ENBRIDGE INC
Form 6-K
May 09, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 6-K

Report of Foreign Issuer

Pursuant to Rule 13a-16 or 15d-16 of

the Securities Exchange Act of 1934

Dated May 9, 2012

Commission file number 001-15254

ENBRIDGE INC.

(Exact name of Registrant as specified in its charter)

Canada	**None**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3000, 425 1st Street S.W.

Calgary, Alberta, Canada T2P 3L8

(Address of principal executive offices and postal code)

(403) 231-3900

(Registrants telephone number, including area code)

Indicate by check mark whether the Registrant files or will file annual reports under cover of Form 20-F or Form 40-F.

Form 20-F Form 40-F **P**

Indicate by check mark if the Registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1):

Yes No **P**

Indicate by check mark if the Registrant is submitting the Form 6-K in paper as permitted by regulation S-T Rule 101(b)(7):

Yes No **P**

Indicate by check mark whether the Registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes No **P**

If Yes is marked, indicate below the file number assigned to the Registrant in connection with Rule 12g3-2(b):

N/A

THIS REPORT ON FORM 6-K SHALL BE DEEMED TO BE INCORPORATED BY REFERENCE IN THE REGISTRATION STATEMENTS ON FORM S-8 (FILE NO. 333-145236, 333-127265, 333-13456, 333-97305 AND 333-6436), FORM F-3 (FILE NO. 33-77022) AND FORM F-10 (FILE NO. 333-170200) OF ENBRIDGE INC. AND TO BE PART THEREOF FROM THE DATE ON WHICH THIS REPORT IS FURNISHED, TO THE EXTENT NOT SUPERSEDED BY DOCUMENTS OR REPORTS SUBSEQUENTLY FILED OR FURNISHED.

The following documents are being submitted herewith:

- Press Release dated May 9, 2012
- Interim Report to Shareholders for the three months ended March 31, 2012.

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.

ENBRIDGE INC.
(Registrant)

Date: May 9, 2012

By: /s/ Alison T. Love
Alison T. Love
Vice President & Corporate Secretary

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NEWS RELEASE

Enbridge reports first quarter adjusted earnings of $376 million or $0.50 per common share

HIGHLIGHTS

(all financial figures are unaudited and in Canadian dollars)

- First quarter earnings were $264 million including unrealized non-cash mark-to-market losses
- First quarter adjusted earnings increased 14% to $376 million
- U.S. Gulf Coast access initiative upsized to a $5.2 billion investment
- Acquisition of a 100% interest in the 50-megawatt Silver State North Solar Project development in Nevada
- Issuance of $1.05 billion in preference shares
- Enbridge named one of the Global 100 Most Sustainable Corporations, one of Canada s Greenest Employers and a member of the FTSE4Good Index

CALGARY, ALBERTA, May 9, 2012 Enbridge Inc. (TSX:ENB) (NYSE:ENB) With first quarter adjusted earnings of $376 million, or $0.50 per share, Enbridge begins 2012 firmly on track to achieve our full year adjusted earnings guidance of $1.58 to $1.74 per share, said Patrick D. Daniel, Chief Executive Officer.

First quarter 2012 earnings of $264 million included unrealized non-cash mark-to-market losses, primarily related to the revaluation of financial derivatives used to risk manage the profitability of forward transportation and storage transactions. These short-term non-cash fluctuations in reported earnings are a result of Enbridge s hedging program, which over the long-term will support the Company s reliable cash flows and capacity for ongoing dividend growth.

In the first quarter, Enbridge announced it had received sufficient commitments from shippers to upsize its proposed Flanagan South Pipeline Project and, with joint venture partner, Enterprise Products Partners, L.P. (Enterprise) to twin the Seaway Crude Pipeline System, bringing Enbridge s expected investment in its U.S. Gulf Coast initiative to $5.2 billion.

The commitments secured in the open seasons held in the fourth quarter of last year and the first quarter of 2012 will support additional infrastructure to meet the growing transportation needs of Bakken and western Canadian producers and U.S. Gulf Coast refiners, contributing to North America s energy security, said Mr. Daniel. The new upsized Flanagan South Pipeline, combined with our existing Spearhead Pipeline system, will offer shippers 775,000 barrels per day of capacity from Flanagan to Cushing, with the Seaway Crude Pipeline System reversal and expansion offering capacity of 850,000 barrels per day from Cushing to the Gulf Coast.

By leveraging existing infrastructure wherever possible, impacts to landowners, communities and the environment will be minimized, added Mr. Daniel.

Forward-Looking Information

This news release contains forward-looking information. Significant related assumptions and risk factors are described under the Forward-Looking Information section of this news release.

In green energy, Enbridge added to its growing portfolio of renewable generation assets with the acquisition of a 100% interest in the Silver State North Solar Project (Silver State) development in Nevada.

Silver State marks Enbridge s entry into the U.S. solar energy market, which offers significant growth opportunities given the excellent solar resource, supportive regulatory environment and expanding portfolio of solar energy projects, said Mr. Daniel. The project complements Enbridge s growing portfolio of renewable and alternative energy technologies that now includes interests in eight wind farms, four solar projects, a hybrid fuel cell, geothermal and four waste heat recovery facilities. Together, Enbridge has interests in a renewable energy portfolio of almost 1,000 megawatts.

During the quarter, Enbridge continued to be active in capital markets. Noted Mr. Daniel, Over the past eight months Enbridge has issued $2 billion in preference shares, bolstering our balance sheet as we embark upon the largest slate of growth projects we ve ever had before us.

In January, Enbridge was recognized as one of the Corporate Knights Global 100 Most Sustainable Corporations, and in March, FTSE Group reaffirmed Enbridge s membership in the FTSE4Good Index series which identifies companies that meet globally recognized corporate responsibility standards. In April, Enbridge was named one of Canada s Greenest Employers.

It is gratifying to be recognized for the sustainability of our business model, our commitment to delivering on our social responsibilities, and our continuing efforts to minimize the environmental impact of our activities, said Mr. Daniel. Enbridge s more than 7,000 employees work tirelessly to achieve our vision of being the leading energy delivery company in North America. I thank all of them for their outstanding work and continuing commitment to our corporate values and to Corporate Social Responsibility.

Enbridge continues to deliver strong financial performance across our liquids pipelines, gas pipelines and processing, gas distribution and green energy businesses, concluded Mr. Daniel. We have had exceptional success in securing new projects across all of our business units, we are well positioned to fund our growth and, with a strong start to the year, we expect to continue to deliver superior returns to our investors.

FIRST QUARTER 2012 OVERVIEW

For more information on Enbridge s growth projects and operating results, please see the Management s Discussion and Analysis (MD&A) which is filed on SEDAR and EDGAR and also available on the Company s website at www.enbridge.com/InvestorRelations.aspx.

- The decrease in earnings from $364 million for the first quarter of 2011 to $264 million for the first quarter of 2012 was primarily due to the recognition of net unrealized fair value losses of $110 million (2011 - nil) from the revaluation of financial derivatives related to the Company s risk management activities. Contributing to the overall decrease in earnings were lower earnings from Enbridge Gas Distribution (EGD) due to warmer weather. Partially offsetting these quarter-over-quarter declines were increased earnings from Liquids Pipelines as a result of favourable operating performance under the Competitive Toll Settlement.

- Enbridge s first quarter adjusted earnings increased 14% to $376 million as a result of increased contributions from Canadian Mainline, which benefited from strong volumes, continued positive performance at EGD reflecting favourable operating performance, and an increase in earnings from Enbridge Energy Partners, L.P. due to stronger results from the liquids and natural gas businesses, as well as higher incentive income. Corporate earnings also contributed to increased first quarter adjusted earnings due to the Company s increased investment in Noverco Inc. (Noverco) and lower residual financing costs.

- On May 7, 2012, Enbridge announced Silver State began commercial operation. A 100% interest in the 50-megawatt Silver State development in Clark County, Nevada, was acquired in March 31, 2012 at an estimated cost of $0.2 billion. Located 65 kilometers (40 miles) south of Las Vegas, Nevada, Silver State was being constructed under a fixed-price engineering, procurement and construction agreement with First Solar, and is expected to begin commercial operation in the second quarter of 2012. First Solar will provide operations and maintenance services under a long-term contract. NV Energy will purchase the energy output under a 25-year power purchase agreement.

- On April 19, 2012, Enbridge announced the closing of the issue of eight million cumulative redeemable preference shares, series J at a price of US$25 per share for aggregate gross proceeds of US$200 million.

- On April 16, 2012, the Government of New Brunswick enacted a final rates and tariffs regulation which set limits on gas distribution rates within the province. Enbridge had advised on March 12, 2012, when the regulation was still in draft form, that it faced a potential write down of a significant portion of the value of its investment in Enbridge Gas New Brunswick (EGNB), the New Brunswick gas distribution utility. With the finalization of the regulation, Enbridge has confirmed a write down of $262 million. The impact of this charge was recognized as a subsequent event in the Company s 2011 United States generally accepted accounting principles (U.S. GAAP) consolidated financial statements, voluntarily filed on May 2, 2012.

On April 26, 2012, the Company, Enbridge Energy Distribution Inc. (EEDI) and EGNB, commenced an action against the Province of New Brunswick in the New Brunswick Court of Queen s Bench, claiming damages in the amount of $650 million as a result of the continuing breaches by the Province of the General Franchise Agreement it signed with Enbridge in 1999. Additionally, on May 2, 2012, the Company, EEDI and EGNB filed a Notice of Application with the New Brunswick Court of Queen s Bench seeking a declaration from the Court that the rates and tariffs regulation is invalid. There is no assurance these actions will be successful or will result in any recovery.

- On March 29, 2012, Enbridge closed its offering of cumulative redeemable preference shares, series H. Due to strong investor demand, the size of the offering was increased to 14 million shares, for aggregate gross proceeds of $350 million.

- Enbridge announced on March 26, 2012, its intent to upsize the capacity of its U.S. Gulf Coast Access projects. The Flanagan South Pipeline from Flanagan, Illinois to Cushing, Oklahoma will be upsized to a 36-inch diameter line with an initial annual capacity of 585,000 barrels per day (bpd). Enbridge, with joint venture partner Enterprise will construct an 805-kilometre (500-mile), 30-inch diameter twin (a parallel line) along the route of their jointly owned Seaway Pipeline, adding 450,000 bpd of capacity to the existing system. The partners will also proceed with construction of an extension from Houston to Port Arthur/Beaumont, adding 560,000 bpd of capacity to that system. The total estimated cost of the Flanagan South Pipeline project, as a result of the larger capacity and pipeline size, has increased from the original US$1.9 billion to

US$2.8 billion. In addition, the Enbridge share of the cost of the Seaway Pipeline twin line and extension is expected to be approximately US$1.0 billion.

The increased Flanagan South Pipeline and Seaway Pipeline capacity is required to accommodate additional commitments for Gulf Coast service, originating from both Flanagan and Cushing, received through recently completed second open seasons. Both the Flanagan South Pipeline and Seaway twin pipeline are expected to be in service by mid-2014.

Enterprise and Enbridge are nearing completion of the first phase of the reversal of the Seaway Pipeline, which will provide 150,000 bpd of southbound takeaway capacity from Cushing to the Gulf Coast, anticipated to be in service in May 2012. Following pump station additions and modifications, which are expected to be completed by the first quarter 2013, capacity would increase to 400,000 bpd depending upon the mix of light and heavy grades of crude oil.

• On March 22, 2012, Noverco sold 22.5 million Enbridge common shares through a secondary offering. Enbridge s share of the proceeds of approximately $317 million, expected to be received as a dividend from Noverco in the second quarter of 2012, will be used to pay a portion of the Company s quarterly dividend on June 1, 2012.

• On February 27, 2012, the Board of Directors of Enbridge announced that Patrick D. Daniel, President and Chief Executive Officer (CEO), will retire at or before the end of 2012. The Board also announced the appointment of Al Monaco, previously President, Gas Pipelines, Green Energy and International, to Enbridge s Board of Directors and to the position of President, effective February 27, 2012. Mr. Daniel will continue as CEO and a member of the Board until his retirement.

• On February 23, 2012, Enbridge welcomed the publication of Transport Canada s TERMPOL Review Process Report of the proposed Northern Gateway Project s proposed marine operations. Transport Canada has filed the results of the study with the federal Joint Review Panel (JRP) tasked with assessing the project. The study reviewed the marine operations associated with the Northern Gateway terminal and associated tanker traffic in Canadian waters. The review concluded that: While there will always be residual risk in any project, after reviewing the proponent s studies and taking into account the proponent s commitments, no regulatory concerns have been identified for the vessels, vessel operations, the proposed routes, navigability, other waterway users and the marine terminal operations associated with vessels supporting the Northern Gateway Project. The TERMPOL report was prepared and approved by Canadian government authorities including Transport Canada; Environment Canada; Fisheries and Oceans Canada; Canadian Coast Guard; and Pacific Pilotage Authority Canada. Further review of the Northern Gateway application by the JRP, as well as other agencies, is ongoing.

• On January 18, 2012, Enbridge closed the offering of cumulative redeemable preference shares, series F. Due to strong investor demand, the size of the offering was increased to 20 million shares, resulting in aggregate gross proceeds of $500 million.

CONFERENCE CALL

Enbridge will hold a conference call on Wednesday, May 9, 2012 at 9:00 a.m. Eastern Time (7:00 a.m. Mountain Time) to discuss the first quarter 2012 results. Analysts, members of the media and other interested parties can access the call at 617-213-8059 or toll-free at 1-866-825-1692 using the access code of 47854821. The call will be audio webcast live at **www.media-server.com/m/p/wd35mvqp**. A webcast replay and podcast will be available approximately two hours after the conclusion of the event and a transcript will be posted to the website within 24 hours. The replay at toll-free 1-888-286-8010 or 617-801-6888 (access code 17767809) will be available until May 16, 2012.

The conference call will begin with presentations by the Company s Chief Executive Officer, the President and the Chief Financial Officer, followed by a question and answer period for investment analysts. A question and answer period for members of the media will then immediately follow.

The unaudited interim Consolidated Financial Statements and MD&A, which contain additional notes and disclosures, are available on the Enbridge website at www.enbridge.com/InvestorRelations.aspx.

Enbridge Inc., a Canadian company, is a North American leader in delivering energy and one of the Global 100 Most Sustainable Corporations. As a transporter of energy, Enbridge operates, in Canada and the U.S., the world s longest crude oil and liquids transportation system. The Company also has a significant and growing involvement in the natural gas gathering transmission and midstream businesses, and an increasing involvement in power transmission. As a distributor of energy, Enbridge owns and operates Canada s largest natural gas distribution company, and provides distribution services in Ontario, Quebec, New Brunswick and New York State. Enbridge employs more than 7,000 people, primarily in Canada and the U.S., and is ranked as one of Canada s Greenest Employers and one of the Top 100 Companies to Work for in Canada. Enbridge s common shares trade on the Toronto and New York stock exchanges under the symbol ENB. For more information, visit www.enbridge.com. None of the information contained in, or connected to, Enbridge s website is incorporated in or otherwise part of this news release.

Forward-Looking Information

Forward-looking information, or forward-looking statements, have been included in this news release to provide the Company s shareholders and potential investors with information about the Company and its subsidiaries and affiliates, including management s assessment of Enbridge s and its subsidiaries future plans and operations. This information may not be appropriate for other purposes. Forward-looking statements are typically identified by words such as anticipate , expect , project , estimate , forecast , plan , intend , believe and similar words suggesting future outcomes or statements regarding an outlook. Forward-looking information or statements included or incorporated by reference in this document include, but are not limited to, statements with respect to: expected earnings or adjusted earnings; expected earnings or adjusted earnings per share; expected costs related to projects under construction; expected in-service dates for projects under construction; expected capital expenditures; estimated future dividends; and expected costs related to leak remediation and potential insurance recoveries.

Although Enbridge believes that these forward-looking statements are reasonable based on the information available on the date such statements are made and processes used to prepare the information, such statements are not guarantees of future performance and readers are cautioned against placing undue reliance on forward-looking statements. By their nature, these statements involve a variety of assumptions, known and unknown risks and uncertainties and other factors, which may cause actual results, levels of activity and achievements to differ materially from those expressed or implied by such statements. Material assumptions include assumptions about: the expected supply and demand for crude oil, natural gas and natural gas liquids (NGL); prices of crude oil, natural gas and NGL; expected exchange rates; inflation; interest rates; the availability and price of labour and pipeline construction materials; operational reliability; customer project approvals;

maintenance of support and regulatory approvals for the Company s projects; anticipated in-service dates; and weather. Assumptions regarding the expected supply and demand of crude oil, natural gas and NGL, and the prices of these commodities, are material to and underlie all forward-looking statements. These factors are relevant to all forward-looking statements as they may impact current and future levels of demand for the Company s services. Similarly, exchange rates, inflation and interest rates impact the economies and business environments in which the Company operates, *may impact levels of demand for the Company s services and cost of inputs, and are therefore inherent in all forward-looking statements. Due to the interdependencies and correlation of these macroeconomic factors, the impact of any one assumption on a forward-looking statement cannot be determined with certainty, particularly with respect to expected earnings or adjusted earnings and associated per share amounts, or estimated future dividends. The most relevant assumptions associated with forward-looking statements on projects under construction, including estimated in-service dates, and expected capital expenditures include: the availability and price of labour and pipeline construction materials; the effects of inflation and foreign exchange rates on labour and material costs; the effects of interest rates on borrowing costs; and the impact of weather and customer and regulatory approvals on construction schedules.*

Enbridge s forward-looking statements are subject to risks and uncertainties pertaining to operating performance, regulatory parameters, project approval and support, weather, economic and competitive conditions, exchange rates, interest rates, commodity prices and supply and demand for commodities, including but not limited to those risks and uncertainties discussed in this news release and in the Company s other filings with Canadian and United States securities regulators. The impact of any one risk, uncertainty or factor on a particular forward-looking statement is not determinable with certainty as these are interdependent and Enbridge s future course of action depends on management s assessment of all information available at the relevant time. Except to the extent required by law, Enbridge assumes no obligation to publicly update or revise any forward-looking statements made in this news release or otherwise, whether as a result of new information, future events or otherwise. All subsequent forward-looking statements, whether written or oral, attributable to Enbridge or persons acting on the Company s behalf, are expressly qualified in their entirety by these cautionary statements.

Non-GAAP Measures

This news release contains references to adjusted earnings/(loss), which represent earnings or loss attributable to common shareholders adjusted for non-recurring or non-operating factors on both a consolidated and segmented basis. These factors are reconciled and discussed in the financial results sections for the affected business segments. Management believes that the presentation of adjusted earnings/(loss) provides useful information to investors and shareholders as it provides increased transparency and predictive value. Management uses adjusted earnings/(loss) to set targets, assess performance of the Company and set the Company s dividend payout target. Adjusted earnings/(loss) and adjusted earnings/(loss) for each of the segments are not measures that have a standardized meaning prescribed by U.S. GAAP and are not considered GAAP measures; therefore, these measures may not be comparable with similar measures presented by other issuers.

