>46</u> |
| Item 5 - <u>Other Information</u>                                                                                                            | <u>46</u> |
| Item 6 - <u>Exhibits</u>                                                                                                                     | <u>46</u> |
| <u>Signatures</u>                                                                                                                            | <u>47</u> |

## PART I

## ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## XYLEM INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED INCOME STATEMENTS (Unaudited)

(in millions, except per share data)

| For the periods ended September 30,                                    | Three Months |          | Nine Months |          |
|------------------------------------------------------------------------|--------------|----------|-------------|----------|
|                                                                        | 2015         | 2014     | 2015        | 2014     |
| Revenue                                                                | \$902        | \$963    | \$2,659     | \$2,874  |
| Cost of revenue                                                        | 551          | 587      | 1,645       | 1,768    |
| Gross profit                                                           | 351          | 376      | 1,014       | 1,106    |
| Selling, general and administrative expenses                           | 207          | 222      | 631         | 688      |
| Research and development expenses                                      | 23           | 24       | 71          | 78       |
| Restructuring charges                                                  | 1            | —        | 5           | 18       |
| Operating income                                                       | 120          | 130      | 307         | 322      |
| Interest expense                                                       | 13           | 14       | 41          | 41       |
| Other non-operating income, net                                        | —            | 1        | —           | 1        |
| Gain from sale of businesses                                           | —            | 11       | 9           | 11       |
| Income before taxes                                                    | 107          | 128      | 275         | 293      |
| Income tax expense                                                     | 19           | 22       | 49          | 52       |
| Net income                                                             | \$88         | \$106    | \$226       | \$241    |
| Earnings per share:                                                    |              |          |             |          |
| Basic                                                                  | \$0.48       | \$0.58   | \$1.25      | \$1.31   |
| Diluted                                                                | \$0.48       | \$0.58   | \$1.24      | \$1.31   |
| Weighted average number of shares:                                     |              |          |             |          |
| Basic                                                                  | 180.8        | 182.2    | 181.5       | 183.4    |
| Diluted                                                                | 181.6        | 183.4    | 182.3       | 184.6    |
| Dividends declared per share                                           | \$0.1408     | \$0.1280 | \$0.4224    | \$0.3840 |
| See accompanying notes to condensed consolidated financial statements. |              |          |             |          |

## XYLEM INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

(in millions)

| For the periods ended September 30,                            | Three Months |        | Nine Months |        |
|----------------------------------------------------------------|--------------|--------|-------------|--------|
|                                                                | 2015         | 2014   | 2015        | 2014   |
| Net income                                                     | \$88         | \$106  | \$226       | \$241  |
| Other comprehensive income (loss), before tax:                 |              |        |             |        |
| Foreign currency translation adjustment                        | (39          | ) (114 | ) (142      | ) (113 |
| Foreign currency gain reclassified into net income             | —            | —      | (8          | ) —    |
| Net change in cash flow hedges:                                |              |        |             |        |
| Unrealized losses                                              | —            | (6     | ) (5        | ) (14  |
| Amount of loss reclassified into net income                    | 5            | 2      | 17          | 1      |
| Net change in postretirement benefit plans:                    |              |        |             |        |
| Net gain                                                       | —            | 10     | —           | 3      |
| Amortization of net actuarial loss into net income             | 4            | 2      | 12          | 8      |
| Other comprehensive loss, before tax                           | (30          | ) (106 | ) (126      | ) (115 |
| Income tax impact related to items of other comprehensive loss | 1            | 3      | 4           | 3      |
| Other comprehensive loss, net of tax                           | (31          | ) (109 | ) (130      | ) (118 |
| Comprehensive income (loss)                                    | \$57         | \$(3   | ) \$96      | \$123  |

See accompanying notes to condensed consolidated financial statements.

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

|                                                                                                                  | September 30,<br>2015 | December 31,<br>2014 |
|------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| <b>ASSETS</b>                                                                                                    |                       |                      |
| Current assets:                                                                                                  |                       |                      |
| Cash and cash equivalents                                                                                        | \$611                 | \$663                |
| Receivables, less allowances for discounts and doubtful accounts of \$29 and \$34 in 2015 and 2014, respectively | 762                   | 771                  |
| Inventories                                                                                                      | 477                   | 486                  |
| Prepaid and other current assets                                                                                 | 132                   | 144                  |
| Deferred income tax assets                                                                                       | 35                    | 38                   |
| Total current assets                                                                                             | 2,017                 | 2,102                |
| Property, plant and equipment, net                                                                               | 418                   | 461                  |
| Goodwill                                                                                                         | 1,584                 | 1,635                |
| Other intangible assets, net                                                                                     | 434                   | 470                  |
| Other non-current assets                                                                                         | 192                   | 192                  |
| Total assets                                                                                                     | \$4,645               | \$4,860              |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                      |                       |                      |
| Current liabilities:                                                                                             |                       |                      |
| Accounts payable                                                                                                 | \$314                 | \$338                |
| Accrued and other current liabilities                                                                            | 422                   | 481                  |
| Short-term borrowings and current maturities of long-term debt                                                   | 79                    | 89                   |
| Total current liabilities                                                                                        | 815                   | 908                  |
| Long-term debt                                                                                                   | 1,196                 | 1,195                |
| Accrued postretirement benefits                                                                                  | 374                   | 388                  |
| Deferred income tax liabilities                                                                                  | 141                   | 158                  |
| Other non-current accrued liabilities                                                                            | 76                    | 84                   |
| Total liabilities                                                                                                | 2,602                 | 2,733                |
| Commitments and contingencies (Note 17)                                                                          |                       |                      |
| Stockholders' equity:                                                                                            |                       |                      |
| Common Stock – par value \$0.01 per share:                                                                       |                       |                      |
| Authorized 750.0 shares, issued 189.8 shares and 188.9 shares in 2015 and 2014, respectively                     | 2                     | 2                    |
| Capital in excess of par value                                                                                   | 1,822                 | 1,796                |
| Retained earnings                                                                                                | 796                   | 648                  |
| Treasury stock – at cost 10.4 shares and 6.6 shares in 2015 and 2014, respectively                               | (348)                 | (220)                |
| Accumulated other comprehensive loss                                                                             | (229)                 | (99)                 |
| Total stockholders' equity                                                                                       | 2,043                 | 2,127                |
| Total liabilities and stockholders' equity                                                                       | \$4,645               | \$4,860              |

See accompanying notes to condensed consolidated financial statements.

## XYLEM INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(in millions)

| For the nine months ended September 30,                                           | 2015  | 2014  |   |
|-----------------------------------------------------------------------------------|-------|-------|---|
| Operating Activities                                                              |       |       |   |
| Net income                                                                        | \$226 | \$241 |   |
| Adjustments to reconcile net income to net cash provided by operating activities: |       |       |   |
| Depreciation                                                                      | 69    | 70    |   |
| Amortization                                                                      | 33    | 37    |   |
| Share-based compensation                                                          | 11    | 14    |   |
| Restructuring charges                                                             | 5     | 18    |   |
| Gain from sale of businesses                                                      | (9)   | (11)  | ) |
| Other, net                                                                        | 10    | (2)   | ) |
| Payments for restructuring                                                        | (11)  | (20)  | ) |
| Changes in assets and liabilities (net of acquisitions):                          |       |       |   |
| Changes in receivables                                                            | (32)  | (40)  | ) |
| Changes in inventories                                                            | (15)  | (62)  | ) |
| Changes in accounts payable                                                       | 6     | (2)   | ) |
| Other, net                                                                        | (33)  | 10    | ) |
| Net Cash – Operating activities                                                   | 260   | 253   |   |
| Investing Activities                                                              |       |       |   |
| Capital expenditures                                                              | (78)  | (77)  | ) |
| Proceeds from sale of businesses                                                  | 1     | 30    |   |
| Proceeds from the sale of property, plant and equipment                           | 1     | 2     |   |
| Other, net                                                                        | 2     | —     |   |
| Net Cash – Investing activities                                                   | (74)  | (45)  | ) |
| Financing Activities                                                              |       |       |   |
| (Repayment) issuance of short-term debt                                           | (3)   | 2     | ) |
| Repurchase of common stock                                                        | (128) | (132) | ) |
| Proceeds from exercise of employee stock options                                  | 14    | 17    |   |
| Dividends paid                                                                    | (77)  | (71)  | ) |
| Other, net                                                                        | —     | 2     |   |
| Net Cash – Financing activities                                                   | (194) | (182) | ) |
| Effect of exchange rate changes on cash                                           | (44)  | (30)  | ) |
| Net change in cash and cash equivalents                                           | (52)  | (4)   | ) |
| Cash and cash equivalents at beginning of year                                    | 663   | 533   |   |
| Cash and cash equivalents at end of period                                        | \$611 | \$529 |   |
| Supplemental disclosure of cash flow information:                                 |       |       |   |
| Cash paid during the period for:                                                  |       |       |   |
| Interest                                                                          | \$37  | \$36  |   |
| Income taxes (net of refunds received)                                            | \$57  | \$69  |   |

See accompanying notes to condensed consolidated financial statements.

**XYLEM INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**Note 1. Background and Basis of Presentation**

**Background**

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

**Basis of Presentation**

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

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

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

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

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

## Note 2. Recently Issued Accounting Pronouncements

### Pronouncements Not Yet Adopted

In September 2015, the Financial Accounting Standards Board (“FASB”) issued guidance regarding simplifying the accounting for measurement-period adjustments attributable to an acquisition. Under prior guidance, adjustments to provisional amounts during the measurement period that arise due to new information regarding acquisition date circumstances must be made retrospectively with a corresponding adjustment to goodwill. The amended guidance requires an acquirer to record adjustments to provisional amounts made during the measurement period in the period that the adjustment is determined. The adjustments should reflect the impact on earnings of changes in depreciation, amortization, or other income effects, if any, as if the accounting had been completed as of the acquisition date. Additionally, amounts recorded in the current period that would have been reflected in prior reporting periods if the adjustments had been recognized as of the acquisition date must be disclosed either on the face of the income statement or in the notes to financial statements. This guidance is effective prospectively for interim and annual periods beginning after December 15, 2015 and early application is permitted. The impact of the guidance on our financial condition, results of operations and financial statement disclosures will depend on the level of acquisition activity performed by the Company.

In July 2015, the FASB issued guidance regarding simplifying the measurement of inventory. Under prior guidance, inventory is measured at the lower of cost or market, where market is defined as replacement cost, with a ceiling of net realizable value and a floor of net realizable value less a normal profit margin. The amended guidance requires the measurement of inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This guidance is effective prospectively for interim and annual periods beginning after December 15, 2016 and early application is permitted. We are evaluating the impact of the guidance on our financial condition, results of operations and financial statement disclosures.

