

Xylem Inc.  
Form 10-Q  
October 29, 2013

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, 2013  
or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number: 1-35229

Xylem Inc.  
(Exact name of registrant as specified in its charter)

Indiana 45-2080495  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

1133 Westchester Avenue, Suite N200, White Plains, NY 10604  
(address of principal executive offices and 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 Website, 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. (Check one):

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 25, 2013, there were 184,488,238 outstanding shares of the registrant's common stock, par value \$0.01 per share.

Xylem Inc.

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## PART I

## ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## XYLEM INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED INCOME STATEMENTS (Unaudited)

(in millions, except per share data)

| For the periods ended September 30,          | Three Months |          | Nine Months |          |
|--|--------------|----------|-------------|----------|
|  | 2013         | 2012     | 2013        | 2012     |
| Revenue                                      | \$965        | \$931    | \$2,804     | \$2,822  |
| Cost of revenue                              | 581          | 557      | 1,715       | 1,702    |
| Gross profit                                 | 384          | 374      | 1,089       | 1,120    |
| Selling, general and administrative expenses | 256          | 231      | 744         | 682      |
| Research and development expenses            | 24           | 24       | 78          | 80       |
| Restructuring charges                        | 5            | 4        | 30          | 4        |
| Separation costs                             | 1            | 4        | 3           | 15       |
| Operating income                             | 98           | 111      | 234         | 339      |
| Interest expense                             | 14           | 14       | 41          | 41       |
| Other non-operating (expense) income, net    | (1           | ) 3      | (2          | ) 1      |
| Income before taxes                          | 83           | 100      | 191         | 299      |
| Income tax expense                           | 10           | 28       | 31          | 75       |
| Net income                                   | \$73         | \$72     | \$160       | \$224    |
| Earnings per share:                          |              |          |             |          |
| Basic  | \$0.39       | \$0.39   | \$0.86      | \$1.20   |
| Diluted                                      | \$0.39       | \$0.38   | \$0.86      | \$1.20   |
| Weighted average number of shares:           |              |          |             |          |
| Basic  | 185.2        | 185.9    | 185.5       | 185.7    |
| Diluted                                      | 186.0        | 186.3    | 186.2       | 186.2    |
| Dividends declared per share                 | \$0.1164     | \$0.1012 | \$0.3492    | \$0.3036 |

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 |       |
|---|--------------|-------|-------------|-------|
|   | 2013         | 2012  | 2013        | 2012  |
| Net income  | \$73         | \$72  | \$160       | \$224 |
| Other comprehensive income, before tax:                           |              |       |             |       |
| Foreign currency translation adjustment                           | 68           | 44    | 4           | 23    |
| Net change in cash flow hedges:                                   |              |       |             |       |
| Unrealized gains  | 2            | 2     | —           | 4     |
| Amount of loss (gain) reclassified into net income <sup>1</sup>   |              | —     | —           | (1)   |
| Net change in postretirement benefit plans:                       |              |       |             |       |
| Amortization of net actuarial loss                                | 5            | 2     | 14          | 7     |
| Settlement  | —            | —     | —           | 2     |
| Other comprehensive income, before tax                            | 76           | 48    | 18          | 35    |
| Income tax expense related to items of other comprehensive income | 2            | 1     | 4           | 4     |
| Other comprehensive loss, net of tax                              | 74           | 47    | 14          | 31    |
| Comprehensive income  | \$147        | \$119 | \$174       | \$255 |

See accompanying notes to condensed consolidated financial statements.

**XYLEM INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(in millions, except per share amounts)

|  | September 30,<br>2013<br>(Unaudited) | December 31,<br>2012 |
|--|--------------------------------------|----------------------|
| <b>ASSETS</b>  |                                      |                      |
| Current assets:  |                                      |                      |
| Cash and cash equivalents  | \$394                                | \$504                |
| Receivables, less allowances for discounts and doubtful accounts of \$30 and \$34 in 2013 and 2012, respectively | 845                                  | 776                  |
| Inventories, net   | 496                                  | 443                  |
| Prepaid and other current assets   | 120                                  | 110                  |
| Deferred income tax assets   | 44                                   | 41                   |
| Total current assets   | 1,899                                | 1,874                |
| Property, plant and equipment, net   | 478                                  | 487                  |
| Goodwill   | 1,704                                | 1,647                |
| Other intangible assets, net   | 497                                  | 484                  |
| Other non-current assets   | 206                                  | 187                  |
| Total assets   | \$4,784                              | \$4,679              |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                                      |                      |
| Current liabilities:   |                                      |                      |
| Accounts payable   | \$324                                | \$332                |
| Accrued and other current liabilities  | 475                                  | 443                  |
| Short-term borrowings and current maturities of long-term debt   | 3                                    | 6                    |
| Total current liabilities  | 802                                  | 781                  |
| Long-term debt   | 1,199                                | 1,199                |
| Accrued postretirement benefits  | 400                                  | 400                  |
| Deferred income tax liabilities  | 173                                  | 173                  |
| Other non-current accrued liabilities  | 52                                   | 52                   |
| Total liabilities  | 2,626                                | 2,605                |
| Commitments and contingencies (Note 18)  |                                      |                      |
| Stockholders' equity:  |                                      |                      |
| Common Stock – par value \$0.01 per share:   |                                      |                      |
| Authorized 750.0 shares, issued 186.8 shares and 186.2 shares in 2013 and 2012, respectively                     | 2                                    | 2                    |
| Capital in excess of par value   | 1,729                                | 1,706                |
| Retained earnings  | 359                                  | 264                  |
| Treasury stock – at cost 2.3 shares and 0.5 shares in 2013 and 2012, respectively                                | (61                                  | ) (13                |
| Accumulated other comprehensive income   | 129                                  | 115                  |
| Total stockholders' equity   | 2,158                                | 2,074                |
| Total liabilities and stockholders' equity   | \$4,784                              | \$4,679              |

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 September 30,   | 2013  | 2012  |   |
|---|-------|-------|---|
| Operating Activities  |       |       |   |
| Net income  | \$160 | \$224 |   |
| Adjustments to reconcile net income to net cash provided by operating activities: |       |       |   |
| Depreciation  | 72    | 68    |   |
| Amortization  | 38    | 35    |   |
| Share-based compensation  | 21    | 16    |   |
| Restructuring charges   | 30    | 4     |   |
| Other, net  | 11    | 1     |   |
| Payments for restructuring  | (24   | ) —   |   |
| Changes in assets and liabilities (net of acquisitions):                          |       |       |   |
| Changes in receivables  | (71   | ) (33 | ) |
| Changes in inventories  | (59   | ) (33 | ) |
| Changes in accounts payable   | 4     | (7    | ) |
| Other, net  | (19   | ) (45 | ) |
| Net Cash – Operating activities   | 163   | 230   |   |
| Investing Activities  |       |       |   |
| Capital expenditures  | (91   | ) (81 | ) |
| Acquisitions of businesses and assets, net of cash acquired                       | (81   | ) (12 | ) |
| Proceeds from the sale of property, plant and equipment                           | 7     | 4     |   |
| Net Cash – Investing activities   | (165  | ) (89 | ) |
| Financing Activities  |       |       |   |
| Issuance of short-term debt   | —     | 12    |   |
| Principal payments of debt and capital lease obligations                          | (2    | ) (6  | ) |
| Repurchase of common stock  | (44   | ) (4  | ) |
| Proceeds from exercise of employee stock options                                  | 2     | 22    |   |
| Dividends paid  | (65   | ) (56 | ) |
| Other, net  | —     | (9    | ) |
| Net Cash – Financing activities   | (109  | ) (41 | ) |
| Effect of exchange rate changes on cash   | 1     | 6     |   |
| Net change in cash and cash equivalents   | (110  | ) 106 |   |
| Cash and cash equivalents at beginning of year                                    | 504   | 318   |   |
| Cash and cash equivalents at end of period  | \$394 | \$424 |   |
| Supplemental disclosure of cash flow information:                                 |       |       |   |
| Cash paid during the period for:  |       |       |   |
| Interest  | \$37  | \$38  |   |
| Income taxes (net of refunds received)  | \$61  | \$76  |   |
| See accompanying notes to condensed consolidated financial statements.            |       |       |   |

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

Note 1. Background and Basis of Presentation

Background

Xylem Inc. ("Xylem" or the "Company") is a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. Xylem was incorporated in Indiana on May 4, 2011. Xylem operates in two 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, 2012 ("2012 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 2012 Annual Report. Certain prior year amounts have been reclassified to conform to the current year presentation.

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 July 2013, the Financial Accounting Standards Board ("FASB") issued guidance on the financial statement presentation of an unrecognized tax benefit. The guidance requires that an unrecognized tax benefit or a portion of an unrecognized tax benefit, be presented as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. If an applicable deferred tax asset is not available or a company does not expect to use the applicable deferred tax asset, the unrecognized tax benefit should be presented in an entity's financial statements as a liability and should not be combined with a deferred tax asset. This guidance is effective for fiscal years beginning after December 15, 2013. The adoption of this guidance is not expected to have a material impact on our financial condition or results of operations.

In March 2013, the FASB issued guidance on the release of a cumulative translation adjustment ("CTA") related to an entity's investment in a foreign entity into income. The guidance requires such CTA to be released when there has been a: (1) sale of a subsidiary or group of net assets within a foreign entity and the sale represents the substantially complete liquidation of the investment in the foreign entity, (2) loss of a controlling financial interest in an investment in a foreign entity or (3) step acquisition for a foreign entity. This guidance is effective for fiscal years beginning after December 15, 2013. The impact of the guidance on our financial condition and results of operations will depend on the occurrence and the significance of transactions that meet the criteria described above.

In February 2013, the FASB issued guidance related to the measurement and disclosure of obligations resulting from joint and several liability arrangements. The new guidance requires companies to measure obligations resulting from joint and several liability arrangements as the sum of (1) the amount the company agreed to pay on the basis of its arrangement among co-obligors and (2) any additional amount the company expects to pay on behalf of its co-obligors. Additionally, the new guidance requires the disclosure of a description of the joint and several arrangement and the total outstanding amount of the obligation for all joint parties. This guidance is effective for fiscal years beginning after December 15, 2013. The adoption of this guidance is not expected to have a material impact on our financial condition or results of operations.

### Recently Adopted Pronouncements

In February 2013, the FASB issued guidance regarding new disclosures for items reclassified out of accumulated other comprehensive income ("AOCI"). The guidance requires entities to present information about items reclassified out of AOCI by component. Additionally, entities are required to present either on the face of the statement where net income is presented or as a separate disclosure in the notes to the financial statements, significant amounts reclassified out of AOCI by the respective line items of net income. This guidance is effective for fiscal years beginning after December 15, 2012. The adoption of this guidance did not have a material impact on our financial statement presentation and disclosures.