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HIGHLIGHTS

	Three months ended March 31,	
	2012	2011
(unaudited; millions of Canadian dollars, except per share amounts)		
Earnings attributable to common shareholders		
Liquids Pipelines	**191**	136
Gas Distribution	**78**	102
Gas Pipelines, Processing and Energy Services	**(111)**	26
Sponsored Investments	**66**	55
Corporate	**40**	45
	264	364
Earnings per common share1	**0.35**	0.49
Diluted earnings per common share1	**0.34**	0.48
Adjusted earnings2		
Liquids Pipelines	**158**	136
Gas Distribution	**102**	91
Gas Pipelines, Processing and Energy Services	**36**	39
Sponsored Investments	**67**	53
Corporate	**13**	11
	376	330
Adjusted earnings per common share1	**0.50**	0.44
Cash flow data		
Cash provided by operating activities	**648**	1,163
Cash used in investing activities	**(928)**	(647)
Cash provided by/(used in) financing activities	**663**	(301)
Dividends		
Common share dividends declared	**221**	188
Dividends paid per common share1	**0.2825**	0.2450
Shares outstanding *(millions)*		
Weighted average common shares outstanding1	**757**	750
Diluted weighted average common shares outstanding1	**769**	758
Operating data		
Liquids Pipelines - Average deliveries *(thousands of barrels per day)*		
Canadian Mainline3	**1,687**	1,602
Regional Oil Sands System4	**333**	

Transport

The Transport application includes all of the equipment and services involved in the safe and efficient movement of water from sources such as oceans, lakes, rivers and ground water, to treatment facilities, and then to users. It also includes the movement of wastewater from the point of use to a treatment facility and then back into the environment. Finally, the Transport application also includes dewatering pumps, equipment and services which provide the safe removal or draining of ground water and surface water from a riverbed, construction site or mine shaft. We serve the higher-value equipment markets, such as water and wastewater submersible pumps, monitoring controls, and application solutions; we do not serve the market for lower-value equipment such as pipes and fittings. We believe our business is one of the largest players in this served market based on management estimates. With operations on six continents, we also have one of the world’s largest dewatering rental fleets, serviced with our Flygt and Godwin brands. In our Water Infrastructure Segment, Transport accounted for approximately 74% of our segment revenue in 2013 and 73% in 2012.

Flygt — Flygt is a world-leader in the design and manufacture of dry and submersible pumps and related intelligent controls systems. Under the Flygt banner, customers have access to a complete range of products and solutions for moving water, wastewater, and advanced monitoring and control equipment to optimize their use. Founded in Sweden in 1901, Flygt is the originator of the reliable, energy-efficient electrical submersible pump. Flygt products

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have applications in various markets, including wastewater lift stations, water and wastewater treatment facilities, pressurized sewage systems, oil and gas, steel, mining and leisure markets. Customers include public utility and industrial water and wastewater systems operators. In 2012, Xylem successfully launched Flygt Experior which brings together advanced controls, hydraulics and energy-efficient motor technology to deliver substantial energy savings. For example, energy consumption at London’s Heathrow Airport cargo center pump station was reduced by 50% following installation of the new Flygt Experior pumps.

Godwin Pumps — With more than 35 years as a leader in pump manufacturing and applications, Godwin Pumps ("Godwin") has established itself as a well-recognized, market leading brand in the global portable pump market. Godwin manufactures, sells, rents and services its products. Its quick response and 24/7 capabilities allow it to provide customized pumping solutions to meet the specific needs of its customers. Founded in Quenington, England, Godwin is currently headquartered in Bridgeport, New Jersey. Godwin's products include fully automatic self-priming Dri-Prime® pumps, a full range of Flygt electric submersible pumps, Heidra hydraulic submersible pumps, Wet-Prime gasoline-powered contractor pumps and a broad line of generators and portable light towers, as well as a multitude of pumping accessories and pipe. Godwin products are primarily used in construction, water & wastewater transport, oil & gas markets, hydraulic fracturing, industrial, mining, and municipal, as well as government, temporary fire protection, environmental, agriculture, and marine. Godwin products are also instrumental in disaster relief efforts. After Superstorm Sandy hit the United States in October 2012, Godwin's pumps were instrumental in minimizing or eliminating flood damage in various flooded regions throughout the Northeast. Godwin's fleet of equipment is rented through 45 U.S. branches and a global network of distributors and Xylem rental and sales facilities.

Treatment

The Treatment application includes equipment and services that treat both water for consumption and wastewater to be returned responsibly to the environment. Primary served markets include public utilities and industrial operations. While there are several treatment solutions in the market today, we focus on three basic treatment types: (i) filtration, (ii) disinfection and (iii) biological treatment systems. Filtration uses gravity-based media filters and clarifiers to clean both water and wastewater. Leopold, with more than 80 years of experience, is our leading filtration brand. Disinfection systems, both ultraviolet ("UV") and ozone oxidation, treat both public utility drinking water and wastewater, as well as industrial process water, and are provided through our WEDECO brand. Biological treatment systems are key to the treatment and mixing of solids in wastewater plants, which are provided through our Sanitaire and Flygt brands. We believe our business is one of the largest players in this served market based on management estimates. In our Water Infrastructure Segment, Treatment accounted for approximately 14% of our segment revenue in 2013 and 15% in 2012.

Leopold — Founded in 1924 in Pittsburgh, Pennsylvania, Leopold is a leader in rapid gravity media filtration and clarification solutions for the water and wastewater industry. In potable drinking water treatment plants, the Clari-DAF system is used to clarify raw water to remove contaminants such as turbidity, algae, color, iron/manganese, organics, and taste and odor compounds. Several years ago, we augmented our filtration products with membrane technology. Our filtration products include the rapid gravity media, membranes and reverse osmosis/ultrafine filtration. Leopold gravity media filtration is used in potable water treatment plants to remove particulate in the final filtration step. In public utility wastewater treatment plants, the ClariVAC system is used in final clarifiers to remove the sludge solids. For those areas where nitrogen and phosphorus nutrient removal is required, we provide elimi-NITE systems which convert the filters to become biologically active so that the effluent meets the mandated nitrate and phosphorus levels. In desalination systems, Leopold Clari-DAF® systems and Filterworx systems are provided to remove contaminants that will harm reverse osmosis membranes, so that salt can be removed from the seawater to make it potable. Primary customers are public utility water and wastewater systems, as well as desalination plant facilities. Leopold won an order in the fourth quarter of 2013 to provide a new pre-treatment DAF system to help ensure an uninterrupted potable water supply to Abu Dhabi Emirate and the east coast of the United Arab Emirates. The source water in the Arabian Gulf is subject to harmful algal blooms also known as "red-tides." Xylem’s Leopold Clari-DAF® system is proven to be over 95 percent effective in removing these microorganisms prior to desalination, ensuring the production of clean, fresh, drinking water.

WEDECO — WEDECO was founded in 1975 in Herford, Germany to develop chemical-free and environmentally friendly water treatment technologies, including ultraviolet light and ozone systems. There are more than 250,000 installed WEDECO systems for UV disinfection and ozone oxidation globally in private, public utility and industrial locations. WEDECO introduced ozone technology in 1988 and has been expanding internationally ever since. UV disinfection systems have a number of applications including water treatment and aquaculture. Ozone disinfection systems have applications in drinking water, wastewater, process water, product polishing, bleaching, ozonolysis/

synthesis and deodorization. Customers include public utility wastewater and clean water treatment facilities, power plants, pulp and paper mills, food product manufacturers and aquaculture facilities. In the fourth quarter of 2013, a WEDECO LBX 1000 UV system was installed in a hospital in the German city of Warstein to combat an outbreak of Legionnaire's disease, a potentially fatal form of pneumonia which had contaminated a municipal wastewater treatment plant.

Sanitaire — Launched in 1967, the Sanitaire brand provides complete biological wastewater treatment solutions for public utility and industrial applications. Sanitaire's comprehensive offering includes diffused aeration, sequencing batch reactors, drum filters and state-of-the-art controls that drive efficient operations. Sanitaire is regarded as a leading brand in diffused aeration, which is a process that introduces air into a liquid, providing an aerobic environment for degradation of organic matter. Fine-pore diffusion of air is highly competitive due to its high oxygen transfer efficiency and lower energy costs. Sanitaire wide-band aeration systems are used in applications such as grit chambers and sludge that require non-clogging, maintenance-free systems. Principal Sanitaire customers are public utility and industrial wastewater treatment facilities. In 2013, Xylem launched the Sanitaire OSCAR process performance optimization system. When combined with Sanitaire's advanced aeration system, Xylem was able to deliver 65 percent energy savings to the operators of the Sterno, Sweden wastewater treatment plant.

Flygt — Flygt is a also a world-leader in the design and manufacturing of submersible, jet and top-entry mixers. Flygt has over 30 years of expertise in the area of wastewater treatment mixing, as well as over 100,000 applications globally. Submersible mixers are often used in sewage treatment plants to keep solids in suspension in the various process tanks and/or sludge holding tanks. During the fourth quarter of 2013, Xylem won an order to provide Flygt submersible mixers for the Panama Canal. The project includes four anti-sedimentation mixers at each lock gate of a new Panama Canal channel, as well as local electrical panels and accessories.

Test

Analytical instrumentation is used across most industries to ensure regulatory requirements are met. Growth in this market is primarily driven by increasing regulation of water and wastewater in North America, Europe and Asia. Our served market is predominately focused on water and the environment for quality levels throughout the water infrastructure loop. Analytical systems are applied in three primary ways: in the field, in a facility laboratory, or real time, online monitoring in a treatment facility process. We believe we have a leading position in this served market based on management estimates. In our Water Infrastructure Segment, Test accounted for approximately 12% of our segment revenue in both 2013 and 2012.

WTW — In wastewater treatment facilities, WTW-branded systems monitor parameters such as dissolved oxygen, pH, and turbidity throughout the water process to ensure regulatory standards are met before water is discharged back into the environment. Founded in 1945 as a major brand in Europe, WTW has particularly strong market penetration in the environmental, water and wastewater segments. WTW holds leading market positions in both field and on-line instrumentation and manufactures premium positioned robust and reliable analysis products for the measurement of pH, dissolved oxygen, conductivity, total dissolved solids, turbidity, specific ions and biological oxygen demand. WTW's product offering includes meters, sensors, data-loggers, photometers and software providing customer solutions for even the most challenging applications. WTW instruments have been placed in major monitoring stations around the globe to monitor water quality. One of our largest installations is in the Yangtze river station in China.

YSI — Yellow Springs Instrument Company ("YSI"), founded in 1948, develops and manufactures sensors, instruments, software and data collection platforms for environmental and coastal water quality monitoring and testing. YSI also offers Life Sciences products including biochemical analyzers for bioprocess monitoring, food and beverage processing, and sports physiology. The main market areas are water quality, environmental monitoring, aquaculture, life sciences and ocean research. YSI sensors played a critical role in monitoring water levels and providing other real-time data that helped track Superstorm Sandy which hit the Mid-Atlantic and Northeast United States in October of 2012.

OI Analytical — Oceanography International Corporation ("OIC"), founded in 1969, provides innovative products used for chemical analysis. Data from our analytical instruments serve as the basis for informed decisions affecting human health and safety, environmental protection, industrial operations and product quality. OIC was originally focused on oceanography equipment moving to production of water-quality measurement instrumentation, as oceanography equipment sales declined. OIC developed the Company's first total organic carbon analyzer. Since that time, the

Company has become recognized worldwide as a provider of quality analytical instrumentation. OIC developed a Total Organic Carbon Analyzer in cooperation with National Aeronautics and Space Administration

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specifically for use on the International Space Station. Without this validation that the drinking water has been purified for human consumption, the Space Station would not be suitable for astronaut habitation.

Aanderaa Data Instruments AS — ("Aandera") was founded in 1966 in Bergen, Norway, and offers sensors, instruments and systems for measuring and monitoring in the most demanding environments such as rivers, oceans and the polar regions through fully networked systems using wireless technology that monitors temperature, salinity, oxygen, turbidity, current and waves for ecosystem health. The main market areas are marine transportation, environmental and ocean research, oil and gas, aquaculture, road and traffic, and construction. Aanderaa's new technologies underlie the most advanced distributed instrumentation for underwater and atmospheric measurements. Hydro-acoustic, electro-optical, electro-chemical, pressure, temperature and meteorological data are captured by observing networks and self-contained instrumentation using real-time communication. Key customers include many oceanographic institutes, universities, geophysical surveyors, navies, offshore oil and gas companies, drilling companies, port and harbor authorities, government agencies, water authorities and international electric power utilities. Key installations include our new on-line tide and salinity station at Palmer Station in the Antarctic and coastal ocean wave and water quality monitoring station for United States Geological Survey alongside a National Oceanic and Atmospheric Administration Sentinel site in Galveston, Texas.

Applied Water

Applied Water encompasses the uses of water. Since water is used to some degree in almost every aspect of human, economic and environmental activity, this segment has a significant number of potential applications and we participate in all major areas of water demand. Irrigation applications constitute the majority of all water usage globally. Examples of what we provide include: boosting systems for farming irrigation, pumps for dairy operations, and rainwater reuse systems for small scale crop and turf irrigation. Industrial Water applications account for the next largest amount of global water consumption. Our pumps, heat exchangers, valves and controls provide cooling to power plants and manufacturing facilities, as well as circulation for food and beverage processing. The remaining portion of global water use resides in human and building consumption, where we deliver water boosting systems for drinking, heating, ventilation and air conditioning ("HVAC") and fire protection systems to Residential and Commercial Building Services. We estimate our served market size in this sector to be approximately $15 billion.

Residential & Commercial Building Services

This business is defined by four main uses of water in building services applications, such as in residential homes and commercial buildings, including offices, hotels, hospitals, schools, restaurants and malls. The first application is in HVAC, where Bell & Gossett and Lowara specialize in pumps and valves that are used in water-driven heating and cooling systems, along with heat exchangers, valves, and monitoring and control products that augment the system. The second is the supply of potable water for consumption, such as for drinking and hygiene. The Goulds Water Technology and Lowara brands provides pumps and boosting systems utilized within buildings, sourcing water from distribution networks or from wells. The third application is wastewater removal with sump and sewage pumps, provided by Bell & Gossett, Goulds Water Technology and Lowara. The fourth water-related building service area is fire protection, where our AC Fire brand supplies full pump systems for emergency fire suppression. Bell & Gossett, Goulds Water Technology and Lowara have continued to innovate, focusing on providing industry-leading energy-efficient pumps for the building services market; many of these products are more efficient than competitive devices. We believe our business is one of the largest players in this served market based on management estimates. In our Applied Water Segment, Building Services accounted for approximately 50% of our segment revenue in 2013 and 53% in 2012.

Industrial Water

Water is used in most industrial facilities to provide processing steps such as cooling, heating, cleaning and mixing. Our Goulds Water Technology brand supplies vertical multistage pumps to bring in source water or to boost pressure for purposes such as circulating water through a manufacturing facility to cool machine tools. Our Lowara brand focuses on industrial washing equipment and machine tool cooling. Our Standard Xchange brand delivers heat exchangers for combined heat and power applications within power generation plants. We also service niche applications such as flexible impeller pumps for wine processing facilities served by our Jabsco brand, and water-based detergent dispensing and water circulation within car washes served by Flojet and Goulds Water Technology air-operated diaphragm and end suction pumps. Our boosting pumps are also increasingly being used in hydraulic fracturing applications. Across all these various end applications, we believe our business is the second largest player in this served market based on management estimates. In our Applied Water Segment, Industrial Water accounted for approximately 43% of our segment revenue in 2013 and 40% in 2012.

Irrigation

The irrigation business consists of irrigation-related equipment and services associated with bringing water from a source to the plant or livestock need, including hoses, sprinklers, center pivot and drip irrigation. We focus on the pumps and boosting systems that supply this ancillary equipment with water. Our Goulds Water Technology brand brings mixed flow pumps, and our Flowtronex group specializes in equipment "packaged solutions" incorporating monitoring and controls to optimize energy efficiency in irrigation delivery. Our Lowara brand also produces pumps for agriculture applications and irrigation of gardens and parks. We believe we have a leading position in this served market based on management estimates. In our Applied Water Segment, Irrigation accounted for approximately 7% of our segment revenue in 2013 and 7% in 2012.

As described above, the following brands and products are used across the applications in our Applied Water segment:

Goulds Water Technology — With origins dating back more than 150 years, Goulds Water Technology is a leading brand of centrifugal and turbine pumps, controllers, variable frequency drives and accessories for residential and commercial water supply and wastewater applications. Goulds Water Technology is a leader in the water technologies market with its line of residential water well pumps. The Goulds Water Technology product portfolio includes submersible and line shaft turbine, 4” submersible, jet, sump, effluent, sewage and centrifugal pumps for residential, agriculture and irrigation, sewage and drainage, commercial and light industrial use. Goulds Water Technology has various vertical configuration high pressure centrifugal pumps which are utilized for water boost, filtration and boiler feed applications in industrial environments. Goulds Water Technology submersible, deepwell or other pumps can be found in more than a quarter of the existing 15 million household wells and more than 380,000 public and community wells in the United States. Products for commercial wastewater include sewage, effluent and grinder pumps and packages. Agriculture products include pump and control products for irrigation, stockwater, wash systems, cooling systems and waste management, with turf irrigation products, including submersible and surface pumps for landscape and turf irrigation systems. We serve the building trades market with filtration, chilling, pressure boost, wash system, water supply, wastewater and boiler feed applications. We also have a range of standard cast iron and bronze end-suction and multistage pumps for various commercial applications. During 2012, Goulds Water Technology products were installed to help protect the Ancient Sphinx and Pyramids in Giza, Egypt from rising ground water that was causing erosion to the soft limestone structures.

Lowara — Founded in 1968 in Vicenza, Italy, Lowara is a leader in stainless steel pump manufacturing technology for water technology applications. The Lowara range of products includes submersible, sump, effluent, sewage, centrifugal pumps and booster packages for water supply and water pumping needs in the residential, agriculture, industrial, public utility, building service and commercial markets worldwide, with particular strength in Europe. Residential applications include pumps for pressurization, conditioning, fire-fighting systems, lifting stations and dewatering. Agriculture applications include pumps for irrigation of gardens and parks. Industrial applications include drinking water, industrial washing equipment and machine tool cooling. The German water services company Erftverband implemented a comprehensive system of Lowara pumps and a Hydrovar speed control smart system to address complex water management needs in Korschenbroich and Kaarst, Germany during 2013.