In May 2015, the FASB issued guidance regarding the disclosure of investments which are valued at fair value using the net asset value per share practical expedient. The amended guidance removes the requirement to categorize such investments within the fair value hierarchy. The amendments also remove the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the net asset value per share practical expedient, instead limiting such disclosures to those investments measured at fair value using the practical expedient. This guidance is effective for interim and annual periods beginning after December 15, 2015. The guidance must be applied retrospectively and early adoption is permitted. We are evaluating the impact of the guidance on our financial condition, results of operations and financial statement disclosures.

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 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 are evaluating the impact of the guidance on our financial condition and results of operations.

#### Recently Adopted Pronouncements

In April 2015, the FASB issued guidance which changes the presentation of debt issuance costs in the balance sheet. Under prior guidance, debt issuance costs are reflected on the balance sheet as an asset. This amendment requires such costs to be reflected as a direct deduction to the related debt liability, with retrospective application upon adoption. Subsequently, in August 2015, the FASB issued additional guidance indicating that debt issuance costs associated with line-of-credit arrangements may be presented as an asset and amortized over the term of the line-of-credit arrangement. We elected to early adopt these standard effective the first and third quarter of 2015, respectively. Accordingly, \$4 million of debt issuance costs are now reflected within long-term debt as of September 30, 2015 and December 31, 2014. These costs were previously recorded within other non-current assets.

In April 2015, the FASB issued guidance regarding whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license then the software license element of the arrangement should be accounted for in a manner that is consistent with accounting for the acquisition of other software licenses. If a cloud computing arrangement does not include a software license then the arrangement should be accounted for as a service contract. This guidance is effective for interim and annual periods beginning after December 15, 2015. The guidance may be applied (1) retrospectively or (2) prospectively to arrangements entered into, or materially modified after the effective date. Early adoption is permitted. We elected to early adopt this standard effective in the second quarter of 2015 with retrospective application. Our adoption of this guidance did not have any impact on our financial condition or results of operations.

In February 2015, the FASB issued guidance which amends the requirements to determine whether a company needs to consolidate certain legal entities into its reported financial statements. Specifically, the amendment: (1) modifies the evaluation of whether limited partnerships and similar legal entities are variable interest entities ("VIEs") or voting interest entities, (2) eliminates the presumption that a general partner should consolidate a limited partnership and (3) affects the consolidation analysis of reporting entities that are involved with VIEs. This guidance is effective for interim and annual reporting periods beginning after December 15, 2015 and may be applied retrospectively to each prior period presented or with the cumulative effect recognized as of the date of initial application. We elected to early adopt this standard effective in the second quarter of 2015 with retrospective application. Our adoption of this guidance did not have any impact on our financial condition or results of operations.

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

In June 2014, as a result of inconsistency in practice, the FASB issued guidance related to the recognition of compensation on employee share-based payments in which the terms of the award provide that a



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

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

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

### Note 3. Divestitures

There were no divestitures during the three months ended September 30, 2015. For the nine months ended September 30, 2015, we divested two businesses for \$1 million, which were not material, individually or in the aggregate, to our results of operations or financial position. The sales resulted in a gain of \$9 million, reflected in gain from sale of businesses in our Condensed Consolidated Income Statement.

On July 2, 2014, we divested our Wolverhampton, U.K.-based pneumatic and hydraulic valves business for approximately \$30 million. The sale resulted in a gain of \$11 million, reflected in gain from sale of business in our Condensed Consolidated Income Statement. The business, which was part of our Applied Water segment, provided a wide range of products, primarily to industrial original equipment manufacturer customers in the oil and gas sector.

## Note 4. Restructuring Charges

During the three and nine months ended September 30, 2015, we recognized restructuring charges of \$1 million and \$5 million, respectively. We incurred these charges primarily in an effort to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges included the elimination of headcount and consolidation of facilities within our Water Infrastructure segment.

During the three and nine months ended September 30, 2014, we recognized restructuring charges of less than \$1 million and \$18 million, respectively, within both our Water Infrastructure and Applied Water segments for the same aforementioned purposes for which we incurred the 2015 charges.

The following table presents the components of restructuring expense for the three and nine months ended September 30, 2015 and 2014.

| (in millions)                      | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|------------------------------------|-------------------------------------|------|------------------------------------|------|
|                                    | 2015                                | 2014 | 2015                               | 2014 |
| By component:                      |                                     |      |                                    |      |
| Severance and other charges        | \$ 1                                | \$—  | \$6                                | \$18 |
| Reversal of restructuring accruals | —                                   | —    | (1                                 | ) —  |
| Total restructuring charges        | \$ 1                                | \$—  | \$5                                | \$18 |
| By segment:                        |                                     |      |                                    |      |
| Water Infrastructure               | \$ 1                                | \$—  | \$5                                | \$12 |
| Applied Water                      | —                                   | —    | —                                  | 6    |

The following table displays a rollforward of the restructuring accruals, presented on our Condensed Consolidated Balance Sheets within accrued and other current liabilities, as of September 30, 2015 and 2014.

| (in millions)                         | 2015 | 2014  |
|---------------------------------------|------|-------|
| Restructuring accruals - January 1    | \$12 | \$13  |
| Restructuring charges                 | 5    | 18    |
| Cash payments                         | (11  | ) (20 |
| Foreign currency and other            | (1   | ) —   |
| Restructuring accruals - September 30 | \$5  | \$11  |
| By segment:                           |      |       |
| Water Infrastructure                  | \$2  | \$6   |
| Applied Water                         | —    | 2     |
| Regional selling locations (a)        | 3    | 3     |

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

The following is a rollforward for the nine months ended September 30, 2015 and 2014 of employee position eliminations associated with restructuring activities.

|                                   | 2015  | 2014  |
|-----------------------------------|-------|-------|
| Planned reductions - January 1    | 133   | 51    |
| Additional planned reductions     | 87    | 233   |
| Actual reductions                 | (120) | (206) |
| Planned reductions - September 30 | 100   | 78    |

Total expected costs associated with actions that commenced during the nine months ended September 30, 2015 are approximately \$6 million and are all within Water Infrastructure. These costs primarily consist of severance charges. Related to these actions, we incurred \$1 million and \$4 million for Water Infrastructure during the three and nine months ended September 30, 2015, respectively. We currently expect activity related to these actions to continue through the second quarter of 2016.

Total expected costs associated with actions that commenced during 2014 are approximately \$19 million for Water Infrastructure. Approximately \$18 million of the expected cost was incurred in 2014, no additional costs were incurred during the three months ended September 30, 2015, and \$1 million was incurred during the nine months ended September 30, 2015. The Water Infrastructure actions commenced in 2014 are substantially complete. Total expected costs associated with actions that commenced during 2014 are approximately \$6 million for Applied Water. Approximately \$6 million of the expected cost was incurred in 2014, substantially all of the costs associated with these actions have been incurred.

#### Note 5. Income Taxes

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

The income tax provision for the three months ended September 30, 2015 was \$19 million resulting in an effective tax rate of 17.4%, compared to \$22 million resulting in an effective tax rate of 17.5% for the same period in 2014. The income tax provision for the nine months ended September 30, 2015 was \$49 million resulting in an effective tax rate of 17.6%, compared to \$52 million resulting in an effective tax rate of 17.7% for the same period in 2014. The effective tax rate was lower than the United States federal statutory rate in each period primarily due to geographic mix of earnings.

#### Unrecognized Tax Benefits

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

The amount of unrecognized tax benefits at September 30, 2015 was \$42 million which, if ultimately recognized, will reduce our annual effective tax rate. We do not believe that the unrecognized tax benefits will significantly change within the next twelve months.

We classify interest expense relating to unrecognized tax benefits as a component of other non-operating expense, net, and tax penalties as a component of income tax expense in our Condensed Consolidated Income Statements. As of September 30, 2015, we had \$1 million of interest accrued for unrecognized tax benefits.

## Note 6. Earnings Per Share

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

|                                                       | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|-------------------------------------------------------|-------------------------------------|---------|------------------------------------|---------|
|                                                       | 2015                                | 2014    | 2015                               | 2014    |
| Net income (in millions)                              | \$88                                | \$106   | \$226                              | \$241   |
| Shares (in thousands):                                |                                     |         |                                    |         |
| Weighted average common shares outstanding            | 180,815                             | 182,196 | 181,428                            | 183,343 |
| Add: Participating securities (a)                     | 30                                  | 48      | 43                                 | 46      |
| Weighted average common shares outstanding — Basic    | 180,845                             | 182,244 | 181,471                            | 183,389 |
| Plus incremental shares from assumed conversions: (b) |                                     |         |                                    |         |
| Dilutive effect of stock options                      | 424                                 | 646     | 489                                | 655     |
| Dilutive effect of restricted stock                   | 363                                 | 542     | 376                                | 529     |
| Weighted average common shares outstanding — Diluted  | 181,632                             | 183,432 | 182,336                            | 184,573 |
| Basic earnings per share                              | \$0.48                              | \$0.58  | \$1.25                             | \$1.31  |
| Diluted earnings per share                            | \$0.48                              | \$0.58  | \$1.24                             | \$1.31  |

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

Incremental shares from stock options, restricted stock and performance share units are computed by the treasury stock method. The weighted average shares listed below were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the periods presented or were otherwise excluded under the treasury stock method. The treasury stock method calculates dilution assuming the exercise of all

- (b) in-the-money options and vesting of restricted stock and performance share awards, reduced by the repurchase of shares with the proceeds from the assumed exercises, unrecognized compensation expense for outstanding awards and the estimated tax benefit of the assumed exercises. Performance share units will be included in the treasury stock calculation of diluted earnings per share upon achievement of underlying performance conditions. See Note 14, "Share-Based Compensation Plans" for further detail on the performance share units.

|                    | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |       |
|--------------------|-------------------------------------|-------|------------------------------------|-------|
| (in thousands)     | 2015                                | 2014  | 2015                               | 2014  |
| Stock options      | 2,703                               | 2,709 | 2,712                              | 2,769 |
| Restricted stock   | 747                                 | 534   | 754                                | 532   |
| Performance shares | 191                                 | 136   | 187                                | 114   |

## Note 7. Inventories

The components of total inventories are summarized as follows:

| (in millions)     | September 30,<br>2015 | December 31,<br>2014 |
|-------------------|-----------------------|----------------------|
| Finished goods    | \$212                 | \$194                |
| Work in process   | 45                    | 42                   |
| Raw materials     | 220                   | 250                  |
| Total inventories | \$477                 | \$486                |

## Note 8. Property, Plant and Equipment

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

| (in millions)                              | September 30,<br>2015 | December 31,<br>2014 |
|--------------------------------------------|-----------------------|----------------------|
| Land, buildings and improvements           | \$246                 | \$252                |
| Machinery and equipment                    | 647                   | 655                  |
| Equipment held for lease or rental         | 208                   | 207                  |
| Furniture and fixtures                     | 84                    | 87                   |
| Construction work in progress              | 34                    | 41                   |
| Other                                      | 21                    | 23                   |
| Total property, plant and equipment, gross | 1,240                 | 1,265                |
| Less accumulated depreciation              | 822                   | 804                  |
| Total property, plant and equipment, net   | \$418                 | \$461                |

Depreciation expense of \$22 million and \$69 million was recognized in the three and nine months ended September 30, 2015, respectively, and \$23 million and \$70 million for the three and nine months ended September 30, 2014, respectively.