In July 2012, the FASB provided companies with the option to make an initial qualitative evaluation, based on events and circumstances, to determine the likelihood of an impairment of an indefinite-lived intangible asset. The results of this qualitative assessment determine whether it is necessary to perform the currently required quantitative comparison of the indefinite-lived intangible asset's fair value to its carrying amount. If it is more likely than not that the fair value of the intangible asset is less than its carrying amount, a company would be required to perform the quantitative assessment. This guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012 with early adoption permitted. The adoption of the guidance did not have a material impact on our financial condition and results of operations.



### Note 3. Acquisitions

During the nine months ended September 30, 2013, we spent \$84 million (\$81 million, net of cash acquired) on acquisitions. As the acquisitions were not material, individually or in the aggregate, to results of operations, pro forma results of operations reflecting results prior to the acquisitions and certain other disclosure items have not been presented.

#### MultiTrode

On March 1, 2013 we acquired MultiTrode Pty Ltd ("MultiTrode"), a water and wastewater technology and services company based in Australia, for approximately \$26 million. MultiTrode offers advanced monitoring and control technologies to municipal and private water and waste water authorities as well as industrial clients. The company had approximately 60 employees and generated revenue of approximately \$13 million in fiscal 2012.

Our condensed consolidated financial statements include MultiTrode's results of operations prospectively from March 1, 2013.

#### PIMS

On February 5, 2013 we acquired PIMS Group ("PIMS"), a wastewater services company based in the United Kingdom, for approximately \$57 million, including a cash payment of \$55 million and the assumption of certain liabilities. PIMS is a supplier of wastewater installation and maintenance services for the private sector, municipal and industrial markets. The company had approximately 220 employees and generated revenue of approximately \$38 million for its fiscal year ended April 30, 2012.

Our condensed consolidated financial statements include PIMS' results of operations prospectively from February 5, 2013.

### Note 4. Restructuring Charges

During the three and nine months ended September 30, 2013, we recognized restructuring charges of \$5 million and \$30 million, respectively. We incurred these charges primarily in an effort to reorganize our structure in Europe and North America to address declines in sales volumes and optimize our cost structure. The charges relate to the reduction in structural costs, including the elimination of headcount and consolidation of facilities within both our Water Infrastructure and Applied Water segments. During the three and nine months ended September 30, 2012 we recognized restructuring charges of \$4 million in each period. These charges primarily related to restructuring related severance payments for manufacturing reduction in force initiatives within our Water Infrastructure segment.

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The following table presents the components of restructuring expense for the three and nine months ended September 30, 2013 and 2012.

| (in millions)                      | Three Months Ended    |      | Nine Months Ended     |      |
|------------------------------------|-----------------------|------|-----------------------|------|
|                                    | September 30,<br>2013 | 2012 | September 30,<br>2013 | 2012 |
| By component:                      |                       |      |                       |      |
| Severance and other charges        | \$4                   | \$4  | \$28                  | \$4  |
| Lease related charges              | 1                     | —    | 1                     | —    |
| Other restructuring charges        | —                     | —    | 1                     | —    |
| Reversal of restructuring accruals | —                     | —    | —                     | —    |
| Total restructuring charges        | \$5                   | \$4  | 30                    | 4    |
| By segment:                        |                       |      |                       |      |
| Water Infrastructure               | \$3                   | \$4  | \$24                  | \$4  |
| Applied Water                      | 2                     | —    | 6                     | —    |
| Corporate and other                | —                     | —    | —                     | —    |

The following table displays a rollforward of the restructuring accruals, presented on our Condensed Consolidated Balance Sheet within accrued and other current liabilities, for the nine months ended September 30, 2013 and 2012.

| (in millions)                         | 2013 | 2012 |   |
|---------------------------------------|------|------|---|
| Restructuring accruals - January 1    | \$9  | \$1  |   |
| Restructuring charges                 | 30   | 4    |   |
| Cash payments                         | (24  | ) —  |   |
| Other                                 | —    | (1   | ) |
| Restructuring accruals - September 30 | \$15 | \$4  |   |
| By segment:                           |      |      |   |
| Water Infrastructure                  | \$12 | \$4  |   |
| Applied Water                         | 3    | —    |   |
| Corporate and other                   | —    | —    |   |

The following is a rollforward of employee position eliminations associated with restructuring activities for the nine months ended September 30, 2013 and 2012.

|                                   | 2013 | 2012  |   |
|-----------------------------------|------|-------|---|
| Planned reductions - January 1    | 54   | —     |   |
| Additional planned reductions     | 439  | 39    |   |
| Actual reductions                 | (346 | ) (27 | ) |
| Planned reductions - September 30 | 147  | 12    |   |

Total expected costs associated with actions that commenced during the nine months ended September 30, 2013 are approximately \$26 million for Water Infrastructure and approximately \$11 million for Applied Water. These costs primarily comprise severance charges. We currently expect these actions to continue through 2014.

#### Note 5. Separation Costs

On October 31, 2011 ITT Corporation ("ITT") completed the spin-off of Xylem, formerly ITT's water equipment and service businesses, and Exelis Inc. ("Exelis"), formerly ITT's defense and service businesses (the "Spin-off"). The components of non-recurring separation costs incurred as a result of the Spin-off are presented below.

| (in millions)                                 | Three Months Ended |      | Nine Months Ended |      |
|---|--------------------|------|-------------------|------|
|   | September 30,      |      | September 30,     |      |
|   | 2013               | 2012 | 2013              | 2012 |
| Advisory fees and other                       | \$—                | \$1  | \$—               | \$6  |
| Rebranding and marketing costs                | —                  | 2    | —                 | 6    |
| Information and technology costs              | 1                  | —    | 2                 | 1    |
| Employee retention and hiring costs           | —                  | —    | —                 | 1    |
| Lease termination and other real estate costs | —                  | —    | 1                 | —    |
| Other   | —                  | 1    | —                 | 1    |
| Total separation costs in operating income    | 1                  | 4    | 3                 | 15   |
| Income tax benefit                            | (1                 | ) (1 | ) (1              | ) (4 |
| Total separation costs, net of tax            | \$—                | \$3  | \$2               | \$11 |

#### Note 6. Income Taxes

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

The income tax provision for the three months ended September 30, 2013 was \$10 million at an effective tax rate of 12.1%, compared to \$28 million at an effective tax rate of 27.8% for the same period in 2012. The income tax provision for the nine months ended September 30, 2013 was \$31 million at an effective tax rate of 16.4% compared to \$75 million at an effective tax rate of 25.2% for the same period in 2012. The decrease in the effective tax rate for the three and nine months ended September 30, 2013 as compared to the same periods in 2012 was primarily due to mix of earnings, including the impact of realignment efforts, as well as certain costs incurred for the change in chief executive officer made during the third quarter of 2013. Additionally, there was a tax benefit from special charges incurred by the Company associated with the settlement of legal proceedings with Xylem Group LLC.

#### 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, 2013 was \$8 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, 2013, we had \$1 million of interest accrued for unrecognized tax benefits.

#### Note 7. Earnings Per Share

The following is a summary of the calculation of basic and diluted net earnings per share.

|  | Three Months Ended |         | Nine Months Ended |         |
|--|--------------------|---------|-------------------|---------|
|  | September 30,      |         | September 30,     |         |
|  | 2013               | 2012    | 2013              | 2012    |
| Net income (in millions)                             | \$73               | \$72    | \$160             | \$224   |
| Shares (in thousands):                               |                    |         |                   |         |
| Weighted average common shares outstanding           | 185,044            | 185,650 | 185,294           | 185,386 |
| Add: Participating securities (a)                    | 122                | 281     | 165               | 340     |
| Weighted average common shares outstanding — Basic   | 185,166            | 185,931 | 185,459           | 185,726 |
| Plus incremental shares from assumed conversions:    |                    |         |                   |         |
| (b)  |                    |         |                   |         |
| Dilutive effect of stock options                     | 175                | 186     | 180               | 231     |
| Dilutive effect of restricted stock                  | 661                | 231     | 547               | 195     |
| Weighted average common shares outstanding — Diluted | 186,002            | 186,348 | 186,186           | 186,152 |
| Basic earnings per share                             | \$0.39             | \$0.39  | \$0.86            | \$1.20  |
| Diluted earnings per share                           | \$0.39             | \$0.38  | \$0.86            | \$1.20  |

- (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 15, "Stock-Based Compensation Plans" for further detail on the performance share units.

| (in thousands)     | Three Months Ended |       | Nine Months Ended |       |
|--------------------|--------------------|-------|-------------------|-------|
|                    | September 30,      |       | September 30,     |       |
|                    | 2013               | 2012  | 2013              | 2012  |
| Stock options      | 4,414              | 4,332 | 4,342             | 4,382 |
| Restricted stock   | 655                | 876   | 758               | 904   |
| Performance shares | 106                | —     | 88                | —     |

## Note 8. Inventories

| (in millions)          | September 30,<br>2013 | December 31,<br>2012 |
|------------------------|-----------------------|----------------------|
| Finished goods         | \$217                 | \$182                |
| Work in process        | 34                    | 30                   |
| Raw materials          | 245                   | 231                  |
| Total inventories, net | \$496                 | \$443                |

## Note 9. Property, Plant and Equipment

| (in millions)                              | September 30,<br>2013 | December 31,<br>2012 |
|--|-----------------------|----------------------|
| Land, buildings and improvements           | \$255                 | \$255                |
| Machinery and equipment                    | 673                   | 653                  |
| Equipment held for lease or rental         | 191                   | 183                  |
| Furniture and fixtures                     | 88                    | 90                   |
| Construction work in progress              | 52                    | 40                   |
| Other                                      | 21                    | 19                   |
| Total property, plant and equipment, gross | 1,280                 | 1,240                |
| Less accumulated depreciation              | 802                   | 753                  |
| Total property, plant and equipment, net   | \$478                 | \$487                |

Depreciation expense of \$23 million and \$72 million was recognized during the three and nine months ended September 30, 2013, respectively, and \$24 million and \$68 million for the three and nine months ended September 30, 2012, respectively.