Bell & Gossett — Founded in 1916 in Chicago, Illinois, Bell & Gossett ("B&G") is a leader in plumbing and water-based heating and air conditioning markets. Products are used in residential applications where single- or multi-family homes are heated with hot water or steam. Key products include circulating pumps, valves, and specialty products used in these systems. B&G also sells wastewater pumps for commercial and residential applications. In commercial applications, B&G provides a broad range of products, including a wide variety of pumps, heat exchangers, valves and controls for heating and air-conditioning systems, sump pumps for wastewater systems, condensate pumping systems for steam heating systems and a comprehensive line of energy-saving variable speed controls. Training is provided for building system design engineers at B&G’s industry renowned Little Red Schoolhouse in Morton Grove, Illinois which has educated more than 60,000 engineers. Key commercial building types include hospitals, schools, and data centers. B&G products are sold globally by independent manufacturer representatives and distributed locally by HVAC wholesalers. One of the most interesting installations of B&G products is at McMurdo Station in Antarctica. McMurdo is operated by the United States through the United States Antarctica Program, a branch of the National Science Foundation. This station includes more than 200 B&G pumps in various applications throughout the facility.

A-C Fire Pump — Allis-Chalmers Company ("A-C Fire Pump") was founded in the 1840s in Milwaukee, Wisconsin. It offers turnkey fire pump systems for commercial, residential and industrial applications. A-C Fire Pump designs and custom-builds a wide range of fire pump systems, including prefabricated packages and house units that meet every fire protection need. A-C Fire Pump products include In-Line Pumps, Vertical Turbine, Package Systems, Split Case (various series) and 13D Home Defender for residential fire pump service. The 13D Home Defender is designed to boost water pressure for automatic residential sprinkler systems. In addition to residential applications, turnkey fire pumping systems from A-C Fire Pump protect an increasing number of petrochemical facilities, commercial buildings and factories around the world. During 2013, A-C Fire Pump provided fire pump packages to CNOOC (Chinese National Offshore Oil Company) as part of a large project in China.

Flowtronex — Flowtronex, founded in 1974 as Pumping Systems, Inc., began by producing some of the golf industry's first prefabricated water pumping systems. The Silent Storm package and Pace Integrated Pump Controller are our two primary products sold into the golf market. In landscape, Flowtronex products, primarily the Floboy system, are sold to customers such as cities and nurseries. In golf, Flowtronex products are sold to golf course superintendents through our Toro Distribution partnership. Retrofit sales of golf pumping systems are sold through our FlowNet Service Network, a group of factory authorized service technicians that provide set up and start up, and service and repair of Flowtronex pump stations. Flowtronex has pumping systems operating in more than seventy countries around the world. In the United States alone, 78 of the Top 100 golf courses use Flowtronex golf irrigation pumping systems.

Standard Xchange — Since 1917, Standard Xchange has been the leader in the design and manufacture of shell and tube heat exchangers. Standard Xchange is the brand of our complete line of heat transfer products used in industrial and process applications such as heating or cooling liquids or gases, heat recovery in chemical processing, power and co-generation, paper and pulp, OEM and commercial marine markets. Products include basic shell-and-tube heat exchangers, air coolers, heat transfer coils, compact brazed, welded, gasketed plate units and packaged steam condensers. Standard Xchange heat exchangers provide cooling for many of the major turbine manufacturers in electrical power generation plants around the world.

Jabsco — The Jabsco brand is known for its marine, industrial, and hygienic/sanitary pumps and systems that are used in many industries, including marine, industrial, healthcare and food processing. It was founded in 1938 by the inventors of the flexible impeller pump. Jabsco is a leader in the leisure marine market, with a broad range of products including water system, engine cooling pumps, searchlights and marine waste systems. Jabsco also offers industrial pumps for hygienic applications, fluid transfer in chemical processing, laboratory, paint processing, plating, and construction. Jabsco rotary lobe pumps offer outstanding performance with unique capabilities. Jabsco Hy-line and Ultima rotary lobe pumps support food and dairy product production, healthcare, chemical, pharmaceutical and biotech applications, whether the product is thin, viscous or fragile. Jabsco also offers multi-purpose and specialized flexible impeller, diaphragm and sliding vane pumps for chemical and general transfer applications. Jabsco marine products can be found under the decks of millions of pleasure boats around the world.

Flojet — Established in 1975, the Flojet brand encompasses a broad range of small pumps, motors and dispensing pumps for the beverage, industrial, recreational vehicle, marine and food processing markets. Flojet is a leader in the small pump market, offering a versatile range of products serving the beverage market, including both air- and motor-operated diaphragm pumps and centrifugal chilling pumps, as well as booster systems and accumulator tanks. Flojet's beverage pumps can be found in applications such as beer dispensing, syrup mixing for carbonated drinks, re-circulation in vending machines and refrigerators, bottled water dispensers, icemakers and coffee machines. In addition to significant beverage applications, Flojet's electric and air-operated diaphragm pumps are utilized in street sweepers, car washes, carpet cleaners, parts washers, agricultural spraying and road rollers. Flojet's positive displacement diaphragm pumps can be driven by air, electric motor or solenoid. The positive displacement diaphragm design of Flojet pumps makes them ideal for use in conditions that require self-priming and dry running capability for short periods of time. Additionally, the compact size of these pumps makes them very useful in tight spaces where one cannot ensure a flooded suction. Flojet pumps are designed to be more efficient and are often the choice of customers for applications where low power consumption is critical. Xylem services many of the world's leading beverage producers and during 2013 secured a large contract that will require 22 Flojet beverage pumps per store for a large national restaurant chain.

Geographic Profile

In addition to the traditional markets of the United States and Europe, opportunities in emerging markets within Asia Pacific, Eastern Europe, Latin America and other countries are growing.

The table below illustrates the annual revenue and percentage of revenue by geographic area for each of the three years ended December 31, 2013.

	Revenue								
(in millions)	2013			2012			2011		
	$ Amount	% of Total		$ Amount	% of Total		$ Amount	% of Total	
United States	$1,434	38	%	$1,400	37	%	$1,363	36	%
Europe	1,387	36	%	1,338	35	%	1,422	37	%
Asia Pacific	467	12	%	469	12	%	426	11	%
Other	549	14	%	584	16	%	592	16	%
Total	$3,837			$3,791			$3,803		

Revenue derived from emerging markets comprised 19%, 20% and 19% of our revenue in 2013, 2012 and 2011, respectively.

The table below illustrates the property, plant & equipment and percentage of property, plant & equipment by geographic area for each of the three years ended December 31, 2013.

	Property, Plant & Equipment								
(in millions)	2013			2012			2011		
	$ Amount	% of Total		$ Amount	% of Total		$ Amount	% of Total	
United States	$186	38	%	$183	38	%	$178	38	%
Europe	225	46	%	219	45	%	209	45	%
Asia Pacific	45	9	%	65	13	%	57	12	%
Other	32	7	%	20	4	%	19	5	%
Total	$488			$487			$463		

Distribution, Training and End Use

Water Infrastructure provides the majority of its sales through direct channels with remaining sales through indirect channels and service capabilities. Both public utility and industrial facility customers increasingly require our teams' global but locally proficient expertise to use our equipment in their specific applications. Several trends are increasing the need for this application expertise: (i) the increase in type and amount of contaminants in water supply, (ii) increasing environmental regulations, (iii) the need to increase system efficiencies due to rising energy costs, and (iv) the retirement of a largely aging water industry workforce not systematically replaced at utilities.

In the Applied Water segment, many end-use areas are widely different, so specialized distribution partners are often preferred. Our commercial teams have built long-standing relationships around our brands in many of these industries through which we can continue to leverage new product and service applications. Revenue opportunities are balanced between OEM and after-market customers. Our products in the Applied Water segment are sold through our global direct sales and strong indirect channels with the majority of revenue going through indirect channels. We have long-standing relationships with the leading independent distributors in the markets we serve, and we provide incentives to distributors, such as specialized training programs, to sell our products exclusively.

Aftermarket Parts and Service
We have many service centers around the world which employ service employees to provide aftermarket parts and services to our customers. During their lifecycle, installed products require maintenance, repair services and parts due to the harsh environments in which they operate.
In addition, depending on the type of product, median lifecycles range from 5 years to over 50 years, at which time they must be replaced. Many of our products are precisely selected and applied within a larger network of equipment driving a strong preference by customers and installers to replace them with the same exact brand and model when they reach the end of their lifecycle. This dynamic establishes a large recurring revenue stream for our business.
Supply and Seasonality
We have a global manufacturing footprint, with production facilities in Europe, North America, Latin America, and Asia. In addition, we maintain a global network of service centers providing after-market customer care. Service centers offer an array of integrated service solutions for the industry including: preventive monitoring, contract maintenance, emergency field service, engineered upgrades, inventory management, and overhauls for pumps and other rotating equipment.
We offer a wide range of highly engineered products. We primarily employ configure-to-order capabilities to maximize manufacturing and logistics efficiencies by producing high volumes of basic product configurations. When we provide a configure-to-order solution, we configure a standard product to our customers' specifications. To a lesser extent, we provide engineer-to-order products to meet the customization requirements of our customers. This process requires that we apply our technical expertise and production capabilities to provide a non-standard solution to the customer.
Our inventory management and distribution practices seek to minimize inventory holding periods by taking delivery of the inventory and manufacturing immediately prior to the sale or distribution of products to our customers. All of our businesses require various parts and raw materials, of which the availability and prices may fluctuate. Parts and raw materials commonly used in our products include motors, fabricated parts, castings, bearings, seals, nickel, copper, aluminum, and plastics. While we may recover some cost increases through operational improvements, we are still exposed to some pricing risk. We attempt to control costs through fixed-priced contracts with suppliers and various other programs, such as our global strategic sourcing initiative.
Our business relies on third-party suppliers, contract manufacturing and commodity markets to secure raw materials, parts and components used in our products. We typically acquire materials and components through a combination of blanket and scheduled purchase orders to support our materials requirements. For most of our products, we have existing alternate sources of supply, or such sources are readily available.
We may experience price volatility or supply constraints for materials that are not available from multiple sources. From time to time, we acquire certain inventory in anticipation of supply constraints or enter into longer-term pricing commitments with vendors to improve the priority, price and availability of supply. There have been no raw material shortages that have had a significant adverse impact on our business as a whole.
Our Water Infrastructure and Applied Water segments experience some modest level of seasonality in its business. This seasonality is dependent on factors such as capital spending of customers as well as weather conditions, including heavy flooding, droughts and fluctuations in temperatures, which can positively or negatively impact portions of our business.

Customers

Our business is not dependent on any single customer or a few customers, the loss of which would have a material adverse effect on the applicable market or on the Company as a whole. No individual customer accounted for more than 10% of our consolidated 2013, 2012 or 2011 revenue.

Backlog

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 $707 million at

December 31, 2013 and $647 million at December 31, 2012. We anticipate that more than 90% of the backlog at December 31, 2013 will be recognized as revenue during 2014.

Competition

Given the highly fragmented nature of the water industry, Water Infrastructure competes with a large number of businesses. Competition in the water transport and treatment technologies markets focuses on product performance, application expertise, design, quality, delivery, and price. In the sale of products and services, we benefit from our large installed base of pumps and complementary products, which require maintenance, repair and replacement parts due to the nature of the products and the conditions under which they operate. Timeliness of delivery, quality and the proximity of service centers are important customer considerations when selecting a provider for after-market products and services as well as equipment rentals. In geographic regions where we are locally positioned to provide a quick response, customers have historically relied on us, rather than our competitors, for after-market products relating to our highly engineered and customized solutions. Our key competitors within the Water Infrastructure segment include KSB Inc., Sulzer Ltd., Evoqua Water Technologies (formerly Siemans AG) and Danaher Corporation.

Competition in the Applied Water segment focuses on brand names, application expertise, product delivery and performance, quality, and price. We compete by offering a wide variety of innovative and high-quality products, coupled with world-class application expertise. We believe our distribution through well-established channels and our reputation for quality significantly enhance our market position. Our ability to deliver innovative product offerings has allowed us to compete effectively, to cultivate and maintain customer relationships and to serve and expand into many niche and new markets. Our key competitors within the Applied Water segment include Grundfos, Wilo SE, Pentair Ltd. and Franklin Electric Co., Inc.

Research and Development

Research and development (“R&D”) is a key element of our engineering culture and is generally focused on the design and development of products and application know-how that anticipate customer needs and emerging trends. Our engineers are involved in new product development and improvement of existing products. Our businesses invest substantial resources for R&D. We anticipate we will continue to develop and invest in our R&D capabilities to promote a steady flow of innovative, high-quality and reliable products and applications to further strengthen our position in the markets we serve. We invested $104 million, $106 million, and $100 million for the years ended December 31, 2013, 2012 and 2011, respectively, towards R&D.

We have engineering and research employees in technology centers around the world. R&D activities are initially conducted in our technology centers, located in conjunction with some of our major manufacturing facilities to ensure an efficient development process. We have a wastewater Center of Excellence in Stockholm, Sweden, with research, development and engineering employees. We have Centers of Excellence in India and China, where we are accelerating the customization of our application expertise to local needs. In the scale-up process, our R&D activities are conducted at our piloting and testing facilities or at strategic customer sites. These piloting and testing facilities enable us to serve our strategic markets in each region of the world.

We generally seek patent protection for those inventions and improvements that we believe will improve our competitive position. We believe that our patents and applications are important for maintaining the competitive differentiation of our products and improving our return on research and development investments. While we own, control or license a significant number of patents, trade secrets, proprietary information, trademarks, trade names, copyrights, and other intellectual property rights which, in the aggregate, are of material importance to our business, management believes that our business, as a whole, as well as each of our core business segments, is not materially dependent on any one intellectual property right or related group of such rights.

Patents, patent applications, and license agreements expire or terminate over time by operation of law, in accordance with their terms or otherwise. As the portfolio of our patents, patent applications, and license agreements has evolved over time, we do not expect the expiration of any specific patent to have a material adverse effect on our financial position or results of operations.

Environmental Matters and Regulation

Our manufacturing operations worldwide are subject to many requirements under environmental laws. In the United States, the Environmental Protection Agency and similar state agencies administer laws and regulations concerning air emissions, water discharges, waste disposal, environmental remediation, and other aspects of environmental protection. Such environmental laws and regulations in the United States include, for example, the Federal Clean Air Act, the Clean Water Act, the Resource, Conservation and Recovery Act, and the Comprehensive Environmental Response, Compensation and Liability Act. Environmental requirements significantly affect our operations. We have established an internal program to address compliance with applicable environmental requirements and, as a result, management believes that we are in substantial compliance with current environmental regulations.

While environmental laws and regulations are subject to change, such changes can be difficult to predict reliably and the timing of potential changes is uncertain. Management does not believe, based on current circumstances, that compliance costs pursuant to such regulations will have a material adverse effect on our financial position or results of operations. However, the effect of future legislative or regulatory changes could be material to our financial condition or results of operations.

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. It can be difficult to estimate reliably the final costs of investigation and remediation due to various factors. 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 based upon the facts and circumstances as currently known to us. 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 do not anticipate these liabilities will have a material adverse effect on our consolidated and combined financial position or results of operations. We cannot make assurances that other sites, or new details about sites known to us, that could give rise to environmental liabilities with such material adverse effects on us will not be identified in the future. At December 31, 2013, we had estimated and accrued $8 million related to environmental matters.

Employees

As of December 31, 2013, Xylem had more than 12,500 employees worldwide. We have over 3,700 employees in the United States, of whom approximately 17% are represented by labor unions, and in certain foreign countries some of our employees are represented by work councils. We believe that our facilities are in favorable labor markets with ready access to adequate numbers of workers and believe our relations with our employees are good.

Available Information

Xylem’s website address is www.xyleminc.com. We make available free of charge on or through www.investors.xyleminc.com our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Information contained on our website is not incorporated by reference unless specifically stated therein.

In addition, the public may read or copy any materials filed with the SEC at the SEC’s Public Reference Room located at 100 F Street NE, Washington, D.C. 20549. The public may also obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. These reports and other information are also available, free of charge, at www.sec.gov.

ITEM 1A. RISK FACTORS

In evaluating our business, each of the following risks should be carefully considered, along with all of the other information in this Report and in our other filings with the SEC. Should any of these risks and uncertainties develop into actual events, our business, financial condition or results of operations could be materially and adversely affected.

Risks Related to Operational and External Factors

Failure to compete successfully in our markets could adversely affect our business.

We provide products and services into competitive markets. We believe the principal points of competition in our markets are product performance, reliability and innovation, application expertise, brand reputation, energy efficiency, product life cycle cost, timeliness of delivery, proximity of service centers, effectiveness of our distribution channels and price. Maintaining and improving our competitive position will require continued investment by us in manufacturing, research and development, engineering, marketing, customer service and support, and our distribution networks. We may not be successful in maintaining our competitive position. Our competitors may develop products that are superior to our products, or may develop more efficient or effective methods of providing products and services or may adapt more quickly than we do to new technologies or evolving customer requirements. Pricing pressures also could cause us to adjust the prices of certain products to stay competitive. We may not be able to compete successfully with our existing or new competitors. Failure to continue competing successfully or to win large contracts could adversely affect our business, financial condition or results of operations.

Our results of operations and financial condition may be adversely affected by global economic and financial market conditions.

We compete around the world in various geographic and product markets. In 2013, 38% and 36% of our total revenue was from customers located in the United States and Europe, respectively. We expect revenue from these markets to be significant for the foreseeable future. Important factors impacting our businesses include the overall strength of these economies and our customers' confidence in both local and global macro-economic conditions; industrial and federal, state, local and municipal governmental spending; the strength of the residential and commercial real estate markets; interest rates; availability of commercial financing for our customers and end-users; and unemployment rates. A slowdown or downturn in these financial or macro-economic conditions could have a significant adverse effect on our business, financial condition and results of operations.

Economic and other risks associated with international sales and operations could adversely affect our business.

In 2013, 62% of our total revenue was from customers outside the United States. We expect our international operations and export sales to continue to be a significant portion of our revenue. Both our sales from international operations and export sales are subject in varying degrees to risks inherent to doing business outside the United States. These risks include the following:

- possibility of unfavorable circumstances arising from host country laws or regulations;
- currency exchange rate fluctuations and restrictions on currency repatriation;
- potential negative consequences from changes to taxation policies;
- disruption of operations from labor and political disturbances;
- changes in tariff and trade barriers and import and export licensing requirements; and
- insurrection or war.