## Note 9. Goodwill and Other Intangible Assets

Changes in the carrying value of goodwill by reportable segment are as follows:

| (in millions)                    | Water<br>Infrastructure | Applied Water | Total   |
|----------------------------------|-------------------------|---------------|---------|
| Balance as of January 1, 2015    | \$1,098                 | \$537         | \$1,635 |
| Activity in 2015                 |                         |               |         |
| Foreign currency and other       | (36                     | ) (15         | ) (51   |
| Balance as of September 30, 2015 | \$1,062                 | \$522         | \$1,584 |

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

## Other Intangible Assets

Information regarding our other intangible assets is as follows:

| (in millions)                          | September 30, 2015 |                          |                 | December 31, 2014 |                          |                 |
|----------------------------------------|--------------------|--------------------------|-----------------|-------------------|--------------------------|-----------------|
|                                        | Carrying Amount    | Accumulated Amortization | Net Intangibles | Carrying Amount   | Accumulated Amortization | Net Intangibles |
| Customer and distributor relationships | \$319              | \$(136)                  | ) \$183         | \$331             | \$(122)                  | ) \$209         |
| Proprietary technology and patents     | 113                | (53)                     | ) 60            | 116               | (49)                     | ) 67            |
| Trademarks                             | 34                 | (18)                     | ) 16            | 36                | (17)                     | ) 19            |
| Software (a)                           | 134                | (92)                     | ) 42            | 131               | (92)                     | ) 39            |
| Other                                  | 8                  | (8)                      | ) —             | 9                 | (9)                      | ) —             |
| Indefinite-lived intangibles           | 133                | —                        | 133             | 136               | —                        | 136             |
|                                        | \$741              | \$(307)                  | ) \$434         | \$759             | \$(289)                  | ) \$470         |

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

Amortization expense related to finite-lived intangible assets was \$11 million and \$33 million for the three and nine months ended September 30, 2015, respectively, and \$12 million and \$37 million for the three and nine months ended September 30, 2014, respectively.

## Note 10. Derivative Financial Instruments

## Risk Management Objective of Using Derivatives

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

## Cash Flow Hedges of Foreign Exchange Risk

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

Certain business units with exposure to foreign currency exchange risks have designated certain currency forward agreements as cash flow hedges of forecasted intercompany inventory purchases and sales. Our principal currency exposures relate to the Euro, Swedish Krona, British Pound, Canadian Dollar, Polish Zloty, Australian Dollar and Hungarian Forint. We held forward foreign exchange contracts with purchase notional amounts totaling \$131 million and \$355 million as of September 30, 2015 and December 31, 2014, respectively. As of September 30, 2015, our most significant foreign currency derivatives include contracts to purchase Swedish Krona and sell Euro, sell US Dollar and purchase Euro, and sell British Pound and purchase Euro. The purchased notional amounts associated with these currency derivatives are \$48 million, \$43 million and \$20 million, respectively. As of December 31, 2014,

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

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

| (in millions)                                                                      | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |         |
|------------------------------------------------------------------------------------|-------------------------------------|--------|------------------------------------|---------|
|                                                                                    | 2015                                | 2014   | 2015                               | 2014    |
| Derivatives in Cash Flow Hedges                                                    |                                     |        |                                    |         |
| Foreign Exchange Contracts                                                         |                                     |        |                                    |         |
| Amount of loss recognized in Other Comprehensive Loss (a)                          | \$—                                 | \$(6 ) | \$(5 )                             | \$(14 ) |
| Amount of loss reclassified from Other Comprehensive Loss into revenue (a)         | 5                                   | 1      | 16                                 | —       |
| Amount of loss reclassified from Other Comprehensive Loss into cost of revenue (a) | —                                   | 1      | 1                                  | 1       |
| (a) Effective portion                                                              |                                     |        |                                    |         |

As of September 30, 2015, \$2 million of the net unrealized losses on cash flow hedges is expected to be reclassified into earnings in the next 12 months. The ineffective portion of the change in fair value of a cash flow hedge is excluded from effectiveness testing and is recognized immediately in selling, general and administrative expenses in the Condensed Consolidated Income Statements. For the three and nine months ended September 30, 2015 and 2014, the amounts were not material.

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

| (in millions)                                 | September 30,<br>2015 | December 31,<br>2014 |
|-----------------------------------------------|-----------------------|----------------------|
| Derivatives designated as hedging instruments |                       |                      |
| Assets                                        |                       |                      |
| Other current assets                          | \$1                   | \$1                  |
| Liabilities                                   |                       |                      |
| Other current liabilities                     | (2 )                  | (13 )                |
| Total fair value                              | \$(1 )                | \$(12 )              |

# Note 11. Accrued and Other Current Liabilities

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

| (in millions)                               | September 30,<br>2015 | December 31,<br>2014 |
|---------------------------------------------|-----------------------|----------------------|
| Compensation and other employee benefits    | \$157                 | \$186                |
| Customer-related liabilities                | 60                    | 66                   |
| Accrued warranty costs                      | 31                    | 31                   |
| Accrued taxes                               | 69                    | 77                   |
| Other accrued liabilities                   | 105                   | 121                  |
| Total accrued and other current liabilities | \$422                 | \$481                |

# Note 12. Credit Facilities and Long-Term Debt

Total debt outstanding is summarized as follows:

| (in millions)                                                        | September 30,<br>2015 | December 31,<br>2014 |
|----------------------------------------------------------------------|-----------------------|----------------------|
| 3.550% Senior Notes due 2016 (a)                                     | \$600                 | \$600                |
| 4.875% Senior Notes due 2021 (a)                                     | 600                   | 600                  |
| Research and development facility agreement                          | 77                    | 84                   |
| Other                                                                | 2                     | 5                    |
| Debt issuance costs                                                  | (4                    | ) (4                 |
| Unamortized discount (b)                                             | —                     | (1                   |
| Total debt                                                           | 1,275                 | 1,284                |
| Less: short-term borrowings and current maturities of long-term debt | 79                    | 89                   |
| Total long-term debt                                                 | \$1,196               | \$1,195              |

The fair value of our Senior Notes (as defined below) was determined using quoted prices in active markets for identical securities, which are considered Level 1 inputs. The fair value of our Senior Notes due 2016 was \$613 (a) million and \$621 million as of September 30, 2015 and December 31, 2014, respectively. The fair value of our Senior Notes due 2021 was \$655 million and \$653 million as of September 30, 2015 and December 31, 2014, respectively.

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

## Senior Notes

On September 20, 2011, we issued 3.550% Senior Notes of \$600 million aggregate principal amount due September 2016 (the "Senior Notes due 2016") and 4.875% Senior Notes of \$600 million aggregate principal amount due October 2021 (the "Senior Notes due 2021" and together with the Senior Notes due 2016 the "Senior Notes").

The Senior Notes include covenants which restrict our ability, subject to exceptions, to incur debt secured by liens and engage in sale and leaseback transactions, as well as provide for customary events of default (subject, in certain cases, to receipt of notice of default and/or customary grace and cure periods). We may redeem the Senior Notes, as applicable, in whole or in part, at any time at a redemption price equal to the principal amount of the Senior Notes to be redeemed, plus a make-whole premium. If a



change of control triggering event (as defined in the Senior Notes indenture) occurs, we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase. As of September 30, 2015, we were in compliance with all covenants.

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

As of September 30, 2015, we have classified \$600 million of our Senior Notes due 2016 as long-term based on our current ability and intent to refinance the outstanding borrowings on a long-term basis.

#### Five-Year Revolving Credit Facility

Effective March 27, 2015, Xylem entered into a Five-Year Revolving Credit Facility (the "Credit Facility") with Citibank, N.A., as administrative agent, and a syndicate of lenders. The Credit Facility provides for an aggregate principal amount of up to \$600 million of: (i) revolving extensions of credit (the "revolving loans") outstanding at any time and (ii) the issuance of letters of credit in a face amount not in excess of \$100 million outstanding at any time. The Credit Facility provides for increases of up to \$200 million for a possible maximum total of \$800 million in aggregate principal amount at our request and with the consent of the institutions providing such increased commitments.

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

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The Credit Facility also contains limitations on, among other things, incurring secured debt, granting liens, entering into sale and leaseback transactions, mergers, consolidations, liquidations, dissolutions and sales of assets. In addition, the Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default. As of September 30, 2015, we were in compliance with all covenants.

As of September 30, 2015, the Credit Facility was undrawn.

#### Research and Development Facility Agreement

On December 4, 2013, the Company amended and restated its Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank (the "EIB") to add an additional borrower under the facility. The facility provides an aggregate principal amount of up to €120 million (approximately \$134 million) to finance research projects and infrastructure development in the European Union. The Company's wholly owned subsidiaries in Luxembourg, Xylem Holdings S.á r.l. and Xylem International S.á r.l., are the borrowers under the R&D Facility Agreement. The obligations of the borrowers under the R&D Facility Agreement are guaranteed by the Company under an Amended and Restated Deed of Guarantee, dated as of December 4, 2013, in favor of the EIB. The funds are available to finance research and development projects during the period from 2013 through 2016 at the Company's R&D facilities in Sweden, Germany, Italy, the United Kingdom, Austria, Norway and Hungary.

Under the R&D Facility Agreement, the borrower can draw loans on or before December 14, 2015 with a maturity of no longer than 12 years. The R&D Facility Agreement provides for Fixed Rate loans and Floating Rate loans. The interest rate per annum applicable to Fixed Rate loans is at a fixed percentage rate per annum specified by the EIB which includes the applicable margin. The interest rate per annum

applicable to Floating Rate loans is at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Pounds Sterling or U.S. Dollars, plus an applicable spread specified by the EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans is determined by reference to the credit rating of the Company.