## Note 10. Goodwill and Other Intangible Assets

Changes in the carrying value of goodwill by reportable segment for the nine months ended September 30, 2013 are as follows:

| (in millions)                    | Water<br>Infrastructure | Applied Water | Total   |
|----------------------------------|-------------------------|---------------|---------|
| Balance as of January 1, 2013    | \$1,085                 | \$562         | \$1,647 |
| Activity in 2013                 |                         |               |         |
| Goodwill acquired (a)            | 48                      | —             | 48      |
| Foreign currency and other       | 5                       | 4             | 9       |
| Balance as of September 30, 2013 | \$1,138                 | \$566         | \$1,704 |

(a) Attributable to the 2013 acquisitions. See Note 3, "Acquisitions" for a description of the acquisitions during 2013. Based on the results of our latest annual impairment tests, we determined that no impairment of goodwill existed as of the measurement date in 2012. 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, 2013 |                          |                 | December 31, 2012 |                          |                 |
|--|--------------------|--------------------------|-----------------|-------------------|--------------------------|-----------------|
|  | Carrying Amount    | Accumulated Amortization | Net Intangibles | Carrying Amount   | Accumulated Amortization | Net Intangibles |
| Customer and distributor relationships | \$350              | \$(96)                   | ) \$254         | \$317             | \$(75)                   | ) \$242         |
| Proprietary technology                 | 109                | (35)                     | ) 74            | 105               | (29)                     | ) 76            |
| Trademarks                             | 33                 | (15)                     | ) 18            | 33                | (14)                     | ) 19            |
| Patents and other                      | 20                 | (17)                     | ) 3             | 21                | (17)                     | ) 4             |
| Indefinite-lived intangibles           | 148                | —                        | ) 148           | 143               | —                        | ) 143           |
|  | \$660              | \$(163)                  | ) \$497         | \$619             | \$(135)                  | ) \$484         |

Based on the results of our latest annual impairment tests, we determined that no impairment of the indefinite-lived intangibles existed as of the measurement date in 2012. However, future impairment tests could result in a charge to earnings. We will continue to evaluate the indefinite-lived intangible assets 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.

Amortization expense related to finite-lived intangible assets of \$9 million and \$28 million was recognized in the three and nine months ended September 30, 2013, respectively, and \$8 million and \$25 million for the three and nine months ended September 30, 2012, respectively.

## Note 11. Derivative Financial Instruments

## Risk Management Objective of Using Derivatives

We are exposed to certain risks arising from both our business operations and economic conditions and principally manage our exposures to these risks through management of our core business activities. Certain of our foreign operations expose us to fluctuations of foreign interest rates and exchange rates that may impact 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.

Beginning in 2012, certain business units within our segments with exposure to foreign currency exchange risks have designated certain currency forward agreements as cash flow hedges of forecasted intercompany inventory purchases and sales. The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges of foreign exchange risk is recorded in other comprehensive income and is subsequently reclassified into either revenue or cost of revenue (hedge of sales classified into revenue and hedge of purchases classified into cost of revenue) in the period that the hedged forecasted transaction affects earnings. Any ineffective portion of the change in fair value of the derivative is recognized directly in selling, general and administrative expenses. Our policy is to de-

designate cash flow hedges at the time forecasted transactions are recognized as assets or liabilities on a business unit's balance sheet and report subsequent changes in fair value through selling, general and administrative expenses where the gain or loss due to movements in currency rates on the underlying asset or liability is recorded. If it becomes probable that the originally forecasted transaction will not occur, the gain or loss related to the hedge recorded within other comprehensive income is recognized into net income.

Listed in the table below are the outstanding foreign currency derivatives that were used to hedge foreign exchange risks as of September 30, 2013.

(in millions; except number of instruments)

| Foreign Currency Derivative | Number of Instruments | Total Notional Sold | Sell Notional Currency       | Total Notional Purchased | Buy Notional Currency |
|-----------------------------|-----------------------|---------------------|------------------------------|--------------------------|-----------------------|
| Sell AUD/ Buy EUR Forward   | 4                     | 6.0                 | Australian Dollar (AUD)      | 4.7                      | Euro (EUR)            |
| Sell CAD/ Buy EUR Forward   | 4                     | 4.6                 | Canadian Dollar (CAD)        | 3.5                      | Euro (EUR)            |
| Sell GBP/ Buy EUR Forward   | 2                     | 2.0                 | British Pound Sterling (GBP) | 2.3                      | Euro (EUR)            |
| Sell USD/ Buy EUR Forward   | 4                     | 15.8                | United States Dollar (USD)   | 12.2                     | Euro (EUR)            |
| Buy SEK/ Sell EUR Forward   | 2                     | 32.8                | Euro (EUR)                   | 280.0                    | Swedish Krona (SEK)   |

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, |      |   |
|--|-------------------------------------|------|------------------------------------|------|---|
|  | 2013                                | 2012 | 2013                               | 2012 |   |
| Derivatives in Cash Flow Hedges                                      |                                     |      |                                    |      |   |
| Foreign Exchange Contracts   |                                     |      |                                    |      |   |
| Amount of gain recognized in OCI (a)                                 | \$2                                 | \$2  | \$—                                | \$4  |   |
| Amount of (gain) reclassified from OCI into revenue (a)              | —                                   | —    | (1                                 | ) —  |   |
| Amount of loss (gain) reclassified from OCI into cost of revenue (a) | 1                                   | —    | 1                                  | (1   | ) |
| (a) Effective portion  |                                     |      |                                    |      |   |

As of September 30, 2013, \$1 million of the net unrealized gains 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, 2013 and 2012, 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>2013 | December 31,<br>2012 |
|---|-----------------------|----------------------|
| Derivatives designated as hedging instruments |                       |                      |
| Assets  |                       |                      |
| Other current assets                          | \$2                   | \$—                  |
| Liabilities                                   |                       |                      |
| Other current liabilities                     | (1                    | ) —                  |

#### Note 12. Accrued and Other Current Liabilities

| (in millions)                               | September 30,<br>2013 | December 31,<br>2012 |
|---|-----------------------|----------------------|
| Compensation and other employee-benefits    | \$204                 | \$201                |
| Customer-related liabilities                | 62                    | 60                   |
| Accrued warranty costs                      | 38                    | 40                   |
| Accrued taxes                               | 47                    | 50                   |
| Other accrued liabilities                   | 124                   | 92                   |
| Total accrued and other current liabilities | \$475                 | \$443                |

#### Note 13. Credit Facilities and Long-Term Debt

| (in millions)  | September 30,<br>2013 | December 31,<br>2012 |
|--|-----------------------|----------------------|
| Short-term borrowings and current maturities of long-term debt | \$3                   | \$6                  |
| Long-term debt   |                       |                      |
| 3.550% Senior Notes due 2016 (a)                               | \$600                 | \$600                |
| 4.875% Senior Notes due 2021 (a)                               | 600                   | 600                  |
| Unamortized discount (b)                                       | (1                    | ) (1                 |
| Long-term debt   | \$1,199               | \$1,199              |
| Total debt   | \$1,202               | \$1,205              |

The fair value of our Senior Notes (as defined below) was determined using quoted prices in active markets for identical securities, which are considered Level 1 inputs. The fair value of our Senior Notes due 2016 (as defined (a) below) was \$631 million and \$639 million as of September 30, 2013 and December 31, 2012, respectively. The fair value of our Senior Notes due 2021 (as defined below) was \$641 million and \$680 million as of September 30, 2013 and December 31, 2012, 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 lease-back 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), including but not limited to: (i) failure to pay interest for 30 days, (ii) failure to pay principal when due, (iii) failure to perform any other covenant for 90 days after receipt of notice from the trustee or from holders of 25% of the outstanding principal amount and (iv) certain events of bankruptcy, insolvency or reorganization. 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. As of September 30, 2013, we were in compliance with all covenants. 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.

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.

#### Four Year Competitive Advance and Revolving Credit Facility

Effective October 31, 2011, Xylem and its subsidiaries entered into a Four Year Competitive Advance and Revolving Credit Facility (the "Credit Facility") with JPMorgan Chase Bank, 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) a competitive advance borrowing option which will be provided on an uncommitted competitive advance basis through an auction mechanism (the "competitive loans"), (ii) revolving extensions of credit (the "revolving loans") outstanding at any time and (iii) the issuance of letters of credit in a face amount not in excess of \$100 million outstanding at any time. At our election, the interest rate per annum applicable to the competitive advances will be based on either (i) a Eurodollar rate determined by reference to LIBOR, plus an applicable margin offered by the lender making such loans and accepted by us or (ii) a fixed percentage rate per annum specified by the lender making such loans. 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 JPMorgan Chase Bank, 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 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. As of September 30, 2013, we were in compliance with all covenants. The Credit Facility also contains limitations on, among other things, incurring debt, granting liens, and entering sale and leaseback transactions. 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, 2013, the Credit Facility remains undrawn.

## Research and Development Facility Agreement

Effective December 14, 2012, we entered into a Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank ("EIB") in an aggregate principal amount of up to €120 million (approximately \$163 million) to finance research projects and research infrastructures in the European Union. The Company's wholly owned subsidiary in Luxembourg, Xylem Holdings S.a.r.l., is the borrower under the R&D Facility Agreement. The funds are made available to finance research and development projects during the period of 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, starting no later than 18 months from the date of the R&D Facility Agreement, draw loans 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 will be at a fixed percentage rate per annum specified by EIB which includes the applicable margin. The interest rate per annum applicable to Floating Rate loans will be at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Sterling or U.S. Dollars, plus an applicable spread specified by EIB, which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans shall be determined by reference to the credit rating of the Company.

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. As of September 30, 2013, we were in compliance with all covenants. The R&D Facility Agreement also contains limitations on, among other things, incurring debt, granting liens, and entering 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, 2013, the R&D Facility Agreement remains undrawn.

## Note 14. Postretirement Benefit Plans

The following table provides the components of net periodic benefit cost and other amounts recognized in other comprehensive income for defined benefit pension plans, disaggregated by domestic and international plans.

| (in millions)  | Three Months Ended<br>September 30, |        | Nine Months Ended<br>September 30, |        |
|--|-------------------------------------|--------|------------------------------------|--------|
|  | 2013                                | 2012   | 2013                               | 2012   |
| Domestic defined benefit pension plans:  |                                     |        |                                    |        |
| Net periodic benefit cost:   |                                     |        |                                    |        |
| Service cost   | \$1                                 | \$1    | \$2                                | \$2    |
| Interest cost  | 1                                   | 1      | 3                                  | 3      |
| Expected return on plan assets   | (1                                  | ) (1   | ) (3                               | ) (3   |
| Amortization of net actuarial loss   | 1                                   | —      | 3                                  | 1      |
| Net periodic benefit cost  | \$2                                 | \$1    | \$5                                | \$3    |
| Other changes in plan assets and benefit obligations recognized in other comprehensive income: |                                     |        |                                    |        |
| Amortization of net actuarial loss   | \$(1                                | ) \$—  | \$(3                               | ) \$(1 |
| Change recognized in other comprehensive income  | \$(1                                | ) \$—  | \$(3                               | ) \$(1 |
| International defined benefit pension plans:   |                                     |        |                                    |        |
| Net periodic benefit cost:   |                                     |        |                                    |        |
| Service cost   | \$3                                 | \$2    | \$10                               | \$7    |
| Interest cost  | 7                                   | 8      | 21                                 | 22     |
| Expected return on plan assets   | (7                                  | ) (7   | ) (23                              | ) (22  |
| Amortization of net actuarial loss   | 3                                   | 2      | 9                                  | 6      |
| Settlement   | —                                   | —      | —                                  | 2      |
| Net periodic benefit cost  | \$6                                 | \$5    | \$17                               | \$15   |
| Other changes in plan assets and benefit obligations recognized in other comprehensive income: |                                     |        |                                    |        |
| Amortization of net actuarial loss   | \$(3                                | ) \$(2 | ) \$(9                             | ) \$(6 |
| Settlement   | —                                   | —      | —                                  | (2     |
| Change recognized in other comprehensive income  | \$(3                                | ) \$(2 | ) \$(9                             | ) \$(8 |
| Totals:  |                                     |        |                                    |        |
| Net periodic benefit cost  | \$8                                 | \$6    | \$22                               | \$18   |
| Recognized in other comprehensive income   | (4                                  | ) (2   | ) (12                              | ) (9   |
| Total recognized in comprehensive income   | \$4                                 | \$4    | \$10                               | \$9    |

The total net periodic benefit cost for other postretirement employee benefit plans for the three and nine months ended September 30, 2013 was \$2 million and \$5 million, respectively, including amounts recognized in other comprehensive income of \$1 million and \$2 million, respectively. Total net periodic benefit cost for other postretirement benefit plans for the three and nine months ended September 30, 2012 was \$1 million and \$3 million, respectively. Amounts recognized in other comprehensive income were immaterial for the three and nine months ended September 30, 2012.