Any payment of distributions, loans or advances to us by our foreign subsidiaries could be subject to restrictions on, or taxation of, dividends on repatriation of earnings under applicable local law, monetary transfer restrictions and foreign currency exchange regulations in the jurisdictions in which our subsidiaries operate. In addition to the general risks that we face outside the United States, we now conduct more of our operations in emerging markets than we have in the past, which could involve additional uncertainties for us, including risks that governments may impose limitations on our ability to repatriate funds; governments may impose withholding or other taxes on remittances and other payments to us, or the amount of any such taxes may increase; an outbreak or escalation of any insurrection or armed conflict may occur; governments may seek to nationalize our assets; or governments may impose or increase investment barriers or other restrictions affecting our business. In addition, emerging markets pose other uncertainties, including the protection of our intellectual property and other assets, pressure on the pricing of our products, higher business conduct risks, less qualified talent and risks of political instability. We cannot predict the impact such future, largely unforeseeable events might have on our business, financial condition and results of operations.

Our business could be adversely affected by the inability of suppliers to meet delivery requirements.

Our business relies on third-party suppliers, contract manufacturing and commodity markets to secure raw materials, parts and components used in our products. Parts and raw materials commonly used in our products include motors, fabricated parts, castings, bearings, seals, nickel, copper, aluminum, and plastics. We are exposed to the availability of these materials, which may be subject to curtailment or change due to, among other things, interruptions in production by suppliers, labor disputes, the impaired financial condition of a particular supplier, suppliers' allocations to other purchasers, changes in exchange rates and prevailing price levels, ability to meet regulatory requirements, weather emergencies or acts of war or terrorism. Any delay in our suppliers' abilities to provide us with necessary materials could impair our ability to deliver products to our customers and, accordingly, could have a material adverse effect on our business, financial condition or results of operations.

Our business could be adversely affected by significant movements in foreign currency exchange rates.

We are exposed to fluctuations in foreign currency exchange rates, particularly with respect to the Euro, Swedish Krona, British Pound, Australian Dollar, Canadian Dollar, Polish Zloty, and Hungarian Forint. Any significant change in the value of currencies of the countries in which we do business relative to the value of the U.S. Dollar or Euro could affect our ability to sell products competitively and control our cost structure, which could have a material adverse effect on our business, financial condition and results of operations.

Weather conditions may adversely affect our financial results.

Weather conditions, including heavy flooding, droughts and fluctuations in temperatures, can positively or negatively impact portions of our business. Within the dewatering space, our pumps provided through our Godwin brand are used to remove excess or unwanted water. Heavy flooding due to weather conditions drives increased demand for these applications. On the other hand, drought conditions drive higher demand for pumps used in agricultural and turf irrigation applications, such as those provided by our Goulds Water Technology, Flowtronex and Lowara brands. Fluctuations to warmer and cooler temperatures result in varying levels of demand for products used in residential and commercial applications where homes and buildings are heated and cooled with HVAC units such as those provided by our B&G brand. Given the unpredictable nature of weather conditions, this may result in volatility for certain portions of our business, as well as the operations of certain of our customers and suppliers.

Our financial results can be difficult to predict.

Our business is impacted by an increasing amount of short cycle, and book and bill business, which we have limited insight into, particularly for the business that we transact through our distributors. We are also impacted by large projects, whose timing can change based upon customer requirements due to a number of factors affecting the project, such as funding, readiness of the project and regulatory approvals. Accordingly, our financial results for any given period can be difficult to predict.

Our strategy includes acquisitions, and we may not be able to make acquisitions of suitable candidates or integrate acquisitions successfully.

Our historical growth has included acquisitions. As part of our growth strategy, we plan to pursue the acquisition of other companies, assets and product lines that either complement or expand our existing business. We cannot make assurances, however, that we will be able to identify suitable candidates successfully, negotiate appropriate acquisition terms, obtain financing that may be needed to consummate those acquisitions, complete proposed acquisitions, successfully integrate acquired businesses into our existing operations or expand into new markets. In addition, we cannot make assurances that any acquisition, once successfully integrated, will perform as planned, be accretive to earnings, or prove to be beneficial to our operations or cash flow.

Acquisitions involve a number of risks and present financial, managerial and operational challenges, including: diversion of management attention from existing businesses and operations; integration of technology, operations personnel, and financial and other systems; potentially insufficient internal controls over financial activities or

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financial reporting at an acquired entity that could impact us on a combined basis; the failure to realize expected synergies; the possibility that we have acquired substantial undisclosed liabilities; and the loss of key employees of the acquired businesses.

We may incur impairment charges for our goodwill and other indefinite-lived intangible assets which would negatively impact our operating results.

We have a significant amount of goodwill and purchased intangible assets on our balance sheet as a result of acquisitions we have completed. As of December 31, 2013, the net carrying value of our goodwill and other indefinite-lived intangible assets totaled approximately $2 billion. The carrying value of goodwill represents the fair value of an acquired business in excess of identifiable assets and liabilities as of the acquisition date. The carrying value of indefinite-lived intangible assets represents the fair value of trademarks and trade names as of the acquisition date. We do not amortize goodwill and indefinite-lived intangible assets that we expect to contribute indefinitely to our cash flows, but instead we evaluate these assets for impairment at least annually, or more frequently if interim indicators suggest that a potential impairment could exist. In testing for impairment, we will make a qualitative assessment, and if we believe that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the quantitative two-step goodwill impairment test is required. Significant negative industry or economic trends, disruptions to our business, inability to effectively integrate acquired businesses, unexpected significant changes or planned changes in use of the assets, divestitures and market capitalization declines may impair our goodwill and other indefinite-lived intangible assets. Any charges relating to such impairments could adversely affect our results of operations and financial condition in the periods recognized.

Our ability to successfully execute our organizational redesign as well as other restructuring and realignment actions could impact our business results.

We initiated an organizational redesign during the fourth quarter of 2013, shifting from individually managed businesses to an integrated approach within geographical regions. We expect that this will enable us to leverage the breadth of the Company's product and services portfolio to better serve our customers and address market opportunities as well as effectively utilize internal support organizations to realize economies of scale and efficient use of resources. The successful implementation and execution of this redesign, which is still in the process of being implemented, as well as our other restructuring and realignment actions, is critical to achieving our expected cost savings as well as effectively competing in the marketplace. Other factors that may impede a successful implementation is retention of key employees, the impact of regulatory matters, and adverse economic market conditions. If the organizational redesign or restructuring and realignment actions are not executed successfully, the Company's financial results could be adversely impacted.

Changes in our effective tax rates may adversely affect our financial results.

We sell our products in more than 150 countries and 62% of our revenue was generated outside the United States in 2013. Given the global nature of our business, a number of factors may increase our future effective tax rates, including:

- our decision to repatriate non-U.S. earnings for which we have not previously provided for U.S. taxes;
- the jurisdictions in which profits are determined to be earned and taxed;
- sustainability of historical income tax rates in the jurisdictions in which we conduct business;
- the resolution of issues arising from tax audits with various tax authorities; and
- changes in the valuation of our deferred tax assets and liabilities, and changes in deferred tax valuation allowances.

Any significant increase in our future effective tax rates could reduce net income for future periods.

Our business could be adversely affected by inflation and other manufacturing and operating cost increases.

Our operating costs are subject to fluctuations, particularly due to changes in commodity prices, raw materials, energy and related utilities, freight, and cost of labor. In order to remain competitive, we may not be able to recuperate all or a portion of these higher costs from our customers through product price increases. Further, our ability to realize financial benefits from Six Sigma and Lean projects may not be able to mitigate fully or in part these manufacturing and operating cost increases and, as a result, could negatively impact our profitability.

Product defects and unanticipated use or inadequate disclosure with respect to our products could adversely affect our business, reputation and financial statements.

Manufacturing or design defects in (including in products or components that we source from third parties), unanticipated use of, or inadequate disclosure of risks relating to the use of products that we make or sell can lead to personal injury, death or property damage. These events could lead to recalls or safety alerts relating to our products, result in the removal of a product from the market and result in product liability claims being brought against us. Although we have liability insurance, we cannot be certain that this insurance coverage will continue to be available to us at a reasonable cost or will be adequate to cover any product liability claims. Recalls, removals and product liability claims can result in significant costs, as well as negative publicity and damage to our reputation that could reduce demand for our products.

Our indebtedness may affect our business and may restrict our operational flexibility.

As of December 31, 2013, our total outstanding indebtedness was $1,241 million including our 3.55% Senior Notes of $600 million aggregate principal amount due September 2016 and 4.875% Senior Notes of $600 million aggregate principal amount due October 2021. We have an existing Four Year Competitive Advance and Revolving Credit Facility (the “Credit Facility”), which provides for an aggregate principal amount of up to $600 million. We have 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 $165 million).

Our indebtedness could:

- increase our vulnerability to general adverse economic and industry conditions;
- limit our ability to obtain additional financing or borrow additional funds;
- limit our ability to pay future dividends;
- limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- require that a substantial portion of our cash flow from operations be used for the payment of interest on our indebtedness instead of funding working capital, capital expenditures, acquisitions or other general corporate purposes; and
- increase the amount of interest expense that we must pay because some of our borrowings are at variable interest rates, which, as interest rates increase, would result in higher interest expense.

In addition, there can be no assurance that future borrowings or equity financing will be available to us on favorable terms or at all for the payment or refinancing of our indebtedness. If we incur additional debt or raise equity through the issuance of preferred stock, the terms of the debt or preferred stock issued may give the holders rights, preferences and privileges senior to those of holders of our common stock, particularly in the event of liquidation. The terms of the debt may also impose additional and more stringent restrictions on our operations than we currently have. Also, regardless of the terms of our debt or equity financing, the amount of our stock that we can issue may be limited because the issuance of our stock may cause the distribution to be a taxable event for ITT under Section 355(e) of the Internal Revenue Code of 1986, as amended (the “Code”), and under the Tax Matters Agreement entered into by ITT in connection with the Spin-off (the “Tax Matters Agreement”), we could be required to indemnify ITT for that tax.

Our ability to make scheduled principal payments of, to pay interest on, or to refinance our indebtedness and to satisfy our other debt obligations will depend on our future operating performance, which may be affected by factors beyond our control. If we are unable to service our indebtedness, our business, financial condition and results of operations would be materially adversely affected.

Failure to comply with the U.S. Foreign Corrupt Practices Act or other applicable anti-corruption legislation could result in fines, criminal penalties and an adverse effect on our business.

We operate in a number of countries throughout the world, including countries considered to have a high risk of corruption. We are committed to doing business in accordance with applicable anti-corruption laws. We are subject, however, to the risk that we or our affiliated entities or our representatives or their respective officers, directors, employees and agents, may take action determined to be in violation of such anti-corruption laws or regulations, including the U.S. Foreign Corrupt Practices Act of 1977, the U.K. Bribery Act of 2010 and others. Any such violation could result in substantial fines, sanctions, civil and/or criminal penalties, and curtailment of operations in certain jurisdictions, and might adversely affect our business, results of operations or financial condition. In addition, actual or alleged violations could damage our reputation and ability to do business. Furthermore, detecting, investigating, and resolving actual or alleged violations is expensive and can consume significant time and attention of our senior management.

We may be negatively impacted by litigation and regulatory proceedings.

We are subject to laws, regulations and potential liability relating to claims, complaints and proceedings, including those related to antitrust, environmental, product, and other matters.

We are subject to various laws, ordinances, regulations and other requirements of government authorities in foreign countries and in the United States, any violation of which could potentially create substantial liability for us and also damage to our reputation. Changes in laws, ordinances, regulations or other government policies, the nature, timing, and effect of which are uncertain, may significantly increase our expenses and liabilities.

From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses, including acquisitions and divestitures. Some of these proceedings seek remedies relating to environmental matters, intellectual property matters, product liability and personal injury claims, employment, labor and pension matters, and government and commercial or contract issues, sometimes related to acquisitions or divestitures. We may become subject to significant claims of which we are currently unaware, or the claims of which we are aware may result in our incurring a significantly greater liability than we anticipate or can estimate. Additionally, we may receive fines or penalties or be required to change or cease operations at one or more facilities if a regulatory agency determines that we have failed to comply with laws, regulations or orders applicable to our business.

Our business could be adversely affected by interruptions in information technology, communications networks and operations.

Our business operations rely on information technology and communications networks, and operations that are vulnerable to damage or disturbance from a variety of sources. Regardless of protection measures, essentially all systems are susceptible to disruption due to failure, vandalism, computer viruses, security breaches, natural disasters, power outages and other events. In addition, cybersecurity threats are evolving and include, among others, malicious software, attempts to gain unauthorized access to data, and other electronic security breaches that could lead to disruptions in our systems, unauthorized release of confidential or otherwise protected information and corruption of data. We also have a concentration of operations on certain sites, e.g. production and shared services centers, where business interruptions could cause material damage and costs. Transport of goods from suppliers, and to customers, could also be hampered for the reasons stated above. Although we continue to assess these risks, implement controls, and perform business continuity planning, we cannot be sure that interruptions with material adverse effects will not occur.

Failure to retain our existing senior management, engineering, sales and other key personnel or the inability to attract and retain new qualified personnel could negatively impact our ability to operate or grow our business.

Our success will continue to depend to a significant extent on our ability to retain or attract a significant number of employees in senior management, engineering, sales and other key personnel. The ability to attract or retain employees will depend on our ability to offer competitive compensation, training and cultural benefits. We will need to continue to develop a roster of qualified talent to support business growth and replace departing employees. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution. A failure to retain or attract highly skilled personnel could adversely affect our operating results or ability to operate or grow our business.

If we do not or cannot adequately protect our intellectual property, if third parties infringe our intellectual property rights, or if third parties claim that we are infringing or misappropriating their intellectual property rights, we may suffer competitive injury, expend significant resources enforcing our rights or defending against such claims, or be prevented from selling products or services.

We own numerous patents, trademarks, copyrights, trade secrets and other intellectual property and licenses to intellectual property owned by others, which in aggregate are important to our business. The intellectual property rights that we obtain, however, may not provide us with a significant competitive advantage because they may not be sufficiently broad or may be challenged, invalidated, circumvented, independently developed, or designed-around, particularly in countries where intellectual property rights laws are not highly developed or protected. Our failure to obtain or maintain intellectual property rights that convey competitive advantage, adequately protect our intellectual property or detect or prevent circumvention or unauthorized use of such property and the cost of enforcing our intellectual property rights could adversely impact our business, financial condition and results of operations.

From time to time, we receive notices from third parties alleging intellectual property infringement or misappropriation. Any dispute or litigation regarding intellectual property could be costly and time-consuming due to the complexity and the uncertainty of intellectual property litigation. Our intellectual property portfolio may not be useful in asserting a counterclaim, or negotiating a license, in response to a claim of infringement or misappropriation. In addition, as a result of such claims of infringement or misappropriation, we could lose our rights to critical technology, be unable to license critical technology or sell critical products and services, be required to pay substantial damages or license fees with respect to the infringed rights or be required to redesign our products at substantial cost, any of which could adversely impact our competitive position and financial statements. Even if we successfully defend against claims of infringement or misappropriation, we may incur significant costs and diversion of management attention and resources, which could adversely affect our business, financial condition and results of operations.

We cannot make assurances that we will pay dividends on our common stock or continue to repurchase our common stock under Board approved share repurchase plans, and likewise our indebtedness could limit our ability to pay dividends or make share repurchases.

The timing, declaration, amount and payment of future dividends to our shareholders fall within the discretion of our Board of Directors and will depend on many factors, including our financial condition, results of operations and capital requirements, as well as applicable law, regulatory constraints, industry practice and other business considerations that our Board of Directors considers relevant. There can be no assurance that we will pay a dividend in the future or continue to pay dividends.

Further, the timing and amount of the repurchase of our common stock under Board approved share repurchase plans has similar dependencies as the payment of dividends and accordingly, there can be no assurances that we will continue to repurchase our common stock.

Additionally, if we cannot generate sufficient cash flow from operations to meet our debt-payment obligations, then our ability to pay dividends, if so determined by the Board of Directors, or make share repurchases will be impaired and we may be required to attempt to restructure or refinance our debt, raise additional capital or take other actions such as selling assets, reducing or delaying capital expenditures, reducing our dividend or delaying or curtailing share repurchases. There can be no assurance, however, that any such actions could be effected on satisfactory terms, if at all, or would be permitted by the terms of our debt or our other credit and contractual arrangements.

The level of returns on postretirement benefit plan assets, changes in interest rates and other factors could affect our earnings and cash flows in future periods.

Certain members of our current and retired employee population are covered by pension and other employee-related defined benefit plans (collectively, postretirement benefit plans). We may experience significant fluctuations in costs related to our postretirement benefit plans as a result of macro-economic factors, such as interest rates, that are beyond our control. The cost of our postretirement plans is incurred over long periods of time and involves factors and uncertainties during those periods which can be volatile and unpredictable, including rates of return on postretirement benefit plan assets, discount rates used to calculate liabilities and expenses and rates of future compensation increases.

Management develops each assumption using relevant plan and Company experience and expectations in conjunction with market-related data. Our liquidity, financial position (including shareholders' equity) and results of operations could be materially affected by significant changes in key economic indicators, actuarial experience, financial market volatility, future legislation and other governmental regulatory actions.

We make contributions to fund our postretirement benefit plans when considered necessary or advantageous to do so. The macro-economic factors discussed above, including the return on postretirement benefit plan assets and the minimum funding requirements established by local government funding or taxing authorities, or established by other agreement, may influence future funding requirements. A significant decline in the fair value of our plan assets, or other adverse changes to our overall pension and other employee-related benefit plans, could require us to make significant funding contributions and affect cash flows in future periods.

Unforeseen environmental issues could impact our financial position or results of operations.

Our operations are subject to and affected by many federal, state, local and foreign environmental laws and regulations. In addition, we could be affected by future environmental laws or regulations, including, for example, those imposed in response to climate change concerns. Compliance with current and future environmental laws and regulations currently requires and is expected to continue to require operating and capital expenditures. Environmental laws and regulations may authorize substantial fines and criminal sanctions as well as facility shutdowns to address violations, and may require the installation of costly pollution control equipment or operational changes to limit emissions or discharges. We also incur, and expect to continue to incur, costs to comply with current environmental laws and regulations.

Developments such as the adoption of new environmental laws and regulations, stricter enforcement of existing laws and regulations, violations by us of such laws and regulations, discovery of previously unknown or more extensive contamination, litigation involving environmental impacts, our inability to recover costs associated with any such developments, or financial insolvency of other responsible parties could in the future have a material adverse effect on our financial position and results of operations.

The market price of our common stock may fluctuate significantly.

We cannot predict the prices at which our common stock may trade. The market price of our common stock may fluctuate widely, depending on many factors, some of which may be beyond our control, including:

- actual or anticipated fluctuations in our operating results due to factors related to our business;
- success or failure of our business strategy;
- our quarterly or annual earnings, or those of other companies in our industry;
- our ability to obtain financing as needed;
- announcements by us or our competitors of significant new business awards;
- announcements by us or our competitors of significant acquisitions or dispositions;
- changes in accounting standards, policies, guidance, interpretations or principles;
- changes in earnings estimates by securities analysts or our ability to meet those estimates;
- the operating and stock price performance of other comparable companies;
- natural or environmental disasters that investors believe may affect us;
- overall market fluctuations;
- fluctuations in the budgets of federal, state and local governmental entities around the world;
- results from any material litigation or government investigation;
- changes in laws and regulations affecting our business; and
- general economic conditions and other external factors.