In accordance with the terms of the R&D Facility Agreement, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The R&D Facility Agreement also contains limitations on, among other things, incurring debt, granting liens, and entering into sale and leaseback transactions. In addition, the R&D Facility Agreement contains other terms and conditions, such as customary representations and warranties, additional covenants and customary events of default. As of September 30, 2015, we were in compliance with all covenants.

As of September 30, 2015, \$77 million was outstanding under the R&D Facility Agreement. Although the borrowing term for this arrangement is up to five years, we have classified it as short-term debt on our Condensed Consolidated Balance Sheet since we intend to repay this obligation in less than a year.

#### Note 13. Postretirement Benefit Plans

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

| (in millions)                                | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |       |
|----------------------------------------------|-------------------------------------|------|------------------------------------|-------|
|                                              | 2015                                | 2014 | 2015                               | 2014  |
| Domestic defined benefit pension plans:      |                                     |      |                                    |       |
| Service cost                                 | \$1                                 | \$1  | \$2                                | \$2   |
| Interest cost                                | 1                                   | —    | 3                                  | 2     |
| Expected return on plan assets               | (2                                  | ) (1 | ) (4                               | ) (3  |
| Amortization of net actuarial loss           | 1                                   | —    | 2                                  | 1     |
| Net periodic benefit cost                    | \$1                                 | \$—  | \$3                                | \$2   |
| International defined benefit pension plans: |                                     |      |                                    |       |
| Service cost                                 | \$3                                 | \$3  | \$9                                | \$11  |
| Interest cost                                | 6                                   | 8    | 18                                 | 22    |
| Expected return on plan assets               | (8                                  | ) (8 | ) (25                              | ) (25 |
| Amortization of net actuarial loss           | 3                                   | 2    | 10                                 | 6     |
| Net periodic benefit cost                    | \$4                                 | \$5  | \$12                               | \$14  |
| Total net periodic benefit cost              | \$5                                 | \$5  | \$15                               | \$16  |

The total net periodic benefit cost for other postretirement employee benefit plans was \$1 million and \$3 million including amounts recognized in other comprehensive income ("OCI") of less than \$1 million for both the three and nine months ended September 30, 2015, respectively. The total net periodic benefit cost for other postretirement employee benefit plans was \$1 million and \$4 million including amounts recognized in OCI of less than \$1 million and \$1 million for the three and nine months ended September 30, 2014, respectively.

We contributed \$21 million and \$30 million to our defined benefit plans during the nine months ended September 30, 2015 and 2014, respectively. Additional contributions ranging between approximately \$6 million and \$10 million are expected during the remainder of 2015.

During the third quarter 2014, we amended one of our international pension plans as well as one of our domestic other postretirement plans. The pension plan amendment froze the accrual of benefits and closed the plan to new entrants. The other postretirement plan amendment modified the accrual of benefits and closed the plan to new entrants. The overall impact of these changes to our third quarter 2014 financial statements was a \$10 million increase to funded status. This included a net loss of \$3 million (\$1 million net of tax) and a prior service credit of \$13 million (\$8 million net of tax) recognized in OCI.

#### Note 14. Share-Based Compensation Plans

Share-based compensation expense was \$3 million and \$11 million during the three and nine months ended September 30, 2015, respectively, and \$5 million and \$14 million during the three and nine months ended September 30, 2014. The unrecognized compensation expense related to our stock options, restricted stock and performance based shares was \$7 million, \$23 million and \$4 million, respectively, at September 30, 2015 and is expected to be recognized over a weighted average period of 2.0, 2.0 and 2.1 years, respectively. The amount of cash received from the exercise of stock options was \$14 million and \$17 million for the nine months ended September 30, 2015 and 2014, respectively.

#### Stock Option Grants

The following is a summary of the changes in outstanding stock options for the nine months ended September 30, 2015:

| (shares in thousands)                                | Shares | Weighted<br>Average<br>Exercise<br>Price / Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (Years) |
|------------------------------------------------------|--------|--------------------------------------------------|-----------------------------------------------------------------|
| Outstanding at January 1, 2015                       | 2,989  | \$28.60                                          | 6.5                                                             |
| Granted                                              | 708    | 35.88                                            | 10.0                                                            |
| Exercised                                            | (519)  | ) 26.85                                          | 5.6                                                             |
| Forfeited and expired                                | (178)  | ) 34.04                                          | 8.5                                                             |
| Outstanding at September 30, 2015                    | 3,000  | \$30.30                                          | 6.7                                                             |
| Options exercisable at September 30, 2015            | 1,939  | \$27.44                                          | 5.4                                                             |
| Vested and expected to vest as of September 30, 2015 | 2,877  | \$30.09                                          | 6.6                                                             |

The aggregate intrinsic value of the outstanding, exercisable, and vested and expected to vest stock options as of September 30, 2015 was \$12 million, \$11 million and \$12 million, respectively. The total intrinsic value of options exercised (which is the amount by which the stock price exceeded the exercise price of the options on the date of exercise) during the nine months ended September 30, 2015 was \$4 million.

## Stock Option Fair Value

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

|                                     |        |   |
|-------------------------------------|--------|---|
| Dividend yield                      | 1.57   | % |
| Volatility                          | 27.77  | % |
| Risk-free interest rate             | 1.64   | % |
| Expected term (in years)            | 5.58   |   |
| Weighted-average fair value / share | \$8.49 |   |

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

## Restricted Stock Grants

The following is a summary of restricted stock activity for the nine months ended September 30, 2015:

| (shares in thousands)             | Shares | Weighted<br>Average<br>Grant Date<br>Fair Value /Share |
|-----------------------------------|--------|--------------------------------------------------------|
| Outstanding at January 1, 2015    | 1,171  | \$ 31.80                                               |
| Granted                           | 411    | 35.84                                                  |
| Vested                            | (345)  | ) 27.82                                                |
| Forfeited                         | (105)  | ) 32.50                                                |
| Outstanding at September 30, 2015 | 1,132  | \$ 34.43                                               |

## Performance-Based Share Grants

The following is a summary of performance-based share grants for the nine months ended September 30, 2015:

| (shares in thousands)             | Shares | Weighted<br>Average<br>Grant Date<br>Fair Value /Share |
|-----------------------------------|--------|--------------------------------------------------------|
| Outstanding at January 1, 2015    | 124    | \$ 33.95                                               |
| Granted                           | 103    | 35.91                                                  |
| Vested                            | —      | —                                                      |
| Forfeited                         | (48)   | ) 33.11                                                |
| Outstanding at September 30, 2015 | 179    | \$ 35.30                                               |

## Note 15. Capital Stock

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. During the three and nine months ended September 30, 2015, we repurchased 0.9 million shares for \$30 million in both periods under this program. There are up to \$470 million in shares that may still be purchased under this plan as of September 30, 2015.

On August 20, 2013, our Board of Directors authorized the repurchase of up to \$250 million in shares with no expiration date. The program's objective was to deploy our capital in a manner that benefited our shareholders and maintain our focus on growth. For the three and nine months ended September 30, 2015, we repurchased 0.6 million and 2.0 million shares for \$20 million and \$70 million, respectively. For the three and nine months ended September 30, 2014, we repurchased 0.8 million and 3.4 million shares for \$30 million and \$130 million, respectively, under this program. As of September 30, 2015, we have exhausted the authorized amount to repurchase shares under this plan.

On August 18, 2012, our Board of Directors authorized the repurchase of up to 2.0 million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem employee stock plans by acquiring shares in the open market from time to time. During the three and nine months ended September 30, 2015 we repurchased 0.8 million shares for \$25 million in both periods. There are up to 0.2 million shares (approximately \$8 million in value) that may still be purchased under this plan as of September 30, 2015. There were no shares repurchased under this program during the three and nine months ended September 30, 2014.

Aside from the aforementioned repurchase programs, we repurchased less than 0.1 million and 0.1 million shares for less than \$1 million and \$3 million during the three and nine months ended September 30, 2015, respectively, in relation to settlement of employee tax withholding obligations due as a result of the vesting of restricted stock. Likewise, during the three and nine months ended September 30, 2014, we repurchased less than 0.1 million shares in both periods for less than \$1 million and \$2 million, respectively.

## Note 16. Accumulated Other Comprehensive Income (Loss)

The following table provides the components of accumulated other comprehensive income (loss) for the three months ended September 30, 2015:

| (in millions)                                                                   | Foreign<br>Currency<br>Translation | Postretirement<br>Benefit Plans | Derivative<br>Instruments | Total   |
|---------------------------------------------------------------------------------|------------------------------------|---------------------------------|---------------------------|---------|
| Balance at July 1, 2015                                                         | \$34                               | \$(225)                         | \$(7)                     | \$(198) |
| Foreign currency translation adjustment                                         | (39)                               | —                               | —                         | (39)    |
| Amortization of net actuarial loss on postretirement benefit plans into:        |                                    |                                 |                           |         |
| Cost of revenue                                                                 | —                                  | 1                               | —                         | 1       |
| Selling, general and administrative expenses                                    | —                                  | 2                               | —                         | 2       |
| Research and development expenses                                               | —                                  | 1                               | —                         | 1       |
| Income tax impact on amortization of postretirement benefit plan items          | —                                  | (1)                             | —                         | (1)     |
| Reclassification of unrealized loss on foreign exchange agreements into revenue | —                                  | —                               | 5                         | 5       |
| Balance at September 30, 2015                                                   | \$(5)                              | \$(222)                         | \$(2)                     | \$(229) |