We contributed \$32 million and \$27 million to postretirement benefit plans during the nine months ended September 30, 2013 and 2012, respectively. Additional contributions ranging between approximately \$10 million and \$15 million are expected during the remainder of 2013.

#### Note 15. Stock-Based Compensation Plans

Share-based compensation expense was \$9 million and \$21 million during the three and nine months ended September 30, 2013, respectively, and \$6 million and \$16 million for the three and nine months ended September 30, 2012, respectively. The unamortized compensation expense related to our stock options, restricted shares and performance based shares was \$8 million, \$19 million and \$2 million, respectively, at September 30, 2013 and is expected to be recognized over a weighted average period of 1.7, 1.7 and 2.4 years, respectively. The amount of cash received from the exercise of stock options was \$2 million and \$22 million for the nine months ended September 30, 2013 and 2012, respectively. We classify as a financing activity the cash flows attributable to excess tax benefits arising from stock option exercises and restricted stock lapses.

#### Restricted Stock Grants

The following is a summary of restricted stock activity for the nine months ended September 30, 2013:

| (in thousands, except for per share amounts) | Shares | Weighted<br>Average<br>Grant Date<br>Fair Value /Share |
|--|--------|--|
| Outstanding at January 1, 2013               | 1,588  | \$ 26.92   |
| Granted                                      | 493    | \$ 27.42   |
| Vested                                       | (587   | ) \$ 26.44   |
| Forfeited                                    | (151   | ) \$ 27.63   |
| Outstanding at September 30, 2013            | 1,343  | \$ 27.21   |

#### Performance-Based Share Grants

As part of the annual March 2013 grant under the long-term incentive plan, performance-based shares were granted to all executive officers of the Company. The performance-based shares vest based upon performance by the Company over a three-year period against targets approved by the compensation committee of the Company's Board of Directors prior to the grant date. For the 2013-2015 performance period, the performance-based shares were granted at a target of 100% with actual payout contingent upon the achievement of a pre-set, three-year adjusted Return on Invested Capital and cumulative adjusted net income performance target. Compensation costs resulting from share-based payment transactions are recognized primarily within selling, general and administrative expenses, at fair value over the requisite service period (typically three years) on a straight-line basis. The calculated compensation cost is adjusted based on an estimate of awards ultimately expected to vest and our assessment of the probable outcome of the performance condition. The fair value of performance-based share awards at 100% target is determined using the closing price of our common stock on date of grant.

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The following is a summary of performance-based share grants for the nine months ended September 30, 2013:

| (in thousands, except for per share amounts) | Shares | Weighted<br>Average<br>Grant Date<br>Fair Value /Share |
|--|--------|--|
| Outstanding at January 1, 2013               | —      | \$ —   |
| Granted                                      | 119    | \$ 27.49   |
| Vested                                       | —      | \$ —   |
| Forfeited                                    | (54    | ) \$ 27.49   |
| Outstanding at September 30, 2013            | 65     | \$ 27.49   |

Stock Option Grants

The following is a summary of the changes in outstanding stock options for the nine months ended September 30, 2013:

| (in thousands, except for per share amounts) | Shares | Weighted<br>Average<br>Exercise<br>Price /Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (Years) |
|--|--------|---|---|
| Outstanding at January 1, 2013               | 4,083  | \$26.46   | 6.4   |
| Granted                                      | 817    | \$27.43   | 10.0  |
| Exercised                                    | (102   | ) \$21.72                                       | 1.9   |
| Forfeited                                    | (465   | ) \$28.15                                       | 5.7   |
| Outstanding at September 30, 2013            | 4,333  | \$26.57   | 6.5   |
| Options exercisable at September 30, 2013    | 2,208  | \$26.36   | 4.5   |

The aggregate intrinsic value of all outstanding and exercisable stock options as of September 30, 2013 was \$10 million and \$7 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, 2013 was \$1 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 our annual March grants in 2013.

|                                     |        |
|-------------------------------------|--------|
| Dividend yield                      | 1.69%  |
| Volatility                          | 31.10% |
| Risk-free interest rate             | 1.27%  |
| Expected term (in years)            | 6.63   |
| Weighted-average fair value / share | \$7.58 |

Expected volatility is calculated based on an analysis of historic and implied volatility measures for a set of peer companies. 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 expected term provided above represents the weighted average of expected behavior for certain groups of employees who have historically exhibited different behavior. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of option grant.

#### Note 16. Capital Stock

On August 20, 2013, the Board of Directors authorized the repurchase up to \$250 million in shares with no expiration date. The program's objective is to deploy our capital in a manner that benefits our shareholders and maintains our focus on growth. During the three and nine months ended September 30, 2013, we repurchased 1.0 million shares for \$25 million under this program. There are up to \$225 million in shares that may still be purchased under this plan. On August 18, 2012, the Board of Directors authorized the repurchase of up to 2.0 million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem employee stock plans by acquiring shares in the open market from time to time. There were no shares repurchased under this program during the three months ended September 30, 2013. There were 0.1 million shares repurchased for \$2 million under this program during the three months ended September 30, 2012. We repurchased 0.6 million and 0.1 million shares for \$17 million and \$2 million under this program for the nine months ended September 30, 2013 and 2012, respectively. There are up to 1.0 million shares that may still be purchased under this plan.

Aside from the aforementioned repurchase programs, we repurchased 0.2 million and less than 0.1 million shares for \$4 million and less than \$1 million during the three months ended September 30, 2013 and 2012, respectively, in relation to settlement of employee tax withholding obligations due as a result of the vesting of restricted stock. Likewise, we repurchased 0.2 million and 0.1 million shares for \$6 million and \$4 million during the nine months ended September 30, 2013 and 2012, respectively.

## Note 17. Accumulated Other Comprehensive Income (Loss)

The following table provides the components of accumulated other comprehensive income for the three months ended September 30, 2013:

| (in millions)   | Foreign<br>Currency<br>Translation | Postretirement<br>Benefit Plans | Derivative<br>Instruments | Total |
|---|------------------------------------|---------------------------------|---------------------------|-------|
| Balance at July 1, 2013   | \$272                              | \$(215 )                        | \$(2 )                    | \$55  |
| Foreign currency translation adjustment   | 68                                 | —                               | —                         | 68    |
| Amortization of net actuarial loss on postretirement benefit plans into:                |                                    |                                 |                           |       |
| Cost of revenue   | —                                  | 1                               | —                         | 1     |
| Selling, general and administrative expenses  | —                                  | 3                               | —                         | 3     |
| Other non-operating expense, net  | —                                  | 1                               | —                         | 1     |
| Income tax expense on amortization of postretirement benefit plan items                 | —                                  | (2 )                            | —                         | (2 )  |
| Unrealized gain on foreign exchange agreements  | —                                  | —                               | 2                         | 2     |
| Reclassification of unrealized loss on foreign exchange agreements into cost of revenue | —                                  | —                               | 1                         | 1     |
| Balance at September 30, 2013   | \$340                              | \$(212 )                        | \$1                       | \$129 |

The following table provides the components of accumulated other comprehensive income for the nine months ended September 30, 2013:

| (in millions)   | Foreign<br>Currency<br>Translation | Postretirement<br>Benefit Plans | Derivative<br>Instruments | Total |
|---|------------------------------------|---------------------------------|---------------------------|-------|
| Balance at January 1, 2013  | \$336                              | \$(222 )                        | \$1                       | \$115 |
| Foreign currency translation adjustment   | 4                                  | —                               | —                         | 4     |
| Amortization of net actuarial loss on postretirement benefit plans into:                |                                    |                                 |                           |       |
| Cost of revenue   | —                                  | 3                               | —                         | 3     |
| Selling, general and administrative expenses  | —                                  | 8                               | —                         | 8     |
| Other non-operating expense, net  | —                                  | 3                               | —                         | 3     |
| Income tax expense on amortization of postretirement benefit plan items                 | —                                  | (4 )                            | —                         | (4 )  |
| Reclassification of unrealized gain on foreign exchange agreements into revenue         | —                                  | —                               | (1 )                      | (1 )  |
| Reclassification of unrealized loss on foreign exchange agreements into cost of revenue | —                                  | —                               | 1                         | 1     |
| Balance at September 30, 2013   | \$340                              | \$(212 )                        | \$1                       | \$129 |

Note 18. 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 October 4, 2013, the Company and Xylem Group LLC entered into a settlement agreement with respect to the proceedings in the U.S. District Court for the Northern District of Georgia originally commenced on October 26, 2011 regarding the Company's use of the "XYLEM" mark. Pursuant to the settlement agreement, both parties released each other from all existing claims, and all claims have been dismissed by the U.S. District Court for the Northern District of Georgia with prejudice. The obligation for the settlement has been reflected on the September 30, 2013 Condensed Consolidated Balance Sheet.

We have estimated and accrued \$21 million and \$8 million as of September 30, 2013 and December 31, 2012 for these general legal matters, respectively. Although we cannot predict the outcome of these and other proceedings with certainty, we believe that they will not have a material adverse effect on our condensed consolidated financial position 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, Exelis and Xylem, ITT has an obligation to indemnify, defend and hold Xylem harmless for asbestos product liability matters, including settlements, judgments, and legal defense costs associated with all pending and future claims that may arise from past sales of ITT's legacy products. We believe ITT 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.

Indemnifications

As part of the Spin-off, ITT, Exelis 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. ITT'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 ITT or Exelis through the Distribution Agreement and we are not aware of any claims or other circumstances that would give rise to material payments from us under such indemnifications.