Stock markets in general have experienced volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations could adversely affect the trading price of our common stock.
Anti-takeover provisions in our organizational documents and Indiana law could delay or prevent a change in control.
Certain provisions of our second amended and restated articles of incorporation and our amended and restated by-laws may delay or prevent a merger or acquisition part or all of our business operations. For example, the second amended and restated articles of incorporation and the amended and restated by-laws, among other things, require advance notice for shareholder proposals and nominations, do not permit shareholders to convene special meetings and do not permit action by written consent of the shareholders, unless unanimous. In addition, the amended and restated articles of incorporation authorize our Board of Directors to issue one or more series of preferred stock. These provisions may also discourage acquisition proposals of our business operations or delay or prevent a change in control, which could harm our stock price. Indiana law also imposes some restrictions on mergers and other business combinations between any holder of 10% or more of our outstanding common stock and us.
Risks Related to our 2011 Separation from ITT Corporation
If the Spin-off were to fail to qualify as a tax-free transaction under the Internal Revenue Code, then we and/or our former parent and our stockholders could be subject to significant tax liability.
In connection with the Spin-off, we and our former parent, ITT Corporation, received an IRS ruling (the "IRS Ruling") stating that ITT and its shareholders will not recognize any taxable income, gain or loss for U.S. Federal income tax purposes as a result of the Spin-off. In addition, ITT received an opinion of tax counsel as to the satisfaction of certain requirements necessary for the Spin-off to receive tax-free treatment upon which the IRS did not rule. The IRS Ruling, while generally binding upon the IRS, was based on certain factual statements and representations. If any such factual statements or representations were incomplete or untrue in any material respect, or if the facts on which the IRS Ruling were based were materially different from the facts at the time of the Spin-off, the IRS could modify or revoke the IRS Ruling retroactively.
As discussed above, certain requirements for tax-free treatment that are not covered in the IRS Ruling were addressed in the opinion of counsel. The opinion of counsel is not binding on the IRS. Accordingly, the IRS may reach conclusions with respect to the Spin-off that are different from the conclusions reached in the opinion. Like the IRS Ruling, the opinion was based on certain factual statements and representations, which, if incomplete or untrue in any material respect, could alter counsel's conclusions.
If all or a portion of the Spin-off does not qualify as a tax-free transaction because any of the factual statements or representations in the IRS Ruling or the legal opinion are incomplete or untrue, or because the facts upon which the IRS Ruling is based were materially different from the facts at the time of the Spin-off, ITT would recognize a substantial gain for U.S. Federal income tax purposes. In such case, under U.S. Treasury regulations each member of the ITT consolidated group at the time of the Spin-off (including us and our subsidiaries), would be jointly and severally liable for the entire amount of any resulting U.S. Federal income tax liability.
Notwithstanding the foregoing, the Spin-off will be taxable to ITT (but not to ITT shareholders) pursuant to Section 355(e) of the Internal Revenue Code if there are one or more acquisitions (including issuances) of the stock of either us or ITT, representing 50% or more, measured by vote or value, of the then-outstanding stock of either corporation and the acquisition or acquisitions are deemed to be part of a plan or series of related transactions that include the Spin-off. Any acquisition of our common stock within two years before or after the Spin-off (with exceptions, including public trading by less-than-5% shareholders and certain compensatory stock issuances) generally will be presumed to be part of such a plan unless that presumption is rebutted. The tax liability resulting from the application of Section 355(e) would be substantial. In addition, under U.S. Treasury regulations, each member of the ITT consolidated group at the time of the Spin-off (including us and our subsidiaries) would be severally liable for the resulting U.S. Federal income tax liability.
We have agreed not to enter into any transaction that could cause any portion of the Spin-off to be taxable to ITT, including under Section 355(e). Pursuant to the Tax Matters Agreement, dated as of October 25, 2011 among ITT, Exelis and Xylem, we have also agreed to indemnify ITT and Exelis for any tax liabilities resulting from such transactions, and ITT and Exelis have agreed to indemnify us for any tax liabilities resulting from such transactions

entered into by ITT or Exelis. These obligations may discourage, delay or prevent a change of control of our Company.

The Spin-off may expose us to potential liabilities arising out of state and federal fraudulent conveyance laws and legal distribution requirements.

The Spin-off could be challenged under various state and federal fraudulent conveyance laws. An unpaid creditor or an entity vested with the power of such creditor (such as a trustee or debtor-in-possession in a bankruptcy) could claim that the Spin-off left us, ITT and/or Exelis insolvent or with unreasonably small capital or that we, ITT and/or Exelis intended or believed it would incur debts beyond its ability to pay as they mature and that ITT did not receive fair consideration or reasonably equivalent value in the Spin-off. If a court were to agree with such a plaintiff, then such court could void the Spin-off as a fraudulent transfer and could impose a number of different remedies, which could adversely affect our financial condition and our results of operations. Among other things, the court could require the return of assets or our shares to ITT, voiding the liens of Xylem and claims against ITT, or providing ITT with a claim for money damages against us.

The measure of insolvency for purposes of the fraudulent conveyance laws will vary depending on which jurisdiction's law is applied. Generally, however, an entity would be considered insolvent if either the fair saleable value of its assets is less than the amount of its liabilities (including the probable amount of contingent liabilities), or it is unlikely to be able to pay its liabilities as they become due. No assurance can be given as to what standard a court would apply to determine insolvency or that a court would determine that we, ITT or Exelis were solvent at the time of or after giving effect to the Spin-off.

The Spin-off could also be challenged under state corporate distribution statutes. Under the Indiana Business Corporation Law, a corporation may not make distributions to its shareholders if, after giving effect to the distribution, (i) the corporation would not be able to pay its debts as they become due in the usual course of business; or (ii) the corporation's total assets would be less than the sum of its total liabilities. No assurance can be given that a court will not later determine that the distribution of our shares in connection with the Spin-off was unlawful.

Under the Distribution Agreement, from and after the Spin-off, we will be responsible for the debts, liabilities and other obligations related to the business or businesses which we own and operate following the consummation of the Spin-off. Although we do not expect to be liable for any of these or other obligations not expressly assumed by us pursuant to the Distribution Agreement, it is possible that we could be required to assume responsibility for certain obligations retained by ITT or Exelis should ITT or Exelis fail to pay or perform its retained obligations (for example, tax, asbestos and/or environmental liabilities).

In connection with our separation, ITT and Exelis will indemnify us for certain liabilities and we will indemnify ITT or Exelis for certain liabilities. If we are required to indemnify ITT or Exelis, we may need to divert cash to meet those obligations and our financial results could be negatively impacted. In the case of ITT's or Exelis's indemnity, there can be no assurance that those indemnities will be sufficient to insure us against the full amount of such liabilities, or as to ITT's or Exelis's ability to satisfy its indemnification obligations in the future.

Pursuant to the Distribution Agreement and certain other agreements with ITT and Exelis, ITT and Exelis agreed to indemnify us from certain liabilities, and we agreed to indemnify ITT and Exelis for certain liabilities. Indemnities that we may be required to provide ITT and Exelis may be significant and could negatively impact our business, particularly indemnities relating to our actions that could impact the tax-free nature of the Spin-off. Third parties could also seek to hold us responsible for any of the liabilities that ITT or Exelis has agreed to retain. Further, there can be no assurance that the indemnities from ITT and Exelis will be sufficient to protect us against the full amount of such liabilities, or that ITT and Exelis will be able to fully satisfy their indemnification obligations. Moreover, even if we ultimately were to succeed in recovering from ITT and Exelis any amounts for which we are held liable, we may be temporarily required to bear these losses ourselves. Each of these risks could negatively affect our business, results of operations and financial condition.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES

We have more than 350 locations in more than 40 countries. These properties total approximately 10.4 million square feet, of which more than 300 locations, or approximately 6.0 million square feet, are leased. We consider the many offices, plants, warehouses, and other properties that we own or lease to be in good condition and generally suitable for the purposes for which they are used. The following table shows the significant locations by segment.

Location	State or Country	Principal Business Activity	Approx. Square Feet	Owned or Expiration Date of Lease
Water Infrastructure				
Emmaboda	Sweden	Administration and Manufacturing	1,156,000	Owned
Stockholm	Sweden	Administration and Research & Development	172,000	2019
Shenyang	China	Manufacturing	125,000	Owned
Yellow Springs	OH	Administration and Manufacturing	108,000	Owned
Applied Water				
Morton Grove	IL	Administration and Manufacturing	530,000	Owned
Montecchio	Italy	Administration and Manufacturing	379,000	Owned
Nanjing	China	Manufacturing	363,000	Owned
Auburn	NY	Manufacturing	273,000	Owned
Lubbock	TX	Manufacturing	229,000	Owned
Cheektowaga	NY	Manufacturing	145,000	Owned
Corporate Headquarters				
Rye Brook	NY	Administration	67,000	2023

In December 2013, we completed the move of our corporate headquarters to 1 International Drive, Rye Brook, NY. The new headquarters consists of approximately 67,000 square feet of office space for a lease period ending in December 2023.

ITEM 3. LEGAL PROCEEDINGS

From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses, including acquisitions and divestitures, environmental matters, intellectual property matters, product liability and personal injury claims, employment and pension matters, government and commercial contract disputes. Although we cannot predict the outcome of these and other proceedings, including the cases below, with certainty, we believe that they will not have a material adverse effect on our consolidated financial position and results of operations.

On or about February 17, 2009, following a statement submitted to the Spanish Competition Authority (Comision Nacional de la Competencia, "CNC") by Grupo Industrial Ercole Marelli, S.A. regarding an anti-competitive agreement in which it said it had been participating, the CNC conducted an investigation at ITT Water & Wastewater España S.A. (now named Xylem Water Solutions España S.A.), at the Spanish Association of Fluid Pump Manufacturers (the "Association"), and at the offices of other members of the Association. On September 16, 2009, the Directorate of Investigation of the CNC commenced formal proceedings for alleged restrictive practices, such as several exchanges of information and a recommendation on general terms and conditions of sale, allegedly prohibited under applicable law. Following the conclusion of the formal proceedings, the CNC Council imposed fines on the Association and nineteen Spanish manufacturers and distributors of fluid pumps, including a fine of Euro 2,373,675 applied to ITT Water & Wastewater España S.A. and ITT Corporation. In March 2012, the Company appealed the CNC's decision to the Audiencia Nacional (the "High Court"), and vigorously defended the case. In March 2013, the High Court upheld the determination of the CNC and the fine previously assessed. In April 2013, the Company filed a notice of appeal before the Tribunal Supremo, the Supreme Court of Spain and in June 2013, the Company filed an appellate brief with the Supreme Court, which was admitted. These appellate proceedings are expected to last one to two years.

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. Pursant to the settelment agreement, both parties

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released each other from all extisting claims, and all claims have been dismissed by the U.S. District Court for the Northern District of Georgia with prejudice.

ITEM 4. MINE SAFETY DISCLOSURES

None.

EXECUTIVE OFFICERS OF THE REGISTRANT

The following information is provided regarding the executive officers of Xylem:

NAME	AGE	CURRENT TITLE	OTHER BUSINESS EXPERIENCE DURING PAST 5 YEARS
Steven R. Loranger	61	President and Chief Executive Officer (2013)	• Chairman Emeritus of Xylem Inc. Board of Directors (2011) • Chairman, President and Chief Executive Officer, ITT Corporation (2004)
Michael T. Speetzen	44	Senior VP and Chief Financial Officer (2011)	• VP of Finance, ITT Fluid and Motion Control (2009)
Christopher R. McIntire	50	Senior VP and President, Global Analytics and Treatment (2013)	• Senior VP and President, Analytics (2011) • President and Chief Operating Officer, Nova Analytics (2006)
Kenneth Napolitano	52	Senior VP and President, Global Applied Water Systems (2013)	• Senior VP and President, Applied Water Systems (2012) • Senior VP and President, Residential and Commercial Water (2011) • President, Residential and Commercial Water (2009)
Angela A. Buonocore	56	Senior VP and Chief Communications Officer (2011)	• Senior VP and Chief Communications Officer, ITT Corporation (2008)
Nicholas R. Colisto	47	Senior VP and Chief Information Officer (2012)	• VP and Chief Information Officer, Hovnanian Enterprises, Inc. (2008)
Robyn T. Mingle	48	Senior VP and Chief Human Resources Officer (2011)	• Senior VP of Human Resources, Hovnanian Enterprises, Inc. (2003)
Colin R. Sabol	46	Senior VP and President, Global Dewatering (2013)	• Senior VP and Chief Strategy and Growth Officer (2011) • VP of Marketing and Business Development, ITT Fluid and Motion Control (2009)

Note: Date in parentheses indicates the year in which the position was assumed.

PART II

ITEM 5. MARKET FOR THE REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

2013 and 2012 Market Price and Dividends

Our common stock trades publicly on the New York Stock Exchange under the trading symbol “XYL”. The following table shows the high and low prices per share of our common stock as reported by the New York Stock Exchange and the dividends declared per share for the periods indicated.

	High	Low	Dividend
Fiscal Year ended December 31, 2013			
First Quarter	$29.49	$26.39	$0.1164
Second Quarter	29.19	25.56	0.1164
Third Quarter	29.79	23.61	0.1164
Fourth Quarter	34.93	26.99	0.1164
Fiscal Year ended December 31, 2012			
First Quarter	$28.87	$24.82	$0.1012
Second Quarter	28.54	23.02	0.1012
Third Quarter	26.00	22.43	0.1012
Fourth Quarter	27.67	23.41	0.1012

The closing price of our common stock on the NYSE on January 31, 2014 was $33.36 per share. As of January 31, 2014, there were 16,626 holders of record of our common stock.

Dividends are declared and paid on the common stock at the discretion of our Board of Directors and depend on our profitability, financial condition, capital needs, future prospects, and other factors deemed relevant by our Board. Therefore, there can be no assurance as to what level of dividends, if any, will be paid in the future. In the first quarter of 2014, we declared a dividend of $0.128 per share to be paid on March 19, 2014 for shareholders of record on February 19, 2014.

There have been no unregistered offerings of our common stock during 2013.

Fourth Quarter 2013 Share Repurchase Activity

The following table summarizes our purchases of our common stock for the quarter ended December 31, 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)
10/1/13 - 10/31/13	—	—	—	$259.5
11/1/13 - 11/30/13	0.6	$34.03	0.6	$239.1
12/1/13 - 12/31/13	0.1	$33.56	0.1	$234.6

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

(b) 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 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 December 31, 2013 and there are 1.0 million shares (approximately $35 million based on a share price of $34.60 per share) 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 December 31, 2013, 0.7 million shares were repurchased at an average price of $33.94 per share for a total cost of $25 million. There are up to $200 million in shares that may still be purchased under this plan.

PERFORMANCE GRAPH

CUMULATIVE TOTAL RETURN

The following graph compares the relative performance of our common stock, the S&P 500 Index and the S&P 500 Industrials Index. This graph covers the period from October 13, 2011 (the first day our common stock began "when-issued" trading on the NYSE) through December 31, 2013. Our common stock began "regular-way" trading following the Spin-off on November 1, 2011.

	XYL	S&P 500	S&P 1500 Industrials Index
October 13, 2011	$100	$100	$100
October 31, 2011	110	104	106
December 31, 2011	106	105	108
December 31, 2012	114	121	124
December 31, 2013	148	161	175

The graph is not, and is not intended to be, indicative of future performance of our common stock.

This performance graph shall not be deemed "filed" with the SEC or subject to the liabilities of Section 18 of the Securities Exchange Act of 1934, and should not be deemed incorporated by reference into any of our prior or subsequent filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference in such filing.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected consolidated and combined financial data for the five years ended December 31, 2013. This selected consolidated financial data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated and combined financial statements and the notes thereto included in this Report.

	Year Ended December 31,									
(in millions, except per share data)	2013		2012		2011 (c)		2010 (b)		2009	
Results of Operations Data:										
Revenue	$3,837		$3,791		$3,803		$3,202		$2,849	
Gross profit	1,499		1,502		1,461		1,214		1,037	
Gross margin	39.1	%	39.6	%	38.4	%	37.9	%	36.4	%
Operating income	363		443		395		388		276	
Operating margin	9.5	%	11.7	%	10.4	%	12.1	%	9.7	%
Net income	228		297		279		329		263	
Per Share Data:										
Earnings per share:										
Basic	$1.23		$1.60		$1.51		$1.78		$1.42	
Diluted	1.22		1.59		1.50		1.78		1.42	
Basic shares outstanding (a)	185.2		185.8		185.1		184.6		184.6	
Diluted shares outstanding (a)	186.0		186.2		185.3		184.6		184.6	
Cash dividends per share	$0.4656		$0.4048		$0.1012		$—		$—	
Balance Sheet Data (at period end):										
Cash and cash equivalents	$533		$504		$318		$131		$81	
Working capital*	930		859		834		759		636	
Total assets	4,896		4,679		4,400		3,742		2,542	
Total debt	1,241		1,205		1,206		4		4	

* The Company calculates Working Capital as follows: Net Accounts Receivable + Net Inventory - Accounts Payable - Customer Advances.

(a) On October 31, 2011, the Spin-off from ITT was completed through a tax-free stock dividend to ITT's shareholders. ITT shareholders received one share of Xylem common stock for each share of ITT common stock. As a result on October 31, 2011, we had 184.6 million shares of common stock outstanding and this share amount is being utilized to calculate earnings per share and diluted earnings per share for all prior periods presented.

(b) In 2010, we acquired Godwin Pumps of America, Inc. and Nova Analytics Corporation. These businesses in the aggregate contributed revenue of $247 million in 2010 and $1,070 million of total assets on date of acquisition.

(c) In 2011, we acquired YSI Incorporated, which contributed revenue of $35 million in 2011 and $371 million of total assets on date of acquisition.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our consolidated and combined financial statements and the notes thereto. This discussion summarizes the significant factors affecting our results of operations and the financial condition of our business during each of the fiscal years in the three-year period ended December 31, 2013. 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 consolidated and combined financial statements to "ITT" or "parent" refer to ITT Corporation (former parent of Xylem) and its consolidated subsidiaries (other than Xylem).

On and prior to October 31, 2011 (the "Distribution Date"), our financial position and results of operations consisted of the water equipment and services businesses of ITT Corporation ("WaterCo"). The Spin-off (the "Spin-off") was completed pursuant to the Distribution Agreement, dated as of October 25, 2011, among ITT, Exelis Inc. and Xylem. After the Distribution Date, ITT did not beneficially own any shares of Xylem common stock and, following such date, financial results of Xylem are not consolidated in ITT's financial reporting. Xylem's financial position and results of operations have been derived from ITT's historical accounting records and are presented on a carve-out basis through our Distribution Date, while our financial results for Xylem post Spin-off are prepared on a stand-alone basis. In addition, financial information for the twelve months ended December 31, 2011 consists of the consolidated results of Xylem on a stand-alone basis for the two months of November and December and the combined results of operations of WaterCo for the first ten months on a carve-out basis.