The following table provides the components of accumulated other comprehensive income (loss) for the nine months ended September 30, 2015:

| (in millions)                                                                                         | Foreign<br>Currency<br>Translation | Postretirement<br>Benefit Plans | Derivative<br>Instruments | Total     |
|-------------------------------------------------------------------------------------------------------|------------------------------------|---------------------------------|---------------------------|-----------|
| Balance at January 1, 2015                                                                            | \$145                              | \$ (231 )                       | \$ (13 )                  | \$ (99 )  |
| Foreign currency translation adjustment                                                               | (142 )                             | —                               | —                         | (142 )    |
| Foreign currency gain reclassified into gain on sale of businesses                                    | (8 )                               | —                               | —                         | (8 )      |
| Amortization of net actuarial loss on postretirement benefit plans into:                              |                                    |                                 |                           |           |
| Cost of revenue                                                                                       | —                                  | 3                               | —                         | 3         |
| Selling, general and administrative expenses                                                          | —                                  | 7                               | —                         | 7         |
| Research and development expenses                                                                     | —                                  | 1                               | —                         | 1         |
| Other non-operating expense, net                                                                      | —                                  | 1                               | —                         | 1         |
| Income tax impact on amortization of postretirement benefit plan items                                | —                                  | (3 )                            | —                         | (3 )      |
| Unrealized loss on foreign exchange agreements                                                        | —                                  | —                               | (5 )                      | (5 )      |
| Reclassification of unrealized loss on foreign exchange agreements into revenue                       | —                                  | —                               | 16                        | 16        |
| Reclassification of unrealized loss on foreign exchange agreements into cost of revenue               | —                                  | —                               | 1                         | 1         |
| Income tax benefit on reclassification of unrealized loss on foreign exchange agreements into revenue | —                                  | —                               | (1 )                      | (1 )      |
| Balance at September 30, 2015                                                                         | \$ (5 )                            | \$ (222 )                       | \$ (2 )                   | \$ (229 ) |

#### Note 17. Commitments and Contingencies

##### General

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

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

In connection with the KFTC matter, the Company commenced an internal investigation relating to the allegations against Xylem South Korea. In late 2014, the Company broadened this internal investigation to assess related allegations made by certain employees of Xylem South Korea during the investigation into the KFTC matter. The broadened investigation includes a review of compliance by Xylem South Korea and its employees with the requirements of the Foreign Corrupt Practices Act. The Company engaged independent outside counsel to assist with its investigation and an independent professional

services firm to provide forensic accounting assistance. In late January 2015, the Company voluntarily contacted the SEC and the Department of Justice ("DOJ") to advise both agencies of this internal investigation. The Company is fully cooperating with any government investigation and has been informed recently by the SEC that it will not bring an enforcement action against the Company in connection with the events at Xylem South Korea. Xylem South Korea's revenue is less than one percent of the Company's total revenue. Although the Company currently cannot reasonably estimate the potential liability, if any, related to the investigation, we currently believe that these matters will not have a material adverse effect on the Company's business, financial condition or results of operations.

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

Although the ultimate outcome of any legal matter cannot be predicted with certainty, based on present information, including our assessment of the merits of the particular claims, we do not expect that any asserted or unasserted legal claims or proceedings, individually or in aggregate, will have a material adverse effect on our results of operations or financial condition. We have estimated and accrued \$6 million and \$9 million for these general legal matters as of September 30, 2015 and December 31, 2014, respectively.

#### Indemnifications

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

## Environmental

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

Accruals for environmental matters are recorded on a site-by-site basis when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated, based on current law and existing technologies. Our accrued liabilities for these environmental matters represent the best estimates related to the investigation and remediation of environmental media such as water, soil, soil vapor, air and structures, as well as related legal fees. These estimates, and related accruals, are reviewed quarterly and updated for progress of investigation and remediation efforts and changes in facts and legal circumstances. Liabilities for these environmental expenditures are recorded on an undiscounted basis. We have estimated and accrued \$5 million as of both September 30, 2015 and December 31, 2014 for environmental matters.

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

## Warranties

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

| (in millions)                                    | 2015 | 2014  |
|--------------------------------------------------|------|-------|
| Warranty accrual – January 1                     | \$31 | \$37  |
| Net changes for product warranties in the period | 21   | 19    |
| Settlement of warranty claims                    | (21  | ) (23 |
| Foreign currency and other                       | —    | (1    |
| Warranty accrual - September 30                  | \$31 | \$32  |

## Note 18. Segment Information

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

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

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

| (in millions)                  | Three Months Ended<br>September 30, |       | Nine Months Ended<br>September 30, |         |
|--------------------------------|-------------------------------------|-------|------------------------------------|---------|
|                                | 2015                                | 2014  | 2015                               | 2014    |
| Revenue:                       |                                     |       |                                    |         |
| Water Infrastructure           | \$551                               | \$602 | \$1,602                            | \$1,770 |
| Applied Water                  | 351                                 | 361   | 1,057                              | 1,104   |
| Total                          | \$902                               | \$963 | \$2,659                            | \$2,874 |
| Operating Income:              |                                     |       |                                    |         |
| Water Infrastructure           | \$83                                | \$95  | \$195                              | \$217   |
| Applied Water                  | 46                                  | 51    | 143                                | 145     |
| Corporate and other            | (9)                                 | (16)  | (31)                               | (40)    |
| Total                          | \$120                               | \$130 | \$307                              | \$322   |
| Depreciation and Amortization: |                                     |       |                                    |         |
| Water Infrastructure           | \$22                                | \$24  | \$70                               | \$74    |
| Applied Water                  | 7                                   | 7     | 19                                 | 19      |
| Regional selling locations (a) | 3                                   | 3     | 8                                  | 9       |
| Corporate and other            | 1                                   | 1     | 5                                  | 5       |
| Total                          | \$33                                | \$35  | \$102                              | \$107   |
| Capital Expenditures:          |                                     |       |                                    |         |
| Water Infrastructure           | \$12                                | \$18  | \$49                               | \$45    |
| Applied Water                  | 5                                   | 9     | 15                                 | 19      |
| Regional selling locations (b) | 3                                   | 2     | 9                                  | 6       |
| Corporate and other            | 1                                   | —     | 5                                  | 7       |
| Total                          | \$21                                | \$29  | \$78                               | \$77    |

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

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

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

| (in millions)                 | Total Assets          |                      |
|-------------------------------|-----------------------|----------------------|
|                               | September 30,<br>2015 | December 31,<br>2014 |
| Water Infrastructure          | \$2,044               | \$2,128              |
| Applied Water                 | 1,101                 | 1,114                |
| Regional selling location (a) | 908                   | 961                  |
| Corporate and other (b)       | 592                   | 657                  |
| Total                         | \$4,645               | \$4,860              |

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

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

#### Note 19. Subsequent Events

On October 22, 2015, we acquired substantially all of the assets of Hypack, Inc., a leading provider of hydrographic software worldwide, for approximately \$18 million. Hypack, a privately-owned company headquartered in Middletown, Connecticut, has approximately 30 employees and annual revenue of approximately \$8 million.

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

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

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

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

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

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

## Overview

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



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

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

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

#### Executive Summary

Xylem reported revenue for the third quarter of 2015 of \$902 million, a decrease of 6.3% compared to \$963 million during the third quarter of 2014. Revenue increased 2.1% on a constant currency basis due to organic growth primarily driven by strength in the public utility and industrial end markets combined with strength in residential and commercial building applications. Operating income for the third quarter of 2015 was \$120 million, a decrease of 7.7% compared to \$130 million in the third quarter of 2014, primarily due to cost inflation, foreign exchange impacts and unfavorable mix. Partially offsetting these headwinds were incremental cost savings from continuous improvement initiatives.

Additional financial highlights for the quarter ended September 30, 2015 include the following:

- Orders of \$939 million, or 8.6% decline from \$1,027 million in the prior year, though flat on an organic basis
- Earnings per share of \$0.48, down 17.2% from the prior year (\$0.49 on an adjusted basis, down 7.5%, though up 3.8% excluding \$0.06 negative impact from currency translation)
- Cash flow from operating activities of \$260 million for the nine months ended September 30, 2015, up 2.8% from prior year, and free cash flow of \$182 million as compared to \$176 million in the prior year

#### Key Performance Indicators and Non-GAAP Measures

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

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

"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, special charges, tax-related special items and gain from sale of businesses. A reconciliation of adjusted net income is provided below.

| (In millions, except for per share data)    | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|---------------------------------------------|-------------------------------------|--------|------------------------------------|--------|
|                                             | 2015                                | 2014   | 2015                               | 2014   |
| Net income                                  | \$88                                | \$106  | \$226                              | \$241  |
| Restructuring and realignment, net of tax   | 3                                   | 3      | 12                                 | 23     |
| Special charges, net of tax                 | 2                                   | —      | 5                                  | —      |
| Tax-related special items                   | (3                                  | ) (1   | ) (6                               | ) (5   |
| Gain from sale of businesses, net of tax    | —                                   | (11    | ) (9                               | ) (11  |
| Adjusted net income                         | \$90                                | \$97   | \$228                              | \$248  |
| Weighted average number of shares - Diluted | 181.6                               | 183.4  | 182.3                              | 184.6  |
| Adjusted earnings per share                 | \$0.49                              | \$0.53 | \$1.25                             | \$1.35 |

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

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

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

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

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

| (In millions)                             | Nine Months Ended<br>September 30, |       |
|-------------------------------------------|------------------------------------|-------|
|                                           | 2015                               | 2014  |
| Net cash provided by operating activities | \$260                              | \$253 |
| Capital expenditures                      | (78)                               | (77)  |
| Free cash flow                            | \$182                              | \$176 |

## 2015 Outlook

We continue to anticipate organic revenue growth in the low-single digits in 2015. This projected organic growth excludes a continued expected negative foreign exchange translation impact on our growth in the high-single digits, primarily driven by a weaker Euro. The following is a summary of our outlook by market.

Industrial markets were flat through the third quarter as general industrial market strength has been offset by oil and gas declines in Canada and the United States. We expect these trends to continue in the fourth quarter resulting in flat performance for the year.

Through the third quarter, we have seen public utilities increase 3%. We expect our fourth quarter performance to be better than this performance as U.S. growth continues driven by the ongoing market recovery and emerging market infrastructure investments continuing to bolster growth. For the year we expect to be up low-to-mid-single digits.

In the commercial markets, we have seen growth of 5% through September driven by strong U.S. and emerging market performance partially offset by weakness in Europe. In the fourth quarter we expect that a positive U.S. market outlook and traction from new product sales in Europe will provide low-to-mid-single digit growth versus a strong fourth quarter in the prior year when we grew 8%. For the year we expect to be up mid-single digits.

In the residential markets, we have grown 2% through the third quarter with balanced growth globally. In the fourth quarter we expect low-to-mid single digit growth driven by new product sales in Europe and continued strength in emerging markets. We expect residential to be up in the low-single digits for the year.

We have seen our agriculture markets, which is our smallest end market, decline 6% through three quarters. We expect fourth quarter to be down mid-to-high single digits as a tough U.S. comparison versus prior year and unfavorable weather impacts will only be partially offset by expected revenue resulting from the drought conditions in California. This would result in the full year to be down mid-to-high single digits.