### Environmental

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

Accruals for environmental matters are recorded on a site-by-site basis when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated, based on current law and existing technologies. Our accrued liabilities for these environmental matters represent the best estimates related to the investigation and remediation of environmental media such as water, soil, soil vapor, air and structures, as well as related legal fees. These estimates, and related accruals, are reviewed quarterly and updated for progress of investigation and remediation efforts and changes in facts and legal circumstances. Liabilities for these environmental expenditures are recorded on an undiscounted basis. We have estimated and accrued \$9 million and \$11 million as of September 30, 2013 and December 31, 2012 for environmental matters, respectively.

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)                                    | 2013 | 2012  |
|--|------|-------|
| Warranty accrual – January 1                     | \$40 | \$42  |
| Net changes for product warranties in the period | 24   | 23    |
| Settlement of warranty claims                    | (26  | ) (23 |
| Other  | —    | (1    |
| Warranty accrual – September 30                  | \$38 | \$41  |

## Note 19. Segment Information

Our business is organized into two reportable segments: Water Infrastructure and Applied Water. The Water Infrastructure segment, comprising our Water Solutions and Analytics operating units, 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. 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 the Spin-off and 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 2012 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, |         |
|--------------------------------|-------------------------------------|-------|------------------------------------|---------|
|                                | 2013                                | 2012  | 2013                               | 2012    |
| Revenue:                       |                                     |       |                                    |         |
| Water Infrastructure           | \$619                               | \$595 | \$1,766                            | \$1,788 |
| Applied Water                  | 360                                 | 350   | 1,086                              | 1,078   |
| Eliminations                   | (14                                 | ) (14 | ) (48                              | ) (44   |
| Total                          | \$965                               | \$931 | \$2,804                            | \$2,822 |
| Operating Income:              |                                     |       |                                    |         |
| Water Infrastructure           | \$88                                | \$85  | \$171                              | \$253   |
| Applied Water                  | 40                                  | 43    | 125                                | 135     |
| Corporate and other            | (30                                 | ) (17 | ) (62                              | ) (49   |
| Total                          | \$98                                | \$111 | \$234                              | \$339   |
| Depreciation and Amortization: |                                     |       |                                    |         |
| Water Infrastructure           | \$27                                | \$27  | \$83                               | \$77    |
| Applied Water                  | 7                                   | 7     | 21                                 | 21      |
| Corporate and other            | 2                                   | 2     | 6                                  | 5       |
| Total                          | \$36                                | \$36  | \$110                              | \$103   |
| Capital Expenditures:          |                                     |       |                                    |         |
| Water Infrastructure           | \$18                                | \$18  | \$57                               | \$59    |
| Applied Water                  | 7                                   | 6     | 26                                 | 19      |
| Corporate and other            | 5                                   | —     | 8                                  | 3       |
| Total                          | \$30                                | \$24  | \$91                               | \$81    |

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

| (in millions)        | Total Assets          |                      |
|----------------------|-----------------------|----------------------|
|                      | September 30,<br>2013 | December 31,<br>2012 |
| Water Infrastructure | \$2,990               | \$2,844              |
| Applied Water        | 1,351                 | 1,253                |
| Corporate and other  | 443                   | 582                  |
| Total                | \$4,784               | \$4,679              |

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

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

This report contains information that may constitute "forward-looking statements." Forward-looking statements by their nature address matters that are, to different degrees, uncertain. Generally, the words "anticipate," "estimate," "expect," "project," "intend," "plan," "believe," "target" 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, but are not limited to, statements about the separation of Xylem Inc. ("Xylem" or the "Company") from ITT Corporation in 2011, capitalization of the Company, future strategic plans and other statements that describe the Company's business strategy, outlook, objectives, plans, intentions or goals, and any discussion of future operating or financial performance. All statements that address operating performance, events or developments that we expect or anticipate will occur in the future — including statements relating to orders, sales, operating margins and earnings per share growth, and statements expressing general views about future operating results — are forward-looking statements.

Caution should be taken not to place undue reliance on any such forward-looking statements because they involve risks, uncertainties and other factors that could cause actual results to differ materially from those expressed or implied in, or reasonably inferred from, such statements. 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. In addition, forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from the Company's historical experience and our present expectations or projections. For a more detailed discussion of these factors, see the information under the heading "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2012 ("2012 Annual Report") and with subsequent filings we make with the Securities and Exchange Commission.

The following discussion should be read in conjunction with the condensed consolidated financial statements, including the notes thereto, included elsewhere in 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 "parent" refer to ITT Corporation and its consolidated subsidiaries (other than Xylem Inc.).

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.

On October 31, 2011 ITT completed the spin-off of Xylem, formerly ITT's water equipment and service businesses, and Exelis Inc. ("Exelis"), formerly ITT's defense and service businesses (the "Spin-off").

### 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 segments: Water Infrastructure and Applied Water. Our segments are aligned with each of the sectors in the cycle of water, supply infrastructure and usage applications. 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 segment's major products include pumps, valves, heat exchangers, controls and dispensing equipment.

Water Infrastructure serves the supply 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.

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.

We sell our equipment and services via direct and indirect channels that serve the needs of each customer type. In the Water Infrastructure segment for the year ended 2012, we provided more than 70% direct sales with strong application expertise, with the remaining amount going through distribution partners. In the Applied Water segment, we provided more than 85% of our sales in 2012 through long-standing relationships with the world's leading distributors, with the remainder going direct to customers. We believe the total market opportunity for this equipment and services portion of the water industry supply chain is estimated at \$280 billion.

#### Executive Summary

Xylem reported revenue for the third quarter of 2013 of \$965 million, an increase of 3.7% compared to \$931 million during the third quarter of 2012. Revenue also increased 3.7% on a constant currency basis, driven by organic revenue growth across most end markets and strength in emerging markets, particularly in China and eastern Europe. The 2012 and 2013 acquisitions within our Water Infrastructure segment contributed \$21 million of incremental revenue for the third quarter 2013. Operating income for the third quarter of 2013 was \$98 million, reflecting a decrease of \$13 million or 11.7% compared to \$111 million in the third quarter of 2012 primarily due to costs incurred from our restructuring and realignment actions, special charges, continued investment in the business, increased pension costs and unfavorable price and mix headwinds, partially offset by sales volume increases combined with savings from our cost reduction initiatives and our restructuring activities in 2012 and 2013.

Additional financial highlights for the quarter ended September 30, 2013 include the following:

- Orders of \$955 million, or 8.3% growth from \$882 million in the third quarter of the prior year
- Net income of \$73 million, or \$0.39 per diluted share (\$0.49 on an adjusted basis) for the third quarter of 2013
- Cash flow from operating activities of \$163 million for the nine months ended September 30, 2013
- Xylem Board of Directors approved a share repurchase program of up to \$250 million in an effort to enhance shareholder return

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

Management reviews key performance indicators including revenue, gross margin, segment and total 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 to 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 and acquisitions, share repurchases and debt repayment. These metrics, however, are not measures of financial performance under accounting principles generally accepted in the United States of America ("GAAP") and should not be considered a substitute for revenue, operating income, net income, earnings per share (basic and diluted) or net cash from operations as determined in accordance with GAAP. We consider the following non-GAAP measures, which may not be comparable to similarly titled measures reported by other companies, to be key performance indicators:

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

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

"adjusted net income" and "adjusted earnings per share" defined as net income and earnings per share, respectively, adjusted to exclude non-recurring separation costs from the Spin-off (not excluded in 2013), restructuring and realignment costs, special charges and tax-related special items. 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, |        |
|---|-------------------------------------|--------|------------------------------------|--------|
|   | 2013                                | 2012   | 2013                               | 2012   |
| Net income                                  | \$73                                | \$72   | \$160                              | \$224  |
| Separation costs, net of tax (a)            | —                                   | 3      | —                                  | 11     |
| Restructuring and realignment, net of tax   | 7                                   | 4      | 36                                 | 4      |
| Special charges, net of tax                 | 12                                  | —      | 12                                 | —      |
| Tax-related special items                   | —                                   | 4      | —                                  | 3      |
| Adjusted net income                         | \$92                                | \$83   | \$208                              | \$242  |
| Weighted average number of shares - Diluted | 186.0                               | 186.3  | 186.2                              | 186.2  |
| Adjusted earnings per share                 | \$0.49                              | \$0.44 | \$1.12                             | \$1.29 |

Costs of \$1 million (\$0 million, net of tax) and \$3 million (\$2 million, net of tax) for the three and nine months (a) ended September 30, 2013, respectively, associated with non-recurring separation activities are not excluded from adjusted net income.

"operating expenses excluding separation, restructuring and realignment costs and special charges" defined as operating expenses, adjusted to exclude non-recurring separation costs from the Spin-off (not excluded in 2013), restructuring and realignment costs and special charges.

"adjusted segment operating income" defined as segment operating income, adjusted to exclude non-recurring separation costs from the Spin-off (not excluded in 2013), 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 non-recurring costs not included in restructuring costs that are incurred as part of actions taken to reposition our business, including items such as professional fees, relocation, travel and other costs.

"special charges" defined as costs incurred by the Company associated with the settlement of legal proceedings with Xylem Group LLC, as well as certain costs incurred for the change in chief executive officer made during the third quarter of 2013.

"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 |       |
|---|-------------------|-------|
|   | September 30,     |       |
|   | 2013              | 2012  |
| Net cash provided by operating activities | \$163             | \$230 |
| Capital expenditures                      | (91               | ) (81 |
| Separation cash payments (a)              | —                 | 22    |
| Free cash flow                            | \$72              | \$171 |

Separation cash payments associated with non-recurring separation activities are included in the 2013 free cash (a) flow. Separation cash payments are excluded from free cash flow in 2012 and include capital expenditures associated with the Spin-off of \$4 million.

## 2013 Outlook

The current global market conditions, particularly the economic conditions within Europe and the United States, have had a varied impact on the results of the Company during 2013. During the first half of the year, we were heavily impacted by the adverse economic environment in Europe, as well as overall difficult market conditions which inhibited our growth. We have seen the region stabilize during the third quarter with the exception of southern Europe, where we continue to experience year-over-year declines and expect ongoing weakness and uncertainty. In the United States, market uncertainty, combined with delays in government funding, have resulted in weaker performance in the industrial markets and delays in public utility projects. We expect the stabilization experienced in the third quarter to continue throughout the remainder of 2013. We are continuing to execute restructuring and realignment actions to reposition our European and North American business to optimize our cost structure and improve our operational efficiency and effectiveness. During the third quarter of 2013, we incurred \$5 million and \$7 million in restructuring and realignment costs, respectively. We expect to incur approximately \$40 to \$50 million in restructuring costs, and approximately \$25 to \$30 million in realignment costs for the full year. As a result of the restructuring actions in 2013, we continue to anticipate approximately \$14 to \$15 million of net savings to be realized during 2013. Additional strategic actions we are taking include investing in growth platforms and new product development, as well as drawing operating efficiencies through lean six sigma and global sourcing initiatives.