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, water 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 water infrastructure sector with pump systems that transport water from aquifers, lakes, rivers and seas; with filtration, ultraviolet and ozone systems that provide treatment, making the water fit to use; and pumping solutions that move the wastewater to treatment facilities where our mixers, biological treatment, monitoring, and control systems provide the primary functions in the treatment process. We provide analytical instrumentation used to measure water quality, flow, and level in wastewater, surface water, and coastal environments.
- 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 through direct and indirect channels that serve the needs of each customer type. In the Water Infrastructure segment for the year ended 2013, we provided the majority of our sales direct to customers with strong application expertise, while the remaining amount was through distribution partners. In the Applied Water segment, we provided the majority of our sales in 2013 through long-standing relationships with the world's leading distributors, with the remainder going direct to customers.

Key Performance Indicators and Non-GAAP Measures

Management reviews key performance indicators including revenue, gross margin, segment operating income and margins, earnings per share, orders growth, working capital, free cash flow and backlog, among others. In addition, we consider certain measures to be useful to management and investors evaluating our operating performance for the periods presented, and provide a tool for evaluating our ongoing operations, liquidity and management of

assets. This information can assist investors in assessing our financial performance and measures our ability to generate capital for deployment among competing strategic alternatives and initiatives, including, but not limited to, dividends, acquisitions, share repurchases and debt repayment. These metrics, however, are not measures of financial performance under accounting principles generally accepted in the United States of America ("GAAP") and should not be considered a substitute for revenue, operating income, net income, earnings per share (basic and diluted) or net cash from operations as determined in accordance with GAAP. We consider the following non-GAAP measures, which may not be comparable to similarly titled measures reported by other companies, to be key performance indicators:

- "organic revenue" and "organic orders" defined as revenue and orders, respectively, excluding the impact of foreign currency fluctuations, intercompany transactions and contributions from acquisitions and divestitures. Divestitures include sales of insignificant portions of our business that did not meet the criteria for classification as a discontinued operation. The period-over-period change resulting from foreign currency fluctuations assumes no change in exchange rates from the prior period.
- "constant currency" defined as financial results adjusted for currency translation impacts by translating current period and prior period activity using the same currency conversion rate. This approach is used for countries whose functional currency is not the U.S. dollar.
- "adjusted net income" and "adjusted earnings per share" defined as net income and earnings per share, respectively, adjusted to exclude 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 per share data)	2013	2012
Net income	$228	$297
Separation costs, net of tax (a)	—	16
Restructuring and realignment, net of tax	46	17
Special charges, net of tax	23	—
Tax-related special items	14	—
Adjusted net income	$311	$330
Weighted average number of shares - Diluted	186.0	186.2
Adjusted earnings per share	$1.67	$1.77

(a) Costs of $4 million ($2 million, net of tax) during 2013, 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 and certain costs incurred for the change in chief executive officer made during the third quarter of 2013, as well as costs incurred in the fourth quarter of 2013 for the contractual indemnification of federal tax obligations to ITT and costs associated with a legal judgment arising from a historical acquisition matter.
- "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)	2013	2012
Net cash provided by operating activities	$324	$396
Capital expenditures	(126)	(112)
Separation cash payments (a)	—	28
Free cash flow	$198	$312

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

Executive Summary

Xylem reported revenue for 2013 of $3,837 million, an increase of 1.2% from $3,791 million reported in 2012. The 2012 and 2013 acquisitions within our Water Infrastructure segment contributed $82 million of incremental revenue during 2013 or 2.2%. Continued challenging market conditions in Europe drove a decrease in revenue while the United States and emerging markets held flat. Operating income for the year ended 2013 was $363 million, reflecting a decrease of $80 million or 18.1% compared to $443 million in 2012, which was primarily due to increased restructuring costs, special charges in 2013 and geographic mix headwinds partially offset by the benefits achieved from cost reductions and higher price realization.

Additional financial highlights for 2013 include the following:

- Net income of $228 million, or $1.22 per diluted share ($311 million or $1.67 on an adjusted basis)
- Free cash flow generation of $198 million, and net cash from operating activities of $324 million
- Orders of $3,912 million (a 3.4% increase from 2012 on a constant currency basis)
- We repurchased $67 million in shares under the $250 million share repurchase program approved by our Board of Directors in 2013 and the previous share repurchase program implemented in 2012 as part of our strategy to enhance shareholder return and offset the impact of employee stock plans
- Dividends paid to shareholders increased 15% in 2013

2014 Business Outlook

In 2014, we are expecting some of the trends that we saw in the second half of 2013 to continue. We expect a continued slow recovery in the United States industrial markets combined with modest improved performance in our European industrial end markets. Globally, while our industrial markets are improving in production and capital outlay, continued weak performance in mining is expected. We expect public utilities to return to modest levels of growth in 2014, with growth driven by operations and maintenance spending, partially offset by continued weakness in capital expenditure spending by our customers. In general, we expect a slow recovery in most of the developed country end markets and modestly higher levels of growth in emerging markets. 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 2013, we incurred $40 million and $24 million in restructuring and realignment costs, respectively. As a result of the restructuring actions in 2013, we realized $13 million of net savings. In 2014, we expect to incur approximately $30 to $35 million in restructuring costs, and approximately $10 to $15 million in realignment costs. We expect to realize $25 million of incremental net savings in 2014 from actions initiated in 2013, and an additional $10 million of net savings from our 2014 actions. Additional strategic actions we are taking include investing in a customer relationship management system, growth platforms and new product development, as well as executing operating efficiencies through lean six sigma and global sourcing initiatives. We also will refocus on the Xylem Management System which integrates our key business processes.

Results of Operations

(in millions)	2013	2012	2011	2013 v. 2012	2012 v. 2011
Revenue	$3,837	$3,791	$3,803	1.2 %	(0.3)%
Gross profit	1,499	1,502	1,461	(0.2)%	2.8 %
Gross margin	39.1 %	39.6 %	38.4 %	(50)bp	120bp
Operating expenses excluding separation, restructuring and realignment costs and special charges (a)	1,048	1,013	979	3.5 %	3.5 %
Expense to revenue ratio	27.3 %	26.7 %	25.7 %	60bp	100bp
Restructuring and realignment costs	64	24	—	166.7 %	NM
Separation costs (a)	—	22	87	NM	(74.7)%
Special charges	24	—	—	NM	NM
Total operating expenses	1,136	1,059	1,066	7.3 %	(0.7)%
Operating income	363	443	395	(18.1)%	12.2 %
Operating margin	9.5 %	11.7 %	10.4 %	(220)bp	130bp
Interest and other non-operating expense (income), net	65	55	12	18.2 %	358.3 %
Income tax expense	70	91	104	(23.1)%	(12.5)%
Tax rate	23.5 %	23.4 %	27.4 %	10bp	(400)bp
Net income	$228	$297	$279	(23.2)%	6.5 %

(a) Separation costs of $4 million ($2 million, net of tax) during 2013 are included within the $1,048 million of operating expenses.

NM Not Meaningful

2013 versus 2012

Revenue

Revenue generated for 2013 was $3,837 million, an increase of $46 million, or 1.2%, compared to $3,791 million in 2012. On a constant currency basis, revenue grew 1.1%. The following table illustrates the impact from organic growth, recent acquisitions, and fluctuations in foreign currency, in relation to revenue during 2013.

(in millions)	$ Change	% Change
2012 Revenue	$3,791	
Organic Growth	(39)	(1.0)%
Acquisitions	82	2.2 %
Constant Currency	43	1.1 %
Foreign currency translation (a)	3	0.1 %
Total change in revenue	46	1.2 %
2013 Revenue	$3,837	

(a) Foreign currency impact primarily due to fluctuations in the value of the Euro, Australian Dollar, South African Rand, Swedish Krona, Canadian Dollar and British Pound against the US Dollar.

The following table summarizes revenue by segment for 2013 and 2012:

(in millions)	2013	2012	As Reported Change	Constant Currency Change
Water Infrastructure	$2,457	$2,425	1.3 %	1.5 %
Applied Water	1,444	1,424	1.4 %	0.4 %
Eliminations	(64)	(58)		
Total	$3,837	$3,791	1.2 %	1.1 %

Water Infrastructure

Water Infrastructure's revenue increased $32 million, or 1.3% in 2013 (1.5% on a constant currency basis). Our 2012 and 2013 acquisitions contributed $82 million of incremental revenue in 2013.

Organic revenue decreased $46 million or 1.9% during the year which was substantially due to lower volumes across the transport, treatment and test applications. The significant declines were primarily caused by weakness in the Europe, Middle East and Africa treatment markets and declines in transport in the Asia Pacific markets from less mining activity. Organic revenue performance improved year-over-year in the third and fourth quarters of 2013 driven by increases in transport revenue which reflected modest market recovery in northern and central Europe as well as the United States. Treatment negatively impacted organic growth for the year as revenue decreased from 2012 substantially due to non-recurring large custom projects shipped in the prior year as well as project delays from government funding uncertainties. Additionally, test applications, which had flat organic revenue in 2013, experienced lower revenue for the year from delays in orders and the government sequestration in the United States during the first half of 2013 which were offset by revenue growth in the second half of the year, specifically in Europe, as well as incremental revenue from price increases, new products and cross-branding initiatives.

Foreign currency translation was unfavorable by $4 million for 2013 as compared to 2012.

Applied Water

Applied Water's revenue increased $20 million, or 1.4% in 2013 (a 0.4% increase on a constant currency basis). The growth on a constant currency basis was driven by organic revenue growth predominately due to irrigation and industrial water applications.

Organic revenue increased $5 million or 0.4% for the year primarily due to irrigation application revenue caused by drought conditions in the United States. Strength in the industrial water application also bolstered revenue, particularly within China from large fire pump projects as well as in northern Europe from increased industrial multistage pump revenue. These revenue increases were partially offset by weakness in Europe, particularly within the residential and commercial building services markets of southern Europe, combined with sluggish industrial and commercial building service markets in the United States and Latin America.

Foreign currency translation was favorable by $9 million for 2013 as compared to 2012.

Orders/Backlog

Orders received during 2013 increased by $130 million, or 3.4% to $3,912 million (a 3.4% increase on a constant currency basis). These amounts include a benefit of $87 million from acquisitions. Organic order growth was $43 million for the year.

The Water Infrastructure segment orders increased $89 million, or 3.7% to $2,510 million (3.8% growth on a constant currency basis), including $87 million from acquisitions. Organic orders increased slightly primarily due to a strong second half of 2013 driven by higher transport volume from Europe public utilities and the dewatering business combined with healthy growth in emerging markets. Orders increased in our Applied Water segment $45 million, or 3.2% to $1,468 million (2.7% growth on a constant currency basis), driven by strong performance in the commercial building services and industrial water markets in China as well as orders within the residential building services and agriculture markets in the United States during 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 $707 million at

December 31, 2013 and $647 million at December 31, 2012. We anticipate that more than 90% of the backlog at December 31, 2013 will be recognized as revenue during 2014.

Gross Margin

Gross margins as a percentage of consolidated revenue declined to 39.1% in 2013 from 39.6% in 2012. The decrease is attributable to negative price realization, 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

(in millions)	2013	2012	Change
Selling, General and Administrative (SG&A)	$986	$914	7.9 %
SG&A as a % of revenue	25.7 %	24.1 %	160bp
Research and Development (R&D)	104	106	(1.9)%
R&D as a % of revenue	2.7 %	2.8 %	(10)bp
Restructuring and asset impairment charges	42	17	147.1 %
Separation Costs	4	22	(81.8)%
Operating expenses	$1,136	$1,059	7.3 %
Expense to revenue ratio	29.6 %	27.9 %	170bp

Selling, General and Administrative Expenses

SG&A increased by $72 million or 7.9% to $986 million or 25.7% of revenue in 2013, as compared to $914 million or 24.1% of revenue in 2012. The increase in SG&A expenses as a percentage of revenue is primarily due to 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. The increase was also driven by realignment costs of $17 million during 2013 incurred by the Company to reposition our European business in an effort to optimize our cost structure and improve our operational efficiency and effectiveness. Acquisitions, increased pension costs and investments in growth platforms also contributed to the increase.

Research and Development Expenses

R&D spending decreased $2 million or 1.9% to $104 million or 2.7% of revenue for 2013 as compared to $106 million or 2.8% of revenue in 2012.

Restructuring and Asset Impairment Charges

During 2013, we incurred restructuring costs of $31 million and $9 million in our Water Infrastructure and Applied Water segments, respectively. These charges were incurred 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. During 2012, we recognized restructuring charges of $17 million related to restructuring related severance payments for manufacturing reduction in force initiatives primarily within our Water Infrastructure segment.

Total expected costs associated with actions that commenced during 2013 are approximately $33 million for Water Infrastructure and approximately $10 million for Applied Water. These costs primarily comprise severance charges. These actions are expected to continue through 2014. As a result of actions initiated during 2013, we achieved net savings of approximately $13 million in 2013 and estimate annual future net savings beginning in 2014 of approximately $38 million.

Additionally, in the fourth quarter of 2013 we recorded a $2 million impairment charge related to three trade names in our Water Infrastructure segment associated with acquired businesses within our Analytics operating unit, reflecting a decline in their value since being acquired. Refer to Note 11, “Goodwill and Other Intangible Assets,” for additional information.

Separation Costs

We had non-recurring separation costs of $4 million and $22 million, or $2 million and $16 million after tax during 2013 and 2012, respectively. The components of separation costs incurred during these periods are presented below.

(in millions)	2013	2012
Rebranding and marketing costs	$—	$8
Advisory and professional fees	—	7
Information and technology costs	2	3
Employee retention and hiring costs	—	1
Lease termination and other real estate costs	2	1
Other	—	2
Total separation costs in operating income	4	22
Income tax benefit	(2)	(6)
Total separation costs, net of tax	$2	$16

Operating Income

We generated operating income of $363 million during 2013, an $80 million or 18.1% decrease from the prior year operating income of $443 million, primarily reflecting higher operating expenses as increased SG&A, and restructuring and asset impairment charges more than offset reductions from lower separation costs and savings from restructuring activities. The following table illustrates operating income results by business segments for 2013 and 2012.

(in millions)	2013	2012	Change
Water Infrastructure	$271	$342	(20.8)%
Applied Water	167	170	(1.8)%
Segment operating income	438	512	(14.5)%
Corporate and other	(75)	(69)	8.7%
Total operating income	$363	$443	(18.1)%
Operating margin			
Water Infrastructure	11.0%	14.1%	(310)bp
Applied Water	11.6%	11.9%	(30)bp
Total Xylem	9.5%	11.7%	(220)bp

The table included below provides a reconciliation from segment operating income to adjusted operating income, and a calculation of the corresponding adjusted operating margin.

(in millions)	2013		2012		Change	
Water Infrastructure						
Operating income	$271		$342		(20.8	)%
Separation costs	—		4		NM	
Restructuring and realignment costs	48		19		152.6	%
Special charges	4		—		NM	
Adjusted operating income	$323		$365		(11.5	)%
Adjusted operating margin	13.1	%	15.1	%	(200)bp	
Applied Water						
Operating income	167		170		(1.8	)%
Separation costs	—		2		NM	
Restructuring and realignment costs	16		5		220.0	%
Adjusted operating income	$183		$177		3.4	%
Adjusted operating margin	12.7	%	12.4	%	30bp	
Total Xylem						
Operating income	$363		$443		(18.1	)%
Separation costs*	—		22		NM	
Restructuring and realignment costs	64		24		166.7	%
Special charges	24		—		NM	
Adjusted operating income*	$451		$489		(7.8	)%
Adjusted operating margin*	11.8	%	12.9	%	(110)bp	

NM Not meaningful percentage change

* Costs associated with non-recurring separation activities of $4 million ($2 million, net of tax) during 2013 are not excluded from adjusted operating income.

Water Infrastructure

Operating income for our Water Infrastructure segment decreased $71 million or 20.8% (decreased $42 million or 11.5% on an adjusted basis) compared with the prior year. The 11.5% decrease was driven by lower volume, inflation, unfavorable foreign exchange impacts, costs associated with the establishment of our European headquarters and investments in growth platforms, specifically acquisitions and new product launches. The decrease was partially offset by restructuring savings and cost reduction initiatives, such as global sourcing and lean six sigma.

Applied Water

Operating income for our Applied Water segment decreased $3 million or 1.8% (increased $6 million or 3.4% on an adjusted basis) compared to the prior year. The 3.4% increase was driven by lean initiatives, global sourcing and price realization partially offset by inflation and new product development.

Interest Expense

Interest expense was $55 million for both 2013 and 2012, reflecting the same full year of interest expense related to the issuance of $1.2 billion aggregate principal amount of senior notes issued in September 2011. Refer to Note 14, “Credit Facilities and Long-Term Debt,” for further details.

Income Tax Expense

The income tax provision for 2013 was $70 million at an effective tax rate of 23.5% compared to $91 million at an effective tax rate of 23.4% in 2012. The 2013 effective tax rate is higher than 2012 due to an increase in foreign repatriations partially offset by mix of earnings.

Other Comprehensive Income/(Loss)

Other comprehensive income of $74 million in 2013 compared to a loss of $30 million in 2012, an improvement of $104 million, was primarily due to a $34 million net gain in 2013 as compared to a net loss of $84 million in 2012 related to postretirement benefit plans. The net gain in 2013 was due to an increase in discount rates as well as actual gains on plan assets in excess of the assumed long-term rate of return as compared to the net loss in 2012 which was due to a reduction in discount rates, partially mitigated by actual gains on plan assets in excess of the assumed long-term rate of return. This year-over-year improvement was partially offset by a $33 million reduction in foreign currency translation benefit primarily due to the Euro strengthening against the U.S. dollar. The effective tax rate on other comprehensive income decreased as compared to 2012 due primarily to the shift in comprehensive earnings from foreign currency translation, which is not taxable, as well as from a change in the jurisdictional mix of net gains/losses from postretirement benefit plans.

2012 versus 2011

Revenue

Revenue generated for 2012 was $3,791 million, a decrease of $12 million, or 0.3%, compared to $3,803 million in 2011. On a constant currency basis, revenue grew 2.5%. The following table illustrates the impact from organic growth, recent acquisitions, and fluctuations in foreign currency, in relation to revenue during the annual 2012 period.