We will continue to execute restructuring and realignment actions to reposition our European and North American business which we expect to optimize our cost structure and improve our operational efficiency and effectiveness. In 2015, we expect to incur approximately \$20 million in restructuring and realignment costs. We expect to realize approximately \$13 million of incremental net savings in 2015 from restructuring actions initiated in 2014, and an additional \$2 million of net savings from our 2015 actions. Additional strategic actions include strategic initiatives which are expected to drive above-market growth, advance continuous improvement activities to increase productivity, focus on improving cash performance and drive a disciplined capital deployment strategy.

## Results of Operations

| (In millions)                                                                        | Three Months Ended<br>September 30, |        |          | Nine Months Ended<br>September 30, |         |          |
|--------------------------------------------------------------------------------------|-------------------------------------|--------|----------|------------------------------------|---------|----------|
|                                                                                      | 2015                                | 2014   | Change   | 2015                               | 2014    | Change   |
| Revenue                                                                              | \$902                               | \$963  | (6.3 )%  | \$2,659                            | \$2,874 | (7.5 )%  |
| Gross profit                                                                         | 351                                 | 376    | (6.6 )%  | 1,014                              | 1,106   | (8.3 )%  |
| Gross margin                                                                         | 38.9 %                              | 39.0 % | (10 )bp  | 38.1 %                             | 38.5 %  | (40 )bp  |
| Operating expenses excluding restructuring and realignment costs and special charges | 227                                 | 242    | (6.2 )%  | 690                                | 753     | (8.4 )%  |
| Expense to revenue ratio                                                             | 25.2 %                              | 25.1 % | 10 bp    | 25.9 %                             | 26.2 %  | (30 )bp  |
| Restructuring and realignment costs                                                  | 4                                   | 4      | — %      | 16                                 | 31      | (48.4 )% |
| Special charges                                                                      | —                                   | —      | NM       | 1                                  | —       | NM       |
| Total operating expenses                                                             | 231                                 | 246    | (6.1 )%  | 707                                | 784     | (9.8 )%  |
| Operating income                                                                     | 120                                 | 130    | (7.7 )%  | 307                                | 322     | (4.7 )%  |
| Operating margin                                                                     | 13.3 %                              | 13.5 % | (20 )bp  | 11.5 %                             | 11.2 %  | 30 bp    |
| Interest and other non-operating expense, net                                        | 13                                  | 13     | — %      | 41                                 | 40      | 2.5 %    |
| Gain on sale of businesses                                                           | —                                   | 11     | NM       | 9                                  | 11      | (18.2 )% |
| Income tax expense                                                                   | 19                                  | 22     | (13.6 )% | 49                                 | 52      | (5.8 )%  |
| Tax rate                                                                             | 17.4 %                              | 17.5 % | (10 )bp  | 17.6 %                             | 17.7 %  | (10 )bp  |
| Net income                                                                           | \$88                                | \$106  | (17.0 )% | \$226                              | \$241   | (6.2 )%  |

NM - Not meaningful percentage change

## Revenue

Revenue generated during the three and nine months ended September 30, 2015 was \$902 million and \$2,659 million, respectively, reflecting decreases of \$61 million or 6.3% and \$215 million or 7.5%, respectively, compared to the same prior year periods. On a constant currency basis, revenue increased 2.1% and 1.0% for the three and nine months ended September 30, 2015. These increases reflect organic growth within emerging markets, Spain, Italy and, to a lesser extent, Australia, partially offset by declines in Canada and the United States. The divestiture of the Wolverhampton valves business early in the third quarter of 2014 also contributed to the revenue decline for the nine month period.

The following table illustrates the impact from organic growth, recent divestitures, and foreign currency translation in relation to revenue during the three and nine months ended September 30, 2015:

| (In millions)                    | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |    |
|----------------------------------|-------------------------------------|----------|------------------------------------|----------|----|
|                                  | Change                              | % Change | Change                             | % Change |    |
| 2014 Revenue                     | \$963                               |          | \$2,874                            |          |    |
| Organic growth                   | 20                                  | 2.1      | % 39                               | 1.4      | %  |
| Divestitures                     | —                                   | —        | % (11                              | ) (0.4   | )% |
| Constant currency                | 20                                  | 2.1      | % 28                               | 1.0      | %  |
| Foreign currency translation (a) | (81                                 | ) (8.4   | )% (243                            | ) (8.5   | )% |
| Total change in revenue          | (61                                 | ) (6.3   | )% (215                            | ) (7.5   | )% |
| 2015 Revenue                     | \$902                               |          | \$2,659                            |          |    |

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

The following table summarizes revenue by segment:

| (In millions)        | Three Months Ended<br>September 30, |       |                       |                                | Nine Months Ended<br>September 30, |         |                          |                                |   |
|----------------------|-------------------------------------|-------|-----------------------|--------------------------------|------------------------------------|---------|--------------------------|--------------------------------|---|
|                      | 2015                                | 2014  | As Reported<br>Change | Constant<br>Currency<br>Change | 2015                               | 2014    | As<br>Reported<br>Change | Constant<br>Currency<br>Change |   |
| Water Infrastructure | \$551                               | \$602 | (8.5                  | )% 1.7                         | % \$1,602                          | \$1,770 | (9.5                     | )% 0.7                         | % |
| Applied Water        | 351                                 | 361   | (2.8                  | )% 2.8                         | % 1,057                            | 1,104   | (4.3                     | )% 1.4                         | % |
| Total                | \$902                               | \$963 | (6.3                  | )% 2.1                         | % \$2,659                          | \$2,874 | (7.5                     | )% 1.0                         | % |

#### Water Infrastructure

Water Infrastructure revenue decreased \$51 million, or 8.5% for the third quarter of 2015 (1.7% increase at constant currency) and decreased \$168 million, or 9.5%, for the nine months ended September 30, 2015 (0.7% increase at constant currency) compared to the respective 2014 periods. The change at constant currency was driven entirely by organic growth of \$10 million or 1.7% in the third quarter and \$12 million or 0.7% for the nine months ended September 30, 2015, due to continued strength in the public utility end market offset by weakness in the industrial market. The industrial market performance decline was due to continued decreases in dewatering applications in the oil and gas market which more than offset increases in the balance of the industrial market.

From an application perspective for the third quarter of 2015, organic revenue grew in treatment and test applications and was essentially flat in transport applications. Revenue from treatment applications increased primarily from ozone and filtration project deliveries in Australia, China and Spain, partly offset by weakness in Latin America and the lapping of a large project in the Middle East in the prior year. Revenue from test applications was driven by strength in emerging markets, particularly in Brazil, China and India. Organic revenue performance from transport applications was driven by public utility strength in the emerging markets as well as southern Europe, nearly fully offset by declines in industrial dewatering applications from weakness in the oil and gas market in Canada and the United States.

For the nine months ended September 30, 2015, there was solid organic revenue growth from treatment and transport applications, while test applications were essentially flat. The organic revenue growth from treatment applications was due to ozone and filtration projects in China and Australia which was slightly



offset by weakness in Europe and the lapping of a large project in the Middle East in the prior year. The modest organic revenue growth from transport applications was predominately due to similar dynamics impacting the third quarter, in addition to growth in western Europe for the nine month period. Organic revenue from test applications was driven by weakness in Europe, which was largely offset by growth in China and India due to demand for new river monitoring products.

#### Applied Water

Applied Water revenue declined \$10 million or 2.8% during the third quarter of 2015 (2.8% increase at constant currency) and decreased \$47 million, or 4.3%, for the nine months ended September 30, 2015 (1.4% increase at constant currency) compared to the respective 2014 periods. The increase at constant currency during both periods was driven by organic growth of \$10 million or 2.8% for the quarter and \$27 million or 2.4% for the nine months ended September 30, 2015. This was due to growth in the industrial water, residential and commercial end markets, which was partially offset by declines in the agriculture end markets. The nine month period was also negatively impacted by the absence of \$11 million in revenue from the divested Wolverhampton valves business.

From an applications perspective for the third quarter of 2015, organic revenue growth from the industrial water and building services applications was slightly offset by declines in irrigation. Growth in industrial water application revenue was primarily in Europe, Canada and the United States due to increased shipments of fire protection systems and reverse osmosis packages. Residential building growth was due to strong distribution stocking and related recovery in the institutional building sector primarily in the United States. The weakness in irrigation was driven by unfavorable weather impacts in the United States.

From an applications perspective for the nine months ended September 30, 2015, the increase in organic revenue was largely due to strong growth in commercial building services from a recovering institutional building sector in the United States and strength in Asia, partially offset by declines in irrigation. The industrial water application was flat due to strength in Europe which was essentially offset by the aforementioned Wolverhampton divestiture. Irrigation applications were largely impacted by flooding in the southeast and southwest regions of the United States.

#### Orders / Backlog

Orders received during the third quarter of 2015 of \$939 million decreased \$88 million, or 8.6% over the third quarter of the prior year (flat at constant currency). Orders received during the nine months ended September 30, 2015 of \$2,798 million decreased by \$253 million, or 8.3%, from the comparable prior year period (0.1% increase at constant currency). Organic order growth was flat and increased 0.5% for the three and nine months ended September 30, 2015, respectively.

Water Infrastructure segment orders decreased \$74 million, or 11.1%, to \$590 million (0.9% decrease at constant currency) for the third quarter of 2015 as compared to the same prior year period. Organic orders decreased 0.9% during the third quarter of 2015, predominately due to decreases in the dewatering transport application due to weakness in the oil and gas market, partially offset by a large custom pump project in India. Treatment and test applications also experienced declines in orders driven by North American and Latin America. For the nine months ended September 30, 2015 orders decreased \$178 million, or 9.3%, to \$1,737 million (0.7% increase at constant currency) from the comparable prior year period. This increase reflected organic orders increases of 0.7% due to similar dynamics impacting the order activity in the third quarter for transport applications. Organic orders for treatment applications experienced increases in North America and western Europe, which were partially offset by declines in Latin America. The organic orders for test applications were essentially flat.

Applied Water segment orders decreased \$14 million, or 3.9% to \$349 million (1.7% increase at constant currency) and decreased \$75 million or 6.6% to \$1,061 million (0.9% decrease at constant currency) for the three and nine months ended September 30, 2015, respectively, as compared to the same prior year

periods. Organic order volume increased 1.7% during the third quarter of 2015 as a result of similar market dynamics impacting revenue in addition to market recovery and new product introductions in Europe. The order decline at constant currency for the nine months ended September 30, 2015 was due flat organic orders as a result of similar dynamics impacting revenue, as well as the absence of orders from our Wolverhampton valves divestiture.