Additionally, we generate nearly two-thirds of our revenue outside the U.S., which is impacted by changes in foreign currency exchange rates, particularly the Euro, Swedish Krona, British Pound, Australian Dollar, Canadian Dollar, South African Rand, Polish Zloty, and Hungarian Forint. Upon consolidation, as

exchange rates vary, our revenue and other operating results may differ from expectations. In this uncertain economy, significant fluctuations in foreign exchange rates may continue.

### Results of Operations

| (In millions)  | Three Months Ended<br>September 30, |        |            | Nine Months Ended<br>September 30, |         |           |  |  |
|--|-------------------------------------|--------|------------|------------------------------------|---------|-----------|--|--|
|  | 2013                                | 2012   | Change     | 2013                               | 2012    | Change    |  |  |
| Revenue  | \$965                               | \$931  | 3.7 %      | \$2,804                            | \$2,822 | (0.6 )%   |  |  |
| Gross Profit   | 384                                 | 374    | 2.7 %      | 1,089                              | 1,120   | (2.8 )%   |  |  |
| Gross Margin   | 39.8 %                              | 40.2 % | (40 )bp    | 38.8 %                             | 39.7 %  | (90 )bp   |  |  |
| Operating expenses excluding separation, restructuring and realignment costs and special charges (a) | 254                                 | 255    | (0.4 )%    | 783                                | 762     | 2.8 %     |  |  |
| Expense to revenue ratio   | 26.3 %                              | 27.4 % | (110 )bp   | 27.9 %                             | 27.0 %  | 90 bp     |  |  |
| Separation costs (a)   | —                                   | 4      | NM*        | —                                  | 15      | NM*       |  |  |
| Restructuring and realignment costs  | 12                                  | 4      | 200.0 %    | 52                                 | 4       | 1,200.0 % |  |  |
| Special charges  | 20                                  | —      | NM*        | 20                                 | —       | NM*       |  |  |
| Total operating expenses   | 286                                 | 263    | 8.7 %      | 855                                | 781     | 9.5 %     |  |  |
| Operating Income   | 98                                  | 111    | (11.7 )%   | 234                                | 339     | (31.0 )%  |  |  |
| Operating Margin   | 10.2 %                              | 11.9 % | (170 )bp   | 8.3 %                              | 12.0 %  | (370 )bp  |  |  |
| Interest and other non-operating expense, net  | 15                                  | 11     | 36.4 %     | 43                                 | 40      | 7.5 %     |  |  |
| Income tax expense   | 10                                  | 28     | (64.3 )%   | 31                                 | 75      | (58.7 )%  |  |  |
| Tax rate   | 12.1 %                              | 27.8 % | (1,580 )bp | 16.4 %                             | 25.2 %  | (880 )bp  |  |  |
| Net Income   | \$73                                | \$72   | 1.4 %      | \$160                              | \$224   | (28.6 )%  |  |  |

(a) Separation costs of \$1 million and \$3 million for the three and nine months ended September 30, 2013, respectively, are included within the \$254 million and \$783 million of operating expenses.

\* NM - Not meaningful percentage change

#### Revenue

Revenue generated during the three and nine months ended September 30, 2013 was \$965 million and \$2,804 million, respectively, reflecting an increase of \$34 million or 3.7% and a decrease of \$18 million or 0.6%, respectively, compared to the same prior year periods. On a constant currency basis, revenue increased 3.7% and declined 0.7% for the three and nine months ended September 30, 2013, respectively.



The following table illustrates the impact from organic growth, recent acquisitions and fluctuations in foreign currency in relation to revenue during the three and nine months ended September 30, 2013:

| (In millions)                    | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |   |    |
|----------------------------------|-------------------------------------|----------|------------------------------------|----------|---|----|
|                                  | Change                              | % Change | Change                             | % Change |   |    |
| 2012 Revenue                     | \$931                               |          | \$2,822                            |          |   |    |
| Organic growth                   | 13                                  | 1.4      | (87)                               | (3.1)    | ) | )% |
| Acquisitions                     | 21                                  | 2.3      | 67                                 | 2.4      |   | %  |
| Constant Currency                | 34                                  | 3.7      | (20)                               | (0.7)    | ) | )% |
| Foreign currency translation (a) | —                                   | —        | 2                                  | 0.1      |   | %  |
| Total change in revenue          | 34                                  | 3.7      | (18)                               | (0.6)    | ) | )% |
| 2013 Revenue                     | \$965                               |          | \$2,804                            |          |   |    |

(a) Foreign currency impact primarily due to fluctuations in the value of the Euro, British Pound, Swedish Krona, Australian Dollar, Canadian Dollar and South African Rand 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, |         |                          |                                |    |  |
|----------------------|-------------------------------------|-------|--------------------------|--------------------------------|------------------------------------|---------|--------------------------|--------------------------------|----|--|
|                      | 2013                                | 2012  | As<br>Reported<br>Change | Constant<br>Currency<br>Change | 2013                               | 2012    | As<br>Reported<br>Change | Constant<br>Currency<br>Change |    |  |
| Water Infrastructure | \$619                               | \$595 | 4.0                      | % 4.7                          | % \$1,766                          | \$1,788 | (1.2)                    | )% (1.1)                       | )% |  |
| Applied Water        | 360                                 | 350   | 2.9                      | % 1.7                          | % 1,086                            | 1,078   | 0.7                      | % (0.1)                        | )% |  |
| Eliminations         | (14                                 | ) (14 | )                        |                                | (48                                | ) (44   | )                        |                                |    |  |
| Total                | \$965                               | \$931 | 3.7                      | % 3.7                          | % \$2,804                          | \$2,822 | (0.6)                    | )% (0.7)                       | )% |  |

#### Water Infrastructure

Water Infrastructure revenue increased \$24 million, or 4.0% for the third quarter of 2013 (4.7% increase at constant currency) and decreased \$22 million, or 1.2% for the nine months ended September 30, 2013 (1.1% decrease at constant currency) compared to the respective 2012 periods. The increase in the third quarter was primarily driven by \$21 million from acquisitions and an increase in organic revenue due to higher volumes in Europe and strength in emerging markets partially offset by negative price realization. The decrease for the nine months ended September 30, 2013 was due to the weakness experienced in the transport and treatment applications, particularly in Europe during the first half of 2013, which was partially offset by contributions from acquisitions of \$67 million.

Organic revenue increased \$7 million or 1.2% during the quarter ended September 30, 2013 driven primarily from increased volumes in transport applications within northern and central Europe as strength, especially in the mining and construction business, reflected modest market recovery in the regions. Growth in transport applications was also bolstered by increases in the dewatering business of the United States from fracking activity, higher stock levels by distributors and continued benefits from efforts related to Superstorm Sandy. The increase in transport was partially offset by weakness in southern Europe and a decline in public utility large capital projects. Additionally, treatment negatively impacted organic growth as revenue decreased compared to 2012 predominately as a result of non-recurring large projects in Europe shipped in the prior year, lower demand for mixers used in Biogas applications due to the elimination of government incentives in certain European countries and continued project delays in the United States from government funding uncertainty. Strong performance in the emerging markets,

particularly in China and Eastern Europe, also provided significant growth in both the transport and treatment applications.

Organic revenue decreased \$86 million or 4.8% during the nine months ended September 30, 2013 substantially due to the lower volumes in the first six months of 2013. The organic revenue growth in the third quarter of 2013 was more than offset by the significant declines in the transport and treatment applications from weakness in the European market, shipment of large custom projects in the same period of 2012 and distributors maintaining lower stock levels. Additionally, test applications, which had flat organic growth in the third quarter of 2013, experienced lower revenue for the nine months ended September 30, 2013 from delays in orders and the government sequestration in the United States which more than offset incremental revenue from price increases, new products and cross-branding initiatives.

#### Applied Water

Applied Water revenue increased \$10 million, or 2.9% for the third quarter of 2013 (1.7% increase at constant currency) and increased \$8 million, or 0.7% for the nine months ended September 30, 2013 (0.1% decrease at constant currency) compared to the respective 2012 periods.

Organic revenue increased \$6 million, or 1.7% for the third quarter of 2013 driven mostly by double-digit growth in emerging markets, with particular strength in China, with growth across most market applications. The developed markets were largely flat, led by increases in commercial building services in the United States from promotional programs and in northern Europe as well as growth in irrigation in the United States due to dry weather conditions and benefits from price realization. These increases were offset by reductions in residential building services and weakness in industrial water in the United States.

Organic revenue decreased \$1 million, or 0.1% during the nine months ended September 30, 2013 as continued weakness in the European businesses through the first nine months, driven by southern Europe, was mostly offset by incremental price realization, strength in emerging markets across industrial water and commercial building services and modest growth in the United States. The slight increase in the United States was led by building services and irrigation, partially offset by declines in industrial water.

#### Orders / Backlog

Orders received during the third quarter of 2013 of \$955 million increased by \$73 million, or 8.3% over the third quarter of the prior year (8.4% increase at constant currency), including a benefit of \$20 million from acquisitions. Orders received during the nine months ended September 30, 2013 of \$2,926 million increased by \$70 million from the prior year, or 2.5% (2.5% increase at constant currency), which includes a benefit of \$71 million from acquisitions. Organic order growth increased 6.1% for the third quarter and was flat for the nine months ended September 30, 2013.

Water Infrastructure segment orders increased \$53 million, or 9.4% to \$617 million (9.9% increase at constant currency) for the quarter ended September 30, 2013 as compared to the prior year, including \$20 million from acquisitions. Organic orders increased 6.4% during the third quarter principally due to the strength in the emerging markets and higher demand for treatment applications, particularly mixers and aeration equipment. The increase was also driven by the dewatering business from restocking by distributors and dry weather conditions in the prior year period as well as the recovery of market conditions within the Americas. For the nine months ended September 30, 2013 orders increased \$46 million, or 2.5% to \$1,865 million (2.7% increase at constant currency) as compared to the prior year. Organic orders decreased by 1.2% on a year-to-date basis, which is attributable to the lower volume and economic uncertainty in Europe during the first six months of 2013.

Applied Water segment orders increased \$21 million, or 6.3% (5.7% increase at constant currency) and \$25 million, or 2.3% (2.0% increase at constant currency) for the three and nine months ended September 30, 2013, respectively. Organic order volume increased for the three month period as a result of similar market dynamics impacting revenue across all regions as well as larger orders within the industrial water market which have longer lead times which did not ship during the quarter. For the nine

months ended September 30, 2013, the increase in orders in the segment was due to strong performance in the commercial building services market in China as well as orders within the residential building services market in the United States during the first six months of 2013, partially offset by weakness in Southern Europe across all end markets.

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 \$752 million at September 30, 2013, an increase of \$62 million or 9.0% as compared to \$690 million at September 30, 2012 and an increase of \$105 million or 16.2% as compared to \$647 million at December 31, 2012. We anticipate that approximately 62% of the backlog at September 30, 2013 will be recognized as revenue in the remainder of 2013.