(in millions)	$ Change		% Change	
2011 Revenue	$3,803			
Organic Growth	2		0.1	%
Acquisitions	94		2.4	%
Constant Currency	96		2.5	%
Foreign currency translation (a)	(108	)	(2.8	)%
Total change in revenue	(12	)	(0.3	)%
2012 Revenue	$3,791			

(a) Foreign currency impact primarily due to fluctuations of the Euro against the US Dollar.

The following table summarizes revenue by segment for 2012 and 2011:

(in millions)	2012		2011		As Reported Change		Constant Currency Change	
Water Infrastructure	$2,425		$2,416		0.4	%	3.7	%
Applied Water	1,424		1,444		(1.4	)%	0.8	%
Eliminations	(58	)	(57	)				
Total	$3,791		$3,803		(0.3	)%	2.5	%

Water Infrastructure

Water Infrastructure’s revenue increased $9 million, or 0.4% in 2012 (3.7% on a constant currency basis), including incremental revenue of $94 million from acquisitions, consisting of YSI in 2011 and MJK and Heartland in 2012. The acquisitions of YSI and MJK contributed $90 million of the incremental revenue as we continued our expansion in the analytical instrumentation market.

Organic revenue decreased $6 million or 0.2% during the year which was primarily attributable to weakness in the transport and treatment markets, as well as sustained drought conditions within the United States. Transport and treatment decreased mostly due to a decline in the public utility sector of developed markets caused by a weak capital project environment and delays on shipments. These declines were partially offset by strength in emerging markets, specifically in the Latin America and Asia Pacific regions. The results also reflect decreases in the dewatering rental and equipment sales as a result of the unfavorable dry weather conditions within North America and lower coal and gas prices, offset slightly by a benefit from Super Storm Sandy. Overall growth was also muted by continued weakness in Europe as a result of challenging economic conditions.

Foreign currency translation was unfavorable by $80 million for 2012 as compared to 2011.

Applied Water

Applied Water's revenue decreased $20 million, or 1.4% in 2012 (a 0.8% increase on a constant currency basis). The growth on a constant currency basis was driven by organic revenue growth.

Organic revenue grew $9 million or 0.6% for the year and was principally due to strength in the industrial water sector from a favorable general industrial market across most regions, especially within the United States, Russia and Asia Pacific markets. The residential and commercial pumps business increased slightly due to favorable growth in the United States but was mostly eclipsed by declines from the weak economic conditions in Europe. The warm, dry weather conditions in North America also drove an increase in the agriculture end market for the year.

Foreign currency translation was unfavorable by $32 million for 2012 as compared to 2011.

Orders/Backlog

Orders received during 2012 decreased by $65 million, or 1.7% to $3,782 million (a 1.3% increase on a constant currency basis). These amounts include a benefit of $95 million from acquisitions. Organic order decline was $46 million for the year.

The Water Infrastructure segment orders decreased $33 million, or 1.3% to $2,421 million (2.2% growth on a constant currency basis), including $95 million from acquisitions. Organic order volume decreased primarily due to the delays in public utility capital expenditure orders coupled with reduced dewatering volumes from dry weather conditions and slowdowns in the oil, gas and mining markets. Orders declined in our Applied Water segment $29 million, or 2.0% to $1,423 million (0.1% growth on a constant currency basis), driven by declining organic orders of 0.4%. The decline in organic order volume is primarily a result of the warm winter weather conditions in the United States and Asia Pacific markets impacting the building services end markets, partially offset by strength in the industrial and agriculture 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 $647 million at December 31, 2012 and $651 million at December 31, 2011.

Gross Margin

Gross margins as a percentage of consolidated revenue increased to 39.6% in 2012 from 38.4% in 2011. The increase is attributable to benefits from price realization initiatives and cost improvements offset, in part, by an unfavorable sales mix and inflation.

Operating Expenses

(in millions)	2012		2011		Change	
Selling, General and Administrative (SG&A)	$914		$877		4.2	%
SG&A as a % of revenue	24.1	%	23.1	%	100bp	
Research and Development (R&D)	106		100		6.0	%
R&D as a % of revenue	2.8	%	2.6	%	20bp	
Restructuring and asset impairment charges	17		2		750	%
Separation Costs	22		87		(74.7	)%
Operating expenses	$1,059		$1,066		0.7	%
Expense to revenue ratio	27.9	%	28.0	%	(10)bp	

Selling, General and Administrative Expenses

SG&A increased by $37 million or 4.2% to $914 million or 24.1% of revenue in 2012, as compared to $877 million or 23.1% of revenue in 2011. The increase in SG&A expenses is principally due to the impact of incremental costs as a standalone Company and costs related to the MJK and Heartland acquisitions.

Additionally, in 2012 we incurred $7 million of realignment costs relating to realigning our European businesses to improve our operational efficiencies.

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Research and Development Expenses

R&D spending increased $6 million or 6.0% to $106 million or 2.8% of revenue for 2012 as compared to $100 million or 2.6% of revenue in 2011. These increases were primarily due to the impact from recent acquisitions, as well as costs associated with the launching of new products.

Restructuring and Asset Impairment Charges

During 2012, we incurred restructuring costs of $17 million primarily related to restructuring-related severance payments for reductions in force initiatives primarily within our Water Infrastructure segment. During 2011, we incurred a $2 million charge related to the impairment of a facility in our Applied Water segment. As of December 31, 2012, we consider those restructuring initiatives commenced to date to be substantially completed, with a remaining liability of $9 million related to the 2012 restructuring actions.

Separation Costs

We had non-recurring pre-tax separation costs of $22 million and $87 million, or $16 million and $72 million after tax during 2012 and 2011, respectively. The components of separation costs incurred during these periods are presented below.

(in millions)	2012	2011
Rebranding and marketing costs	$8	$13
Advisory and professional fees	7	18
Information and technology costs	3	19
Employee retention and hiring costs	1	14
Lease termination and other real estate costs	1	10
Non-cash asset impairments (a)	—	8
Other	2	5
Total separation costs in operating income	22	87
Tax-related separation costs	—	6
Income tax benefit	(6)	(21)
Total separation costs, net of tax	$16	$72

(a) During the third quarter of 2011, we recorded an impairment charge of $8 million on one of our facilities in China within our Applied Water segment. Prior to the separation this was a shared facility among certain Xylem and ITT businesses and in connection with the separation, the removal of certain ITT operations triggered an impairment evaluation. The fair value of the applicable assets was calculated using the cost approach.

Operating Income

We generated operating income of $443 million during 2012, a 12.2% increase from the prior year, primarily reflecting the benefits achieved from cost reductions and price improvements offset, in part, by an unfavorable sales mix, acquisition costs and non-recurring separation costs. The following table illustrates operating income results by business segments for 2012 and 2011.

(in millions)	2012	2011	Change
Water Infrastructure	$342	$343	(0.3)%
Applied Water	170	160	6.3%
Segment operating income	512	503	1.8%
Corporate and Other	(69)	(108)	
Total operating income	$443	$395	12.2%
Operating margin			
Water Infrastructure	14.1%	14.2%	(10)bp
Applied Water	11.9%	11.1%	80bp
Total Xylem	11.7%	10.4%	130bp

The table included below provides a reconciliation from segment operating income to adjusted operating income, and a calculation of the corresponding adjusted operating margin.

(in millions)	2012	2011	Change
Water Infrastructure			
Operating income	$342	$343	(0.3)%
Separation costs	4	16	
Restructuring and realignment costs	19	—	
Adjusted operating income	$365	$359	1.7%
Adjusted operating margin	15.1%	14.9%	20bp
Applied Water			
Operating income	$170	$160	6.3%
Separation costs	2	13	
Restructuring and realignment costs	5	—	
Adjusted operating income	$177	$173	2.3%
Adjusted operating margin	12.4%	12.0%	40bp
Total Xylem			
Operating income	$443	$395	12.2%
Separation costs (a)	22	87	
Restructuring and realignment costs	24	—	
Adjusted operating income	$489	$482	1.5%
Adjusted operating margin	12.9%	12.7%	20bp

(a) Comprising non-recurring separation costs of $6 million and $29 million in our business segments and $16 million and $58 million within Corporate for 2012 and 2011, respectively.

Water Infrastructure

Operating income for our Water Infrastructure segment decreased $1 million or 0.3% (increased $6 million or 1.7% excluding separation, restructuring and realignment costs) compared with the prior year. The 1.7% increase was predominately driven by incremental operating income of $20 million from the acquisitions of YSI, MJK and Heartland combined with price realization efforts and operating cost reductions. These benefits were largely offset by inflation costs on labor and material as well as unfavorable mix from lower dewatering revenue and higher revenue in emerging markets.

Applied Water

Operating income for our Applied Water segment increased $10 million or 6.3% ($4 million or 2.3% excluding separation, restructuring and realignment costs) compared to the prior year. The 2.3% increase is primarily attributable to operating cost reductions put in place by the Company and savings achieved from restructuring actions in the latter part of 2011. The increases were offset, in part, by lower sales volume, an unfavorable sales mix and inflationary pressures on labor and materials.

Interest Expense

Interest expense was $55 million and $17 million for 2012 and 2011, respectively. The increase during the current year reflected a full year of interest expense related to the issuance of $1.2 billion aggregate principal amount of senior notes issued in September 2011. Refer to Note 14, “Credit Facilities and Long-Term Debt,” for further details.

Income Tax Expense

The income tax provision for 2012 was $91 million at an effective tax rate of 23.4% compared to $104 million at an effective tax rate of 27.4% in 2011. The 2012 effective tax rate is lower than 2011 as a result of the decrease in non-deductible separation costs and a change in the mix of earnings.

Effective January 1, 2013, the Swedish government enacted legislation that will increase the effective tax rate of the Company. The Company has implemented strategies to address the impact of this legislation.

Other Comprehensive Income/(Loss)

Other comprehensive loss was $30 million in 2012 compared to a loss of $132 million in 2011, primarily due to the favorable impact of foreign currency translation adjustments in 2012 versus the unfavorable impact in 2011. In 2012, foreign currency translation adjustment was a positive impact of $48 million as compared to 2011, which was a negative impact of $61 million. The year-over-year change was primarily due to movements in the Euro against the US Dollar. Other comprehensive loss was further impacted by a loss from postretirement benefit plans of $84 million loss in 2012 compared to $74 million loss in 2011. This was primarily due to net foreign exchange losses experienced on the benefit obligations which more than offset net foreign exchange gains on plan assets. The effective tax rate on other comprehensive income increased as compared to 2011 due primarily to the shift in comprehensive earnings from foreign currency translation, which is not taxable, as well as from a change in the jurisdictional mix of net gains/losses from postretirement benefit plans.

Liquidity and Capital Resources

The following table summarizes our sources and uses of cash:

	Year Ended December 31,		
(in millions)	2013	2012	2011
Operating activities	$324	$396	$449
Investing activities	(199)	(147)	(423)
Financing activities	(100)	(74)	172
Foreign exchange	4	11	(11)
Total	$29	$186	$187

Sources and Uses of Liquidity

Operating Activities

During 2013, net cash provided by operating activities was $324 million, compared to $396 million in 2012. The $72 million year-over-year decrease was driven by an increase in the use of working capital in both segments, due to increased 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 shorter lead times. 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, largely offset by lower tax payments.

During 2012, net cash provided by operating activities was $396 million, compared to $449 million in 2011. The $53 million year-over-year decrease is primarily the result of interest payments on debt of $53 million in 2012, higher tax payments of $40 million and additional contributions to postretirement benefit plans, partially offset by an increase in receivable collections and a decline in payments for separation costs.

Investing Activities

Cash used in investing activities was $199 million for 2013, compared to $147 million in 2012 and $423 million in 2011. The changes in investing activities are driven almost entirely by cash used for acquisitions and, to a lesser extent, from changes in spending on capital expenditures. We invested $81 million for the acquisitions during 2013 while $41 million was used in 2012 and $309 million in 2011. Capital expenditures for 2013 of $126 million were $14 million greater than in 2012 primarily due 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 in addition to capital expenditures required for the relocation of our corporate headquarters as required by the Spin-off from ITT. In 2012 we spent $112 million on capital expenditures, a decrease of $14 million over 2011, primarily due to a reduction in dewatering asset purchases to align with current rental demand.

Financing Activities

Cash used by financing activities was $100 million and $74 million during 2013 and 2012, respectively compared to cash provided by financing activities of $172 million during 2011. The increase in cash used for financing activities in 2013 compared to 2012 was primarily driven by an increase in share repurchase activity of $60 million and an increase in dividend payments of $12 million. The 2013 share repurchase activity was impacted by $50 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.

Additionally, there was an increase in short-term debt for borrowings under the European Investment Bank facility of $38 million in 2013. The decrease in financing activities from 2011 to 2012 was primarily attributable to net proceeds from the issuance of $1.2 billion in Senior Notes which funded a net cash transfer of $1 billion to our former parent, ITT, in 2011. In general, the components of net transfers to ITT included: (i) cash transfers from the Company to parent, (ii) cash investments from our parent used to fund operations, capital expenditures and acquisitions, (iii) charges (benefits) for income taxes, and (iv) allocations of the parent company's corporate expenses described in this Report.

Funding and Liquidity Strategy

Our ability to fund our capital needs depends on our ongoing ability to generate cash from operations, and access to the bank and capital markets.

Our global funding requirements are continually monitored with appropriate strategies executed to ensure liquidity needs are met cost effectively. Based on our current global cash positions, cash flows for operations and access to the commercial paper markets, we believe there is sufficient liquidity to meet our funding requirements. In addition, our existing committed credit facilities and access to the public debt markets would provide further liquidity if required. 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, 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). 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 December 31, 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, 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 December 31, 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 December 31, 2013, this credit facility remains undrawn.

Research and Development Facility Agreement

On December 4, 2013, the Company amended and restated its Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank (the "EIB") to add an additional borrower under the facility. The facility provides an aggregate principal amount of up to €120 million (approximately $165 million) to finance research projects and infrastructure development in the European Union. The Company's wholly-owned subsidiaries in Luxembourg, Xylem Holdings S.a.r.l. and Xylem International S.a.r.l., are the borrowers under the R&D Facility Agreement. The obligations of the borrowers under the R&D Facility Agreement are guaranteed by the Company under an Amended and Restated Deed of Guarantee, dated as of December 4, 2013, in favor of the EIB. The funds are available to finance research and development projects during the period from 2013 through 2016 at the Company's R&D facilities in Sweden, Germany, Italy, the United Kingdom, Austria, Norway and Hungary.

Under the R&D Facility Agreement, the borrower can draw loans 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 the 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 Pounds Sterling or U.S. Dollars, plus an applicable spread specified by the EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans shall be determined by reference to the credit rating of the Company.

In accordance with the terms of the R&D Facility Agreement, we may not exceed a maximum leverage ratio of 3.50 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. As of December 31, 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 December 31, 2013, $38 million was outstanding under the R&D Facility Agreement. Although the borrowing term for this arrangement is for five years, we have classified it as short-term debt on our Consolidated Balance Sheet since we intend to repay this obligation in less than one year.

Non-U.S. Operations

For 2013 and 2012, we generated 62% and 63%, respectively, of our revenue from non-U.S. operations. 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. Our intent is to indefinitely reinvest all but $84 million of these funds outside of the United States. However, we continually review our domestic and foreign cash profile, expected future cash generation and investment opportunities that support our current designation 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 would be required to accrue U.S. taxes related to future tax payments associated with the repatriation of these funds. As of December 31, 2013, our foreign subsidiaries were holding $423 million in cash or marketable securities.

As of December 31, 2013, our excess of financial reporting over the tax basis of investments in certain foreign subsidiaries totaled $1.9 billion. We have not asserted that $84 million of our excess basis difference will be indefinitely reinvested and have therefore provided for United States or additional foreign withholding taxes for that portion. Generally, such amounts become subject to U.S. taxation upon the remittance of dividends and under certain other circumstances.

Contractual Obligations

The following table summarizes our contractual commitments as of December 31, 2013:

(in millions)	2014	2015 - 2016	2017 - 2018	Thereafter	Total
Debt and capital lease obligations (1)	$42	$600	$—	$600	$1,242
Interest payments (2)	51	94	59	78	282
Operating lease obligations	63	90	46	26	225
Purchase obligations (3)	68	4	—	—	72
Other long-term obligations reflected on the balance sheet	1	4	2	13	20
Total commitments	$225	$792	$107	$717	$1,841

In addition to the amounts presented in the table above, we have recorded liabilities for uncertain tax positions of $30 million. These amounts have been excluded from the contractual obligations table due to an inability to reasonably estimate the timing of such payments in individual years. Further, benefit payments which reflect expected future service related to the Company's pension and other postretirement employee benefit obligations are presented in Note 15, “Postretirement Benefit Plans” and not included in the above table. Finally, estimated environmental payments are excluded from the table above. We estimate, based on historical experience, that we will spend between $1 million and $4 million per year on environmental investigation and remediation. At December 31, 2013, we had estimated and accrued $8 million related to environmental matters.

(1) Refer to Note 14, “Credit Facilities and Long-Term Debt,” in the notes to the consolidated financial statements for discussion of the use and availability of debt and revolving credit agreements. Amounts represent principal payments of long-term debt including current maturities and exclude unamortized discounts.

(2) Amounts represent estimate of future interest payments on long-term debt outstanding as of December 31, 2013.

(3) Represents unconditional purchase agreements that are enforceable and legally binding and that specify all significant terms to purchase goods or services, including fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Purchase agreements that are cancellable without penalty have been excluded.

Off-Balance Sheet Arrangements

As of December 31, 2013, we have issued guarantees for the debt and other obligations of consolidated subsidiaries. We do not consider the maximum exposure to be material either individually or in the aggregate.

Critical Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and the disclosure of contingent liabilities. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.

Significant accounting policies used in the preparation of the Consolidated and Combined Financial Statements are discussed in Note 1, “Summary of Significant Accounting Policies,” in the notes to the consolidated and combined financial statements. Accounting estimates and assumptions discussed in this section are those that we consider

most critical to an understanding of our financial statements because they are inherently uncertain, involve significant judgments, include areas where different estimates reasonably could have been used, and changes in the estimate that are reasonably possible could materially impact the financial statements. Management believes that the accounting estimates employed and the resulting balances are reasonable; however, actual results in these areas could differ from management's estimates under different assumptions or conditions.

Revenue Recognition. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collectability of the sales price is reasonably assured. For product sales, delivery does not occur until the products have been shipped, risk of loss has been transferred to the customer and the contractual terms have been fulfilled. In instances where contractual terms include a provision for customer acceptance, revenue is recognized when either (i) we have previously demonstrated that the product meets the specified criteria based on either seller- or customer-specified objective criteria or (ii) upon formal acceptance received from the customer where the product has not been previously demonstrated to meet customer-specified objective criteria. Revenue on service and repair contracts is recognized after services have been agreed to by the customer and rendered.