Delivery schedules vary from customer to customer based upon their requirements. Typically, large projects require longer lead production cycles and delays can occur from time to time. Total backlog was \$812 million at September 30, 2015, a decrease of \$32 million or 3.8% as compared to September 30, 2014 and an increase of \$72 million or 9.7%, as compared to December 31, 2014. We anticipate that 56% of the backlog at September 30, 2015 will be recognized as revenue in the remainder of 2015.

#### Gross Margin

Gross margin decreased to 38.9% and 38.1% for the three and nine months ended September 30, 2015, compared to 39.0% and 38.5%, respectively, for 2014. The gross margin decline in both periods was primarily due to negative currency translation impacts. Excluding the negative currency translation impacts, gross margin was slightly better as compared to 2014. Cost inflation headwinds and unfavorable sales mix, primarily due to higher volume sold to the emerging markets, were more than offset by benefits realized from cost saving initiatives through global sourcing and lean six sigma.

#### Operating Expenses

The following table presents operating expenses for the three and nine months ended September 30, 2015 and 2014:

| (In millions)                                         | Three Months Ended<br>September 30, |        |          | Nine Months Ended<br>September 30, |        |           |
|-------------------------------------------------------|-------------------------------------|--------|----------|------------------------------------|--------|-----------|
|                                                       | 2015                                | 2014   | Change   | 2015                               | 2014   | Change    |
| Selling, general and administrative expenses ("SG&A") | \$207                               | \$222  | (6.8 ) % | \$631                              | \$688  | (8.3 ) %  |
| SG&A as a % of revenue                                | 22.9 %                              | 23.1 % | (20 ) bp | 23.7 %                             | 23.9 % | (20 ) bp  |
| Research and development expenses ("R&D")             | 23                                  | 24     | (4.2 ) % | 71                                 | 78     | (9.0 ) %  |
| R&D as a % of revenue                                 | 2.5 %                               | 2.5 %  | — bp     | 2.7 %                              | 2.7 %  | — bp      |
| Restructuring charges                                 | 1                                   | —      | — %      | 5                                  | 18     | (72.2 ) % |
| Operating expenses                                    | \$231                               | \$246  | (6.1 ) % | \$707                              | \$784  | (9.8 ) %  |
| Expense to revenue ratio                              | 25.6 %                              | 25.5 % | 10 bp    | 26.6 %                             | 27.3 % | (70 ) bp  |

#### Selling, General and Administrative Expenses

SG&A decreased by \$15 million to \$207 million or 22.9% of revenue in the third quarter of 2015, as compared to \$222 million or 23.1% of revenue in the comparable period of 2014; and decreased \$57 million to \$631 million or 23.7% of revenue in the nine months ended September 30, 2015, as compared to \$688 million or 23.9% of revenue in the comparable period of 2014. The decrease in SG&A expenses as a percentage of revenue in both periods was primarily due to currency translation impacts. Additionally, cost inflation was offset by cost savings from continuous improvement initiatives and restructuring actions.

## Research and Development Expenses

R&D spending was \$23 million or 2.5% of revenue in the third quarter of 2015 as compared to \$24 million or 2.5% of revenue in the comparable period of 2014. R&D spending was \$71 million or 2.7% of revenue for the nine months ended September 30, 2015 as compared to \$78 million or 2.7% of revenue in the comparable period of 2014.

## Restructuring Charges

During the three and nine months ended September 30, 2015, we recognized restructuring charges of \$1 million and \$5 million, respectively. We incurred these charges related to actions taken in 2015 primarily in an effort to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. The charges relate to the reduction in structural costs, including a decrease in headcount and consolidation of facilities within our Water Infrastructure segment. No additional costs related to actions commenced in prior years were included in the charges recorded during the three months ended September 30, 2015. During the nine months ended September 30, 2015, charges of \$1 million related to actions that commenced in prior years.

During the three and nine months ended September 30 2014, we recognized restructuring charges of less than \$1 million and \$18 million, respectively. These charges related to the reduction in structural costs, including the elimination of headcount and consolidation of facilities within both our Water Infrastructure and Applied Water segments.

Total expected costs associated with actions that commenced during the nine months ended September 30, 2015 are approximately \$6 million for Water Infrastructure. These costs primarily consist of severance charges. We currently expect activity related to these actions to continue through the second quarter of 2016. As a result of actions initiated during the nine months ended September 30, 2015, we estimate net savings of approximately \$2 million in 2015 and annual future net savings beginning in 2016 of approximately \$5 million.

We expect to incur approximately \$8 million in restructuring costs for the full year, which contemplates additional actions beyond those discussed above. As a result of all of the actions taken and expected to be taken in 2015, we anticipate approximately \$2 million of total net savings to be realized during 2015.

# Operating Income

We generated operating income of \$120 million during the third quarter of 2015, a \$10 million decrease compared to \$130 million in the third quarter of 2014, and \$307 million during the nine months ended September 30, 2015, a \$15 million decrease compared to \$322 million for the comparable prior year period. The decline in both periods was due to cost inflation, unfavorable foreign exchange translation impacts and unfavorable mix. Partially offsetting these headwinds were incremental cost savings from continuous improvement initiatives and restructuring actions.

The following table illustrates operating income results for our business segments:

| (In millions)            | Three Months Ended |        |            | Nine Months Ended |        |           |
|--------------------------|--------------------|--------|------------|-------------------|--------|-----------|
|                          | September 30,      |        |            | September 30,     |        |           |
|                          | 2015               | 2014   | Change     | 2015              | 2014   | Change    |
| Water Infrastructure     | \$83               | \$95   | (12.6 )%   | \$195             | \$217  | (10.1 )%  |
| Applied Water            | 46                 | 51     | (9.8 )%    | 143               | 145    | (1.4 )%   |
| Segment operating income | 129                | 146    | (11.6 )%   | 338               | 362    | (6.6 )%   |
| Corporate and other      | (9 )               | (16 )  | (43.8 )%   | (31 )             | (40 )  | (22.5 )%  |
| Total operating income   | \$120              | \$130  | (7.7 )%    | \$307             | \$322  | (4.7 )%   |
| Operating margin         |                    |        |            |                   |        |           |
| Water Infrastructure     | 15.1               | % 15.8 | % (70 )bp  | 12.2              | % 12.3 | % (10 )bp |
| Applied Water            | 13.1               | % 14.1 | % (100 )bp | 13.5              | % 13.1 | % 40 bp   |
| Total Xylem              | 13.3               | % 13.5 | % (20 )bp  | 11.5              | % 11.2 | % 30 bp   |

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<br>September 30, |        |        |     | Nine Months Ended<br>September 30, |        |        |     |
|---------------------------------------|-------------------------------------|--------|--------|-----|------------------------------------|--------|--------|-----|
| (In millions)                         | 2015                                | 2014   | Change |     | 2015                               | 2014   | Change |     |
| Water Infrastructure                  |                                     |        |        |     |                                    |        |        |     |
| Operating income                      | \$83                                | \$95   | (12.6  | )%  | \$195                              | \$217  | (10.1  | )%  |
| Restructuring and realignment costs 2 |                                     | 3      | (33.3  | )%  | 11                                 | 20     | (45.0  | )%  |
| Special charges                       | —                                   | —      | NM     |     | 1                                  | —      | NM     |     |
| Adjusted operating income             | \$85                                | \$98   | (13.3  | )%  | \$207                              | \$237  | (12.7  | )%  |
| Adjusted operating margin             | 15.4                                | % 16.3 | % (90  | )bp | 12.9                               | % 13.4 | % (50  | )bp |
| Applied Water                         |                                     |        |        |     |                                    |        |        |     |
| Operating income                      | \$46                                | \$51   | (9.8   | )%  | \$143                              | \$145  | (1.4   | )%  |
| Restructuring and realignment costs 2 |                                     | 1      | 100.0  | %   | 5                                  | 11     | (54.5  | )%  |
| Adjusted operating income             | \$48                                | \$52   | (7.7   | )%  | \$148                              | \$156  | (5.1   | )%  |
| Adjusted operating margin             | 13.7                                | % 14.4 | % (70  | )bp | 14.0                               | % 14.1 | % (10  | )bp |
| Total Xylem                           |                                     |        |        |     |                                    |        |        |     |
| Operating income                      | \$120                               | \$130  | (7.7   | )%  | \$307                              | \$322  | (4.7   | )%  |
| Restructuring and realignment costs 4 |                                     | 4      | —      | %   | 16                                 | 31     | (48.4  | )%  |
| Special charges                       | —                                   | —      | NM     |     | 1                                  | —      | NM     |     |
| Adjusted operating income             | \$124                               | \$134  | (7.5   | )%  | \$324                              | \$353  | (8.2   | )%  |
| Adjusted operating margin             | 13.7                                | % 13.9 | % (20  | )bp | 12.2                               | % 12.3 | % (10  | )bp |

NM - Not meaningful percentage change

#### Water Infrastructure

Operating income for our Water Infrastructure segment decreased \$12 million, or 12.6%, (decreased \$13 million or 13.3% on an adjusted basis) for the third quarter of 2015 and decreased \$22 million, or 10.1%, (decreased \$30 million or 12.7% on an adjusted basis) for the nine months ended September 30, 2015 compared with the same respective periods for the prior year. On an adjusted basis, the reduction in operating income for both periods was due to cost inflation, which was partially offset by cost savings from procurement initiatives, lean six sigma initiatives and restructuring actions.

#### Applied Water

Operating income for our Applied Water segment decreased \$5 million, or 9.8%, (decreased \$4 million or 7.7% on an adjusted basis) for the third quarter of 2015 and decreased \$2 million, or 1.4%, (decreased \$8 million or 5.1% on an adjusted basis) for the nine months ended September 30, 2015 compared with the same respective periods for the prior year. On an adjusted basis, the reduction in operating income in both periods was due to cost inflation, foreign exchange translation and transaction headwinds and unfavorable mix, partially offset by cost reductions from procurement and lean six sigma initiatives.

**Interest Expense**

Interest expense was \$13 million and \$41 million for the respective three and nine months ended September 30, 2015, and \$14 million and \$41 million for the respective three and nine months ended September 30, 2014, primarily related to the interest on the \$1.2 billion long-term debt issued in September 2011. See "Liquidity and Capital Resources" for further details.

**Income Tax Expense**

The income tax provision for the three months ended September 30, 2015 was \$19 million resulting in an effective tax rate of 17.4%, compared to \$22 million resulting in an effective tax rate of 17.5% for the same period in 2014. The income tax provision for the nine months ended September 30, 2015 was \$49 million resulting in an effective tax rate of 17.6%, compared to \$52 million resulting in an effective tax rate of 17.7% for the same period in 2014. In both periods the variance in the effective tax rates resulted primarily from the geographic mix of earnings.