#### Gross Margin

Gross margin declined to 39.8% from 40.2% for the three months ended September 30, 2013 from 2012 driven by negative price realization and geographic sales mix, partially mitigated by revenue volume increases. For the nine months ended September 30, 2013, gross margin decreased to 38.8% from 39.7% from the prior year, primarily due to the overall revenue volume declines, geographic sales mix and additional costs associated with recent acquisitions. These negative impacts were partially mitigated by benefits from restructuring savings and cost saving initiatives such as lean six sigma and global sourcing.

#### Operating Expenses

The following table presents operating expenses for the three and nine months ended September 30, 2013 and 2012:

| (In millions)                                       | Three Months Ended |        |        |     | Nine Months Ended |        |        |    |
|---|--------------------|--------|--------|-----|-------------------|--------|--------|----|
|   | September 30,      |        | Change |     | September 30,     |        | Change |    |
| 2013  | 2012               | 2013   |        |     | 2012              |        |        |    |
| Selling, general and administrative expenses (SG&A) | \$256              | \$231  | 10.8   | %   | \$744             | \$682  | 9.1    | %  |
| SG&A as a % of revenue                              | 26.5               | % 24.8 | % 170  | bp  | 26.5              | % 24.2 | % 230  | bp |
| Research and development expenses (R&D)             | 24                 | 24     | —      | %   | 78                | 80     | (2.5)  | )% |
| R&D as a % of revenue                               | 2.5                | % 2.6  | % (10) | )bp | 2.8               | % 2.8  | % —    | bp |
| Restructuring charges                               | 5                  | 4      | 25.0   | %   | 30                | 4      | 650.0  | %  |
| Separation costs                                    | 1                  | 4      | (75.0) | )%  | 3                 | 15     | (80.0) | )% |
| Operating expenses                                  | \$286              | \$263  | 8.7    | %   | \$855             | \$781  | 9.5    | %  |
| Expense to revenue ratio                            | 29.6               | % 28.2 | % 140  | bp  | 30.5              | % 27.7 | % 280  | bp |

#### Selling, General and Administrative Expenses

SG&A increased by \$25 million to \$256 million or 26.5% of revenue in the third quarter of 2013, as compared to \$231 million or 24.8% of revenue in the third quarter of 2012; and increased by \$62 million to \$744 million or 26.5% of revenue in the nine months ended September 30, 2013, as compared to \$682 million or 24.2% of revenue in 2012. The increase in SG&A expenses as a percentage of revenue is primarily due to an increase in realignment costs of \$6 million and \$21 million for the three and nine months ended September 30, 2013, respectively, incurred by the Company to reposition our European business in an effort to optimize our cost structure and improve our operational efficiency and effectiveness. Further impacting the increase were the combined impacts from the legal settlement with Xylem Group LLC and costs incurred for the change in our chief executive officer of \$20 million. Acquisitions, increased pension costs and investments in growth platforms also impacted the increase.

## Research and Development Expenses

R&D spending was flat at \$24 million or 2.5% of revenue in the third quarter of 2013 as compared to \$24 million or 2.6% of revenue in the comparable period of 2012; and decreased by \$2 million to \$78 million or 2.8% of revenue in the nine months ended September 30, 2013, as compared to \$80 million or 2.8% of revenue in 2012. The decrease to R&D for the year-to-date period was reflective of timing of investments.

## Restructuring Charges

During the three and nine months ended September 30, 2013, we recognized restructuring charges of \$5 million and \$30 million, respectively. We incurred these charges primarily in an effort to realign our organizational structure in Europe and North America to address declines in sales volumes and optimize our cost structure. The charges relate to the reduction in structural costs, including a decrease in headcount and consolidation of facilities within both our Water Infrastructure and Applied Water segments. During the three and nine months ended September 30, 2012, we recognized restructuring charges of \$4 million in each period. These charges primarily relate to restructuring related severance payments for manufacturing reduction in force initiatives within our Water Infrastructure segment.

Total expected costs associated with actions that commenced during the nine months ended September 30, 2013 are approximately \$26 million for Water Infrastructure and approximately \$11 million for Applied Water. These costs primarily comprise severance charges. These actions are currently expected to continue through 2014. As a result of actions initiated during the nine months ended September 30, 2013, we estimate net savings of approximately \$14 million in 2013 and annual future net savings beginning in 2014 of approximately \$34 million.

We continue to expect to incur approximately \$40 to \$50 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 2013, we continue to anticipate approximately \$14 to \$15 million of total net savings to be realized during 2013, and annual future total net savings beginning in 2014 of \$34 to \$36 million.

## Separation Costs

We incurred non-recurring separation costs as a result of the Spin-off as follows:

| (in millions)                                 | Three Months Ended |      | Nine Months Ended |      |
|---|--------------------|------|-------------------|------|
|   | September 30,      |      | September 30,     |      |
|   | 2013               | 2012 | 2013              | 2012 |
| Advisory fees and other                       | \$—                | \$1  | \$—               | \$6  |
| Rebranding and marketing costs                | —                  | 2    | —                 | 6    |
| Information and technology costs              | 1                  | —    | 2                 | 1    |
| Employee retention and hiring costs           | —                  | —    | —                 | 1    |
| Lease termination and other real estate costs | —                  | —    | 1                 | —    |
| Other   | —                  | 1    | —                 | 1    |
| Total separation costs in operating income    | 1                  | 4    | 3                 | 15   |
| Income tax (benefit) expense                  | (1                 | ) (1 | ) (1              | ) (4 |
| Total separation costs, net of tax            | \$—                | \$3  | \$2               | \$11 |

## Operating Income

We generated operating income of \$98 million during the third quarter of 2013, a \$13 million decrease compared to \$111 million in the third quarter of 2012, and \$234 million in the nine months ended September 30, 2013, a decrease of \$105 million compared to \$339 million in 2012. The following table illustrates operating income results for our business segments:

| (In millions)            | Three Months Ended<br>September 30, |        |            | Nine Months Ended<br>September 30, |        |            | Change |
|--------------------------|-------------------------------------|--------|------------|------------------------------------|--------|------------|--------|
|                          | 2013                                | 2012   | Change     | 2013                               | 2012   | Change     |        |
| Water Infrastructure     | \$88                                | \$85   | 3.5 %      | \$171                              | \$253  | (32.4 )%   |        |
| Applied Water            | 40                                  | 43     | (7.0 )%    | 125                                | 135    | (7.4 )%    |        |
| Segment operating income | 128                                 | 128    | — %        | 296                                | 388    | (23.7 )%   |        |
| Corporate and other      | (30 )                               | (17 )  | 76.5 %     | (62 )                              | (49 )  | 26.5 %     |        |
| Total operating income   | \$98                                | \$111  | (11.7 )%   | \$234                              | \$339  | (31.0 )%   |        |
| Operating margin         |                                     |        |            |                                    |        |            |        |
| Water Infrastructure     | 14.2                                | % 14.3 | % (10 )bp  | 9.7                                | % 14.1 | % (440 )bp |        |
| Applied Water            | 11.1                                | % 12.3 | % (120 )bp | 11.5                               | % 12.5 | % (100 )bp |        |
| Total Xylem              | 10.2                                | % 11.9 | % (170 )bp | 8.3                                | % 12.0 | % (370 )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:

| (In millions)                       | Three Months Ended |        |          | Nine Months Ended |        |          | Change |  |
|-------------------------------------|--------------------|--------|----------|-------------------|--------|----------|--------|--|
|                                     | September 30,      |        | Change   | September 30,     |        | Change   |        |  |
|                                     | 2013               | 2012   |          |                   | 2013   |          | 2012   |  |
| <b>Water Infrastructure</b>         |                    |        |          |                   |        |          |        |  |
| Operating income                    | \$88               | \$85   | 3.5 %    | \$171             | \$253  | (32.4 %) |        |  |
| Separation costs                    | —                  | —      | NM*      | —                 | 3      | NM*      |        |  |
| Restructuring and realignment costs | 8                  | 4      | 100.0 %  | 40                | 4      | 900.0 %  |        |  |
| Adjusted operating income**         | \$96               | \$89   | 7.9 %    | \$211             | \$260  | (18.8 %) |        |  |
| Adjusted operating margin**         | 15.5 %             | 15.0 % | 50 bp    | 11.9 %            | 14.5 % | (260 bp) |        |  |
| <b>Applied Water</b>                |                    |        |          |                   |        |          |        |  |
| Operating income                    | \$40               | \$43   | (7.0 %)  | \$125             | \$135  | (7.4 %)  |        |  |
| Separation costs                    | —                  | 1      | NM*      | —                 | 2      | NM*      |        |  |
| Restructuring and realignment costs | 4                  | —      | NM*      | 12                | —      | NM*      |        |  |
| Adjusted operating income**         | \$44               | \$44   | — %      | \$137             | \$137  | — %      |        |  |
| Adjusted operating margin**         | 12.2 %             | 12.6 % | (40 bp)  | 12.6 %            | 12.7 % | (10 bp)  |        |  |
| <b>Total Xylem</b>                  |                    |        |          |                   |        |          |        |  |
| Operating income                    | \$98               | \$111  | (11.7 %) | \$234             | \$339  | (31.0 %) |        |  |
| Separation costs                    | —                  | 4      | NM*      | —                 | 15     | NM*      |        |  |
| Restructuring and realignment costs | 12                 | 5      | 140.0 %  | 52                | 5      | 940.0 %  |        |  |
| Special charges                     | 20                 | —      | NM*      | 20                | —      | NM*      |        |  |
| Adjusted operating income**         | \$130              | \$120  | 8.3 %    | \$306             | \$359  | (14.8 %) |        |  |
| Adjusted operating margin**         | 13.5 %             | 12.9 % | 60 bp    | 10.9 %            | 12.7 % | (180 bp) |        |  |

\* NM - Not meaningful percentage change

\*\* Costs associated with non-recurring separation activities of \$1 million and \$3 million for the three and nine months ended September 30, 2013, respectively, are not excluded from adjusted operating income.

#### Water Infrastructure

Operating income for our Water Infrastructure segment increased \$3 million or 3.5% (increased \$7 million or 7.9% on an adjusted basis) for the quarter ended September 30, 2013 and decreased by \$82 million or 32.4% (decreased \$49 million or 18.8% on an adjusted basis) for the nine months ended September 30, 2013, compared with the same respective prior year periods. The increase for the three months ended September 30, 2013 is related to revenue volume increases, cost reduction initiatives and restructuring savings which were partially offset by cost inflation, including increased pension costs. The decrease for the nine months ended September 30, 2013 was driven by the year-to-date revenue volume decline, inflation costs, negative price realization, foreign exchange headwinds, increased pension costs and investments in growth platforms, specifically acquisitions and new product launches.

#### Applied Water

Operating income for our Applied Water segment decreased \$3 million or 7.0% (flat on an adjusted basis) for the quarter ended September 30, 2013 compared with the prior year as the increase in revenue

volume and benefits from cost reductions, price realization and restructuring savings were offset by inflation costs, including increased pension costs, and geographic sales mix. Operating income decreased for the segment by \$10 million or 7.4% (flat on an adjusted basis) for the nine months ended September 30, 2013, compared with the same period for the prior year as lean initiatives and price realization offset inflation costs, including increased pension costs, lower revenue volume, and geographic sales mix.

#### Interest Expense

Interest expense was \$14 million and \$41 million for the respective three and nine months ended September 30, 2013 and 2012, primarily related to the interest on the \$1.2 billion aggregate principal amount of senior notes issued in September 2011. See "Funding and Liquidity Strategy" for further details.

#### Income Tax Expense

The income tax provision for the three months ended September 30, 2013 was \$10 million at an effective tax rate of 12.1%, compared to \$28 million at an effective tax rate of 27.8% for the same period in 2012. The income tax provision for the nine months ended September 30, 2013 was \$31 million at an effective tax rate of 16.4%, compared to \$75 million at an effective tax rate of 25.2% for the same period in 2012. The decrease in the effective tax rate for the three and nine months ended September 30, 2013 as compared to the same periods in 2012 was primarily due to mix of earnings, including the impact of realignment efforts, as well as certain costs incurred for the change in chief executive officer made during the third quarter of 2013. Additionally, there was a tax benefit from special charges incurred by the Company associated with the settlement of legal proceedings with Xylem Group LLC.

#### Liquidity and Capital Resources

The following table summarizes our sources and uses of cash:

| (In millions)        | Nine Months Ended |       | Change  |
|----------------------|-------------------|-------|---------|
|                      | 2013              | 2012  |         |
| Operating activities | \$163             | \$230 | \$(67)  |
| Investing activities | (165)             | (89)  | (76)    |
| Financing activities | (109)             | (41)  | (68)    |
| Foreign exchange     | 1                 | 6     | (5)     |
| Total                | \$(110)           | \$106 | \$(216) |

#### Sources and Uses of Liquidity

##### Operating Activities

During the nine months ended September 30, 2013, net cash provided by operating activities declined by \$67 million as compared to the prior year. The year-over-year decrease was driven by an increase in the use of working capital, due to accounts receivable primarily from longer collection times in Europe and increased inventories to support a higher backlog as well as to be able to support a higher mix of book and bill business. Additionally, revenue volume declines during the first half of 2013 reduced cash inflow from income. Payments made for restructuring and realignment activities in 2013 also contributed to the decline.

#### Investing Activities

Cash used in investing activities was \$165 million for the first nine months of 2013 as compared to \$89 million in the prior year due almost entirely to an increase in cash used for acquisitions of \$69 million. Additionally, capital expenditures increased \$10 million due primarily to information technology investments within both the Applied Water segment and Corporate as a result of system requirements subsequent to the Spin-off from ITT.

#### Financing Activities

Cash used in financing activities was \$109 million for the first nine months of 2013 as compared to \$41 million in the prior year, primarily driven by an increase in share repurchase activity of \$40 million. Additionally, there was a decrease in proceeds from the exercise of stock options of \$20 million and a \$9 million, or 16%, increase in dividends paid to shareholders.

The 2013 share repurchase activity was impacted by \$25 million of repurchases under a new share repurchase program approved on August 20, 2013 by the Board of Directors to repurchase up to \$250 million in shares.

#### 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 we will continue to have access to the capital markets on terms acceptable to us. We cannot assure 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 (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 lease-back 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), including but not limited to: (i) failure to pay interest for 30 days, (ii) failure to pay principal when due, (iii) failure to perform any other covenant for 90 days after receipt of notice from the trustee or from holders of 25% of the outstanding principal amount and (iv) certain events of bankruptcy, insolvency or reorganization. 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. As of September 30, 2013, we were in compliance with all covenants. If a change of control triggering event occurs (as defined in the Senior Notes indenture), we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase.



Interest on the Senior Notes due 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.

#### Credit Facility

Effective October 31, 2011, Xylem and its subsidiaries entered into a Four Year Competitive Advance and Revolving Credit Facility (the "Credit Facility") with JPMorgan Chase Bank, 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) a competitive advance borrowing option which will be provided on an uncommitted competitive advance basis through an auction mechanism (the "competitive loans") (ii) revolving extensions of credit (the "revolving loans") outstanding at any time and (iii) the issuance of letters of credit in a face amount not in excess of \$100 million outstanding at any time.

At our election, the interest rate per annum applicable to the competitive advances will be based on either (i) a Eurodollar rate determined by reference to LIBOR, plus an applicable margin offered by the lender making such loans and accepted by us or (ii) a fixed percentage rate per annum specified by the lender making such loans. 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 JPMorgan Chase Bank, 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 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. As of September 30, 2013, we were in compliance with all covenants. The Credit Facility also contains limitations on, among other things, incurring debt, granting liens, and entering sale and leaseback transactions. 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, 2013 the Credit Facility remains undrawn.

#### Research and Development Facility Agreement

Effective December 14, 2012, we entered into a Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank ("EIB") in an aggregate principal amount of up to €120 million (approximately \$163 million) to finance research projects and research infrastructures in the European Union. The Company's wholly owned subsidiary in Luxembourg, Xylem Holdings S.a.r.l., is the borrower under the R&D Facility Agreement. The funds are made available to finance research and development projects during the period of 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, starting no later than 18 months from the date of the R&D Facility Agreement, draw loans 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 will be at a fixed percentage rate per annum specified by EIB which includes the applicable margin. The interest rate per annum applicable to Floating Rate loans will be at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Sterling or U.S. Dollars, plus an applicable spread specified by EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans shall be determined by reference to the credit rating of the Company.

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. As of September 30, 2013, we were in compliance with all covenants. The R&D Facility Agreement also



contains limitations on, among other things, incurring debt, granting liens, and entering 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, 2013, the R&D Facility Agreement remains undrawn.

#### Non-U.S. Operations

We generated approximately 63% and 62% of our revenue from non-U.S. operations for the three and nine months ended September 30, 2013, respectively, and 62% for both the three and nine months ended September 30, 2012. 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 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, 2013, our foreign subsidiaries were holding \$325 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 2012 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 2012 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. There were no new pronouncements that we expect to have a material impact on our financial condition or 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 2012 Annual Report.

ITEM 4. CONTROLS AND PROCEDURES

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

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

## PART II

## ITEM 1. LEGAL PROCEEDINGS

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

On October 4, 2013, the Company and Xylem Group LLC entered into a settlement agreement with respect to the proceedings in the U.S. District Court for the Northern District of Georgia originally commenced on October 26, 2011 regarding the Company's use of the "XYLEM" mark. Pursuant to the settlement agreement, both parties released each other from all existing claims, and all claims have been dismissed by the U.S. District Court for the Northern District of Georgia with prejudice.

## ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors previously disclosed in our 2012 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, 2013:

| (IN MILLIONS, EXCEPT PER SHARE AMOUNTS) PERIOD | TOTAL NUMBER OF SHARES PURCHASED | AVERAGE PRICE PAID PER SHARE (a) | TOTAL NUMBER OF SHARES PURCHASED AS PART OF PUBLICLY ANNOUNCED PLANS OR PROGRAMS (b) | APPROXIMATE DOLLAR VALUE OF SHARES THAT MAY YET BE PURCHASED UNDER THE PLANS OR PROGRAMS (b) |
|--|----------------------------------|----------------------------------|--|--|
| 7/1/13 - 7/31/13                               | —                                | —                                | —  | 24.9   |
| 8/1/13 - 8/31/13                               | 0.3                              | 24.63                            | 0.3  | 267.3  |
| 9/1/13 - 9/30/13                               | 0.7                              | 26.23                            | 0.7  | 252.9  |

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

On August 18, 2012, the Board of Directors authorized the repurchase of up to two million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem (b)employee stock plans by acquiring shares in the open market from time to time. There were no shares purchased under this program during the three months ended September 30, 2013 and there are 1.0 million shares (approximately \$28 million) that may still be purchased under this plan.

On August 20, 2013, the Board of Directors authorized the repurchase of shares up to \$250 million with no expiration date. The program's objective is to deploy our capital in a manner that benefits our shareholders and maintains our focus on growth. During the three months ended September 30, 2013, 1.0 million shares were repurchased at an average price of \$25.63 per share for a total cost of \$25 million. There are up to \$225 million in shares that may still be purchased under this plan.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.



ITEM 4. MINE SAFETY DISCLOSURE

None.

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.

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**SIGNATURES**

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

XYLEM INC.  
(Registrant)

/s/ John P. Connolly  
John P. Connolly  
Vice President, Controller and Chief Accounting Officer  
(Principal Accounting Officer)

October 29, 2013

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XYLEM INC.  
EXHIBIT INDEX

| Exhibit Number | Description   | Location   |
|----------------|---|--|
| (3.1)          | Second Amended and Restated Articles of Incorporation of Xylem Inc.   | Filed herewith.  |
| (3.2)          | Amended and Restated By-laws of Xylem Inc.  | Filed herewith.  |
| (4.1)          | Indenture, dated as of September 20, 2011, between Xylem Inc., ITT Corporation, as initial guarantor, and Union Bank, N.A., as trustee                          | Incorporated by reference to Exhibit 4.2 of ITT Corporation's Form 8-K Current Report filed on September 21, 2011 (CIK No. 216228, File No. 1-5672).   |
| (4.2)          | Form of Xylem Inc. 3.550% Senior Notes due 2016   | Incorporated by reference to Exhibit 4.5 of Xylem Inc.'s Form S-4 Registration Statement filed on May 24, 2012 (CIK No. 1524472, File No. 333-181643).   |
| (4.3)          | Form of Xylem Inc. 4.875% Senior Notes due 2021   | Incorporated by reference to Exhibit 4.6 of Xylem Inc.'s Form S-4 Registration Statement filed on May 24, 2012 (CIK No. 1524472, File No. 333-181643).   |
| (10.1)         | Letter agreement dated September 8, 2013 between Steven R. Loranger and Xylem Inc.  | Filed herewith.  |
| (11)           | Statement Re-Computation of Per Share Earnings  | Information required to be presented in Exhibit 11 is provided under "Earnings Per Share" in Note 7 to the Condensed Consolidated Financial Statements in Part I, Item 1 "Condensed Consolidated Financial Statements" of this Report in accordance with the provisions of Financial Accounting Standards Board Accounting Standards Codification 260, Earnings Per Share. |
| (31.1)         | Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | Filed herewith.  |
| (31.2)         | Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | Filed herewith.  |



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| Exhibit Number | Description   | Location  |
|----------------|---|---|
| (32.1)         | Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  | This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b)(32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference. |
| (32.2)         | Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002  | This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b)(32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference. |
| (101.0)        | The following materials from Xylem Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2013, 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 | Submitted electronically with this Report.  |