**Other Comprehensive Loss**

Other comprehensive loss was \$31 million for the three months ended September 30, 2015 compared to \$109 million in the prior year. For the nine months ended September 30, 2015 other comprehensive loss was \$130 million compared to \$118 million for the same period in 2014. The changes were driven primarily from foreign currency translation impacts. The lower translation loss in the third quarter of 2015 versus the prior year was due to less weakening of the Euro against the U.S. Dollar. The higher translation loss for the nine months ended September 30, 2015 as compared to the prior year was due to the weakening of several currencies against the U.S. Dollar, primarily the Swedish Krona, the Canadian Dollar and the Australian Dollar, which were largely offset by less weakening of the Euro during the same period. Additionally, there was a release of \$8 million of currency gains out of other comprehensive loss and into gain on sale of businesses.

**Liquidity and Capital Resources**

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

| (In millions)        | Nine Months Ended<br>September 30, |       | Change |
|----------------------|------------------------------------|-------|--------|
|                      | 2015                               | 2014  |        |
| Operating activities | \$260                              | \$253 | \$7    |
| Investing activities | (74)                               | (45)  | (29)   |
| Financing activities | (194)                              | (182) | (12)   |
| Foreign exchange (a) | (44)                               | (30)  | (14)   |
| Total                | \$(52)                             | \$(4) | \$(48) |

(a) The impact is primarily due to the weakness of the Euro against the U.S. Dollar.

## Sources and Uses of Liquidity

### Operating Activities

During the nine months ended September 30, 2015, net cash provided by operating activities increased by \$7 million as compared to the prior year. The year-over-year increase was primarily driven by a decrease in the use of working capital from reduced inventory levels in 2015, as well as lower income tax and restructuring payments as compared to the prior year. These increases were mostly offset by lower net income excluding non-cash charges and increased payments for foreign value-added taxes as compared to the prior year.

### Investing Activities

Cash used in investing activities was \$74 million for the nine months ended September 30, 2015 as compared to \$45 million in the comparable prior year period. This increase was primarily due to prior year's cash received of \$30 million for the sale of our Wolverhampton business.

### Financing Activities

Cash used in financing activities was \$194 million for the nine months ended September 30, 2015 as compared to \$182 million in the comparable prior year period, primarily driven by an increase of \$6 million, or a 10% per share increase in dividends paid to shareholders, as well as decreased proceeds from the exercise of stock options of \$3 million which was partially offset by a decrease in share repurchase activity of \$4 million.

### 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, and strategic investments. 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 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 in both the United States and outside of the United States over the next twelve months.

### Senior Notes

On September 20, 2011, we issued 3.550% Senior Notes of \$600 million aggregate principal amount due September 2016 and 4.875% Senior Notes of \$600 million aggregate principal amount due October 2021.

The Senior Notes include covenants which restrict our ability, subject to exceptions, to incur debt secured by liens and engage in sale and leaseback transactions, as well as provide for customary events of default (subject, in certain cases, to receipt of notice of default and/or customary grace and cure periods). We may redeem the Senior Notes, as applicable, in whole or in part, at any time at a redemption price



equal to the principal amount of the Senior Notes to be redeemed, plus a make-whole premium. If a change of control triggering event (as defined in the Senior Notes indenture) occurs, we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase. As of September 30, 2015, we were in compliance with all covenants.

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

As of September 30, 2015, we have classified \$600 million of our Senior Notes due 2016 as long-term based on our current ability and intent to refinance the outstanding borrowings on a long-term basis.

#### Credit Facility

Effective March 27, 2015, Xylem entered into a Five-Year Revolving 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 outstanding at any time and (ii) the issuance of letters of credit in a face amount not in excess of \$100 million outstanding at any time. The Credit Facility provides for increases of up to \$200 million for a possible maximum total of \$800 million in aggregate principal amount at our request and with the consent of the institutions providing such increased commitments.

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

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The Credit Facility also contains limitations on, among other things, incurring secured debt, granting liens, entering into sale and leaseback transactions, mergers, consolidations, liquidations, dissolutions and sales of assets. In addition, the Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default. As of September 30, 2015, we were in compliance with all covenants.

As of September 30, 2015, the Credit Facility was undrawn.

#### Research and Development Facility Agreement

On December 4, 2013, the Company amended and restated its Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank (the "EIB") to add an additional borrower under the facility. The facility provides an aggregate principal amount of up to €120 million (approximately \$134 million) to finance research projects and infrastructure development in the European Union. The Company's wholly owned subsidiaries in Luxembourg, Xylem Holdings S.á r.l. and Xylem International S.á r.l., are the borrowers under the R&D Facility Agreement. The obligations of the borrowers under the R&D Facility Agreement are guaranteed by the Company under an Amended and Restated Deed of Guarantee, dated as of December 4, 2013, in favor of the EIB. The funds are available to finance research and development projects during the period from 2013 through 2016 at the Company's R&D facilities in Sweden, Germany, Italy, the United Kingdom, Austria, Norway and Hungary.

Under the R&D Facility Agreement, the borrower can draw loans on or before December 14, 2015 with a maturity of no longer than 12 years. The R&D Facility Agreement provides for Fixed Rate loans and

Floating Rate loans. The interest rate per annum applicable to Fixed Rate loans is at a fixed percentage rate per annum specified by the EIB which includes the applicable margin. The interest rate per annum applicable to Floating Rate loans is at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Pounds Sterling or U.S. Dollars, plus an applicable spread specified by the EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans is determined by reference to the credit rating of the Company.

In accordance with the terms of the R&D Facility Agreement, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The R&D Facility Agreement also contains limitations on, among other things, incurring debt, granting liens, and entering into sale and leaseback transactions. In addition, the R&D Facility Agreement contains other terms and conditions, such as customary representations and warranties, additional covenants and customary events of default. As of September 30, 2015, we were in compliance with all covenants.

As of September 30, 2015, \$77 million was outstanding under the R&D Facility Agreement. Although the borrowing term for this arrangement is up to five years, we have classified it as short-term debt on our Condensed Consolidated Balance Sheet since we intend to repay this obligation in less than a year.

#### Non-U.S. Operations

We generated approximately 59% of our revenue from non-U.S. operations for the three and nine months ended September 30, 2015, respectively, and 61% and 62% for the three and nine months ended September 30, 2014, respectively. 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 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, which support our current designation of a portion of these funds as being indefinitely reinvested and reassess whether there is a demonstrated need to repatriate funds held internationally to support our U.S. operations. If, as a result of our review, it is determined that all or a portion of the funds may be needed for our operations in the United States, we may be required to accrue additional U.S. taxes. As of September 30, 2015, our foreign subsidiaries were holding \$593 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 2014 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 2014 Annual Report.

New Accounting Pronouncements

See Note 2, "Recently Issued Accounting Pronouncements," in the Notes 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 2014 Annual Report.

ITEM 4. CONTROLS AND PROCEDURES

Our management, with the Chief Executive Officer and Interim 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 Interim 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 17 "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 2014 Annual Report.

## 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 September 30, 2015:

| (IN MILLIONS,<br>EXCEPT PER SHARE<br>AMOUNTS)<br>PERIOD | TOTAL NUMBER<br>OF SHARES<br>PURCHASED | AVERAGE PRICE<br>PAID PER SHARE<br>(a) | TOTAL NUMBER<br>OF SHARES<br>PURCHASED AS<br>PART OF<br>PUBLICLY<br>ANNOUNCED<br>PLANS OR<br>PROGRAMS (b) | APPROXIMATE<br>DOLLAR VALUE<br>OF SHARES THAT<br>MAY YET BE<br>PURCHASED<br>UNDER THE<br>PLANS OR<br>PROGRAMS (b) |
|---------------------------------------------------------|----------------------------------------|----------------------------------------|-----------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------|
| 7/1/15 - 7/31/15                                        | —                                      | —                                      | —                                                                                                         | \$56                                                                                                              |
| 8/1/15 - 8/31/15                                        | 0.9                                    | 32.96                                  | 0.9                                                                                                       | \$524                                                                                                             |
| 9/1/15 - 9/30/15                                        | 1.4                                    | 32.15                                  | 1.4                                                                                                       | \$478                                                                                                             |

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

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

(b) maintains our focus on growth. For the three months ended September 30, 2015, we repurchased 0.9 million shares for \$30 million. There are up to \$470 million in shares that may still be purchased under this plan as of September 30, 2015.

On August 20, 2013, our Board of Directors authorized the repurchase of up to \$250 million in shares with no expiration date. The program's objective was to deploy our capital in a manner that benefited our shareholders and maintain our focus on growth. For the three months ended September 30, 2015, we repurchased 0.6 million and shares for \$20 million under this program. As of September 30, 2015, we have exhausted the authorized amount to repurchase shares under this plan.

On August 18, 2012, our Board of Directors authorized the repurchase of up to 2.0 million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem employee stock plans by acquiring shares in the open market from time to time. For the three months ended September 30, 2015 we repurchased 0.8 million shares for \$25 million under this program. There are up to 0.2 million of shares (approximately \$8 million in value) that may still be purchased under this plan as of September 30, 2015.

## 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 following the signature page hereto for a list of exhibits filed as part of this report and incorporated herein by reference.

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/ John P. Connolly

John P. Connolly  
Vice President, Controller and Chief Accounting Officer  
(Duly Authorized Officer)

October 29, 2015

XYLEM INC.  
EXHIBIT INDEX

| Exhibit Number | Description                                                                                                                                                     | Location                                                                                                                                                                                                                                                                                                                                                                                   |
|----------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| (3.1)          | Third Amended and Restated Articles of Incorporation of Xylem Inc.                                                                                              | Incorporated by reference to Exhibit 3.1 of Xylem Inc.'s Form 10-Q filed on July 29, 2014 (CIK No. 1524472, File No. 1-35229).                                                                                                                                                                                                                                                             |
| (3.2)          | Amended and Restated By-laws of Xylem Inc.                                                                                                                      | Incorporated by reference to Exhibit 3.2 of Xylem Inc.'s Form 10-Q filed on July 29, 2014 (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 6 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.

Edgar Filing: Xylem Inc. - Form 10-Q

| Exhibit<br>Number | Description                                                                                                                                                                                                                                                                                                                                                                                                                                                                | Location                                   |
|-------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------|
| (101.0)           | <p>The following materials from Xylem Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2015, 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</p> | Submitted electronically with this Report. |