We enter into contracts to sell our products and services, and while the majority of our sales agreements contain standard terms and conditions, certain agreements contain multiple elements or non-standard terms and conditions. Where sales agreements contain multiple elements or non-standard terms and conditions, judgment is required to determine the appropriate accounting, including whether the deliverables specified in these agreements should be treated as separate units of accounting for revenue recognition purposes, and, if so, how the transaction price should be allocated among the elements and when to recognize revenue for each element. When a sale involves multiple deliverables, the total revenue from the arrangement is allocated to each unit of accounting based on the relative selling price of the deliverable to all other deliverables in the contract. Revenue for multiple element arrangements is recognized when the appropriate revenue recognition criteria for the individual deliverable have been satisfied. The allocation of sales price between elements may impact the timing of revenue recognition, but will not change the total revenue recognized on the arrangement. For delivered elements accounted for as separate units of accounting in a multiple element arrangement, revenue is recognized only when the delivered elements have standalone value, there are no uncertainties regarding customer acceptance and there are no customer-negotiated refund or return rights affecting the sales recognized.

We record a reduction in revenue at the time of sale for estimated product returns, rebates and other allowances, based on historical experience and known trends.

Warranty Accrual. Accruals for estimated expenses related to warranties are made at the time products are sold or services are rendered and are recorded as a component of cost of revenue. These accruals are established using historical information on the nature, frequency and average cost of warranty claims and consider any factors that may cause differences in expected future warranty costs as compared to historical claim experience. While we engage in extensive product quality programs and processes, we base our estimated warranty obligation on product warranty terms offered to customers, ongoing product failure rates, material usage and service delivery costs incurred in correcting a product failure, as well as specific product class failures outside of our baseline experience. We assess the adequacy of our recorded warranty liabilities quarterly and adjust amounts as necessary.

Income Taxes. Deferred tax assets and liabilities are determined based on temporary differences between the financial reporting and tax bases of assets and liabilities, applying enacted tax rates in effect for the year in which we expect the differences will reverse. Based on the evaluation of available evidence, we recognize future tax benefits, such as net operating loss carryforwards, to the extent that we believe it is more likely than not we will realize these benefits. We periodically assess the likelihood that we will be able to recover our deferred tax assets and reflect any changes to our estimate of the amount we are more likely than not to realize in the valuation allowance, with a corresponding adjustment to earnings or other comprehensive income, as appropriate.

In assessing the need for a valuation allowance, we look to the future reversal of existing taxable temporary differences, taxable income in carryback years and the feasibility of tax planning strategies and estimated future taxable income. The valuation allowance can be affected by changes to tax laws, changes to statutory tax rates and changes to future taxable income estimates.

Our effective tax rate reflects the impact of certain undistributed foreign earnings for which we have not provided U.S. taxes because we plan to reinvest such earnings indefinitely outside the United States. We plan foreign earnings remittance amounts based on projected cash flow needs, as well as the working capital and long-term

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investment requirements of our foreign subsidiaries and our domestic operations. Based on these assumptions, we estimate the amount we will distribute to the United States and provide the U.S. federal taxes due on these amounts. Material changes in our estimates of cash, working capital and long-term investment requirements in the various jurisdictions in which we do business could impact our effective tax rate.

The calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations in a multitude of jurisdictions across our global operations. We recognize potential liabilities and record tax liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and to the extent to which, additional taxes will be due. Furthermore, we recognize the tax benefit from an uncertain tax position 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 in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

We adjust our liability for uncertain tax positions in light of changing facts and circumstances; however, due to the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our current estimate of the tax liabilities. If our estimate of tax liabilities proves to be less than the ultimate assessment, an additional tax expense would result. If a payment of these amounts ultimately proves to be less than the recorded amounts, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary.

Goodwill and Intangible Assets. We review goodwill and indefinite-lived intangible assets for impairment annually and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. We also review the carrying value of our finite-lived intangible assets for potential impairment when impairment indicators arise. We conduct our annual impairment test as of the first day of the fourth quarter. We perform a two-step impairment test for goodwill. In the first step, we compare the estimated fair value of each reporting unit to its carrying value. If the estimated fair value of the reporting unit exceeds the carrying value of the net assets assigned to that reporting unit, goodwill is not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds its fair value, then we must perform the second step of the impairment test in order to measure the impairment loss to be recorded, if any. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference. In our annual impairment test for indefinite-lived intangible assets, we compare the fair value of those assets to their carrying value. We recognize an impairment loss when the estimated fair value of the indefinite-lived intangible asset is less than its carrying value. We estimate the fair value of our reporting units and intangible assets with indefinite lives using an income approach. Under the income approach, we calculate fair value based on the present value of estimated future cash flows.

Determining the fair value of a reporting unit or an indefinite-lived intangible asset is judgmental in nature and involves the use of significant estimates and assumptions, particularly related to future operating results and cash flows. These estimates and assumptions include, but are not limited to, revenue growth rates and operating margins used to calculate projected future cash flows, risk-adjusted discount rates, assumed royalty rates, future economic and market conditions and identification of appropriate market comparable data. In addition, the identification of reporting units and the allocation of assets and liabilities to the reporting units when determining the carrying value of each reporting unit also require judgment. Goodwill is tested for impairment at either the operating segment identified in Note 21, "Industry Segment and Geographic Data," of the consolidated and combined financial statements, or one level below. The fair value of our reporting units and indefinite-lived intangible assets is based on estimates and assumptions that are believed to be reasonable. Significant changes to these estimates and assumptions could adversely impact our conclusions. Actual future results may differ from those estimates.

During the fourth quarter of 2013 we performed our annual impairment assessment and determined that that the estimated fair values of our goodwill reporting units were substantially in excess of each of their carrying values with the exception of our Analytics business within our Water Infrastructure segment. While the fair value of the Analytics business initially increased over the first couple of years after acquisition, challenging economic conditions, including reduced government spending in the U.S. and sluggish growth in European markets, have led to a reduction in fair value during the past two years. Our 2013 impairment analysis indicated that the fair value of the Analytics reporting unit exceeded its carrying value by approximately 18%. The goodwill associated with the Analytics business was $439 million at December 31, 2013. 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.

During the fourth quarter of 2013 we performed our annual impairment test of our indefinite-lived intangibles assets which resulted in an impairment charge of $2 million related to trade names within our Water Infrastructure segment. Refer to Note 11, "Goodwill and Other Intangible Assets," for additional information.

Postretirement Plans. Company employees around the world participate in numerous defined benefit pension plans. The determination of projected benefit obligations and the recognition of expenses related to these pension plans are dependent on various assumptions. These major assumptions primarily relate to discount rates, expected long-term rates of return on plan assets, rate of future compensation increases, mortality, health care inflation and termination (some of which are disclosed in Note 15, "Postretirement Benefit Plans," in the notes to the consolidated and combined financial statements) and other factors. Actual results that differ from our assumptions are accumulated and are amortized generally over the estimated future working life of the plan participants, or for plans with all or substantially all inactive participants, over the average remaining life expectancy.

Significant Assumptions

Management develops each assumption using relevant Company experience, in conjunction with market-related data for each individual country in which such plans exist. All assumptions are reviewed annually with third-party consultants and adjusted as necessary. The table included below provides the weighted average assumptions used to estimate our defined benefit pension obligations and costs as of and for the years ended 2013 and 2012.

	2013				2012			
	U.S.		Int'l		U.S.		Int'l	
Benefit Obligation Assumptions								
Discount rate	4.79	%	4.23	%	4.13	%	4.04	%
Rate of future compensation increase	NM		3.48	%	4.50	%	3.50	%
Net Periodic Benefit Cost Assumptions								
Discount rate	4.13	%	4.04	%	4.87	%	4.76	%
Expected long-term return on plan assets	8.00	%	7.33	%	8.00	%	7.35	%
Rate of future compensation increase	4.50	%	3.50	%	4.50	%	3.58	%

NM Not meaningful. During 2013, an amendment to one of the Company's business unit's pension plans, the Xylem Standard Hourly Bargaining Unit Pension Plan, modified the benefit formula. Similar to all other U.S. pension plans, pension benefits for future service will be based on years of service and not impacted by future compensation increases.

We determine the expected long-term rate of return on plan assets by evaluating both historical returns and estimates of future returns. Specifically, the Company analyzes the estimated future returns based on independent estimates of asset class returns and evaluates historical broad market returns over long-term timeframes based on the strategic asset allocation, which is detailed in Note 15, "Postretirement Benefit Plans," in the notes to the consolidated financial statements.

Based on the approach described above, the chart below shows weighted average actual returns versus the weighted average expected long-term rates of return for our pension plans that were utilized in the calculation of the net periodic pension cost for each respective year.

	2013		2012		2011	
Expected long-term rate of return on plan assets	7.40	%	7.42	%	7.52	%
Actual rate of return on plan assets	10.17	%	10.09	%	(1.40	)%

For the recognition of net periodic pension cost, the calculation of the expected long-term rate of return on plan assets is generally derived using a market-related value of plan assets based on average asset values at the measurement date over the last five years. The use of fair value, rather than a calculated value, could materially affect net periodic pension cost. Our weighted average expected long-term rate of return on plan assets for all pension plans, effective January 1, 2014 is 7.38%. We estimate that every 25 basis point change in the expected return on plan assets impacts the expense by $1 million.

The discount rate reflects our expectation of the present value of expected future cash payments for benefits at the measurement date. A decrease in the discount rate increases the present value of benefit obligations and increases

pension expense. We base the discount rate assumption on current investment yields of high-quality fixed income investments during the retirement benefits maturity period. The pension discount rate was determined by considering an interest rate yield curve comprising AAA/AA bonds, with maturities between zero and thirty years, developed by the plan's actuaries. Annual benefit payments are then discounted to present value using this yield curve to develop a single-point discount rate matching the plan's characteristics. Our weighted average discount rate for all pension plans effective January 1, 2014, is 4.29%. We estimate that every 25 basis point change in the discount rate impacts the expense by $1 million.

The rate of future compensation increase assumption reflects our long-term actual experience and future and near-term outlook. Effective January 1, 2014, our expected rate of future compensation is 3.48% for all pension plans. The estimated impact of a 25 basis point change in the expected rate of future compensation is less than $1 million.

The assumed rate of future increases in the per capita cost of health care (the health care trend rate) is 7.19% for 2014, decreasing ratably to 5.00% in 2020. An increase or decrease in the health care trend rates by one percent per year would impact the aggregate annual service and interest components by less than $1 million, and impact the benefit obligation by approximately $8 million. To the extent that actual experience differs from these assumptions, the effect will be amortized over the average future service of the covered active employees.

We currently anticipate making contributions to our pension and postretirement benefit plans in the range of $40 million to $50 million during 2014, of which $11 million is expected to be made in the first quarter.

Funded Status

Funded status is derived by subtracting the respective year-end values of the projected benefit obligations from the fair value of plan assets. We estimate that every 25 basis point change in the discount rate impacts the funded status by approximately $25 million.

Fair Value of Plan Assets

The plan assets of our pension plans comprise a broad range of investments, including domestic and foreign equity securities, interests in private equity and hedge funds, fixed income investments, insurance contracts, real estate, and cash and cash equivalents.

A portion of our pension benefit plan assets portfolio comprises investments in private equity and hedge funds. The private equity and hedge fund investments are generally measured at net asset value. However, in certain instances, the values reported by the asset managers were not current at the measurement date. Accordingly, we made estimate adjustments to the last reported value where necessary to measure the assets at fair value at the measurement date. These adjustments consider information received from the asset managers, as well as general market information. The adjustment recorded at December 31, 2013 and 2012 for these assets represented less than one half of one percent of total plan assets in each respective year. Asset values for other positions were generally measured using market observable prices. We estimate that a 5% change in asset values will impact funded status by approximately $24 million.

New Accounting Pronouncements

See Note 2, "Recently Issued Accounting Pronouncements," in the notes to the consolidated and combined financial statements for a complete discussion of recent accounting pronouncements. There were no new pronouncements which we expect to have a material impact on our financial condition and results of operations in future periods.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk, primarily related to foreign currency exchange and interest rates. These exposures are actively monitored by management. Our exposure to foreign exchange rate risk is due to certain costs, revenue and borrowings being denominated in currencies other than one of our subsidiaries functional currency. Similarly, we are exposed to market risk as the result of changes in interest rates which may affect the cost of our financing. It is our policy and practice to use derivative financial instruments only to the extent necessary to manage exposures.

Foreign Currency Exchange Rate Risk

Our foreign currency exchange rate risk relates to receipts from customers, payments to suppliers and intercompany transactions denominated in foreign currencies. We may use derivative financial instruments to offset risk related to receipts from customers and payments to suppliers, when it is believed that the exposure will not be limited by our normal operating and financing activities. In January 2012, we began to enter into currency forward contracts periodically in order to manage the exchange rate fluctuation risk on certain intercompany transactions associated with third party sales and purchases. Our principal currency exposures relate to the Euro, Swedish Krona, British Pound, Australian Dollar, Canadian Dollar, Polish Zloty, and Hungarian Forint. We estimate that a hypothetical 10% adverse movement in foreign currency exchange rates would not be material to Xylem's financial position and results of operations.

Interest Rate Risk

As of December 31, 2013, we do not have a material exposure to interest rate risk as our debt portfolio entirely comprises long-term, fixed-rate instruments. We do not account for our long-term debt using the fair value option.

Commodity Price Exposures

Portions of our business are exposed to volatility in the prices of certain commodities, such as copper, nickel and aluminum, among others. Our primary exposure to this volatility resides with the use of these materials in purchased component parts. We generally maintain long-term fixed price contracts on raw materials and component parts; however, we are prone to exposure as these contracts expire. We estimate that a hypothetical 10% adverse movement in prices for raw metal commodities would not be material to our financial position and results of operations.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
INDEX TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Xylem Inc.
Rye Brook, New York

We have audited the accompanying consolidated balance sheets of Xylem Inc. and subsidiaries (the "Company") as of December 31, 2013 and 2012, and the related consolidated and combined statements of income, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2013. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Xylem Inc. and subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2013, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1 to the consolidated and combined financial statements, prior to October 31, 2011, the accompanying financial statements were derived from the accounting records of the water equipment and services businesses of ITT Corporation. For periods prior to October 31, 2011, the financial statements include expense allocations for certain corporate functions historically provided by ITT Corporation. These allocations may not be reflective of the actual expenses that would have been incurred had the Company operated as a separate entity apart from ITT Corporation. Included in Note 20 to the consolidated and combined financial statements is a summary of transactions with related parties.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2013, based on the criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 27, 2014 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP
Stamford, Connecticut
February 27, 2014

XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED AND COMBINED INCOME STATEMENTS
(In Millions, except per share data)

Year Ended December 31,	2013	2012	2011
Revenue	$3,837	$3,791	$3,803
Cost of revenue	2,338	2,289	2,342
Gross profit	1,499	1,502	1,461
Selling, general and administrative expenses	986	914	877
Research and development expenses	104	106	100
Separation costs	4	22	87
Restructuring and asset impairment charges	42	17	2
Operating income	363	443	395
Interest expense	55	55	17
Other non-operating (expense) income, net	(10)	—	5
Income before taxes	298	388	383
Income tax expense	70	91	104
Net income	$228	$297	$279
Earnings per share:			
Basic	$1.23	$1.60	$1.51
Diluted	$1.22	$1.59	$1.50
Weighted average number of shares – Basic	185.2	185.8	185.1
Weighted average number of shares – Diluted	186.0	186.2	185.3

See accompanying notes to consolidated and combined financial statements.

XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED AND COMBINED STATEMENTS OF COMPREHENSIVE INCOME
(In Millions)

Year Ended December 31,	2013	2012	2011
Net income	$228	$297	$279
Other comprehensive income, before tax:			
Foreign currency translation adjustment	15	48	(61)
Net change in cash flow hedges:			
Unrealized gains	1	4	—
Amount of gain reclassified into net income	—	(3)	—
Net change in postretirement benefit plans:			
Net gain (loss)	34	(84)	(74)
Prior service cost	4	(1)	—
Amortization of prior service cost	1	1	1
Amortization of net actuarial loss	17	11	2
Settlement	—	2	—
Foreign exchange	2	(8)	—
Other comprehensive income (loss), before tax	74	(30)	(132)
Income tax expense (benefits) related to other comprehensive loss	22	(23)	(14)
Other comprehensive income (loss), net of tax	52	(7)	(118)
Comprehensive income	$280	$290	$161

See accompanying notes to consolidated and combined financial statements.

XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Millions, except per share amounts)

December 31,	2013	2012
ASSETS		
Current assets:		
Cash and cash equivalents	$533	$504
Receivables, less allowances for discounts and doubtful accounts of $31 and $34 in 2013 and 2012, respectively	817	776
Inventories, net	475	443
Prepaid and other current assets	143	110
Deferred income tax assets	41	41
Total current assets	2,009	1,874
Property, plant and equipment, net	488	487
Goodwill	1,718	1,647
Other intangible assets, net	488	484
Other non-current assets	193	187
Total assets	$4,896	$4,679
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$332	$332
Accrued and other current liabilities	479	443
Short-term borrowings and current maturities of long-term debt	42	6
Total current liabilities	853	781
Long-term debt	1,199	1,199
Accrued postretirement benefits	348	400
Deferred income tax liabilities	191	173
Other non-current accrued liabilities	64	52
Total liabilities	2,655	2,605
Commitment and Contingencies (Note 19)		
Stockholders' equity:		
Common Stock — par value $0.01 per share:		
Authorized 750.0 shares, issued 187.6 and 186.2 shares in 2013 and 2012, respectively	2	2
Capital in excess of par value	1,753	1,706
Retained earnings	405	264
Treasury stock – at cost 3.0 shares and 0.5 shares in 2013 and 2012, respectively	(86)	(13)
Accumulated other comprehensive income	167	115
Total stockholders' equity	2,241	2,074
Total liabilities and stockholders' equity	$4,896	$4,679

See accompanying notes to consolidated and combined financial statements.

XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED AND COMBINED STATEMENTS OF CASH FLOWS
(In Millions)

Year Ended December 31,	2013	2012	2011
Operating Activities			
Net income	$228	$297	$279
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	99	94	93
Amortization	51	48	44
Deferred income taxes	(14)	1	8
Share-based compensation	27	22	13
Non-cash separation costs	—	—	10
Restructuring and asset impairment charges, net	42	17	2
Other, net	15	2	5
Payments of restructuring	(35)	(9)	(7)
Contributions to postretirement benefit plans	(43)	(46)	(16)
Changes in assets and liabilities (net of acquisitions):			
Changes in receivables	(47)	2	(61)
Changes in inventories	(39)	5	(18)
Changes in accounts payable	4	(4)	(9)
Changes in accrued liabilities	18	(28)	53
Changes in accrued taxes	20	(17)	56
Net changes in other assets and liabilities	(2)	12	(3)
Net Cash — Operating activities	324	396	449
Investing Activities			
Capital expenditures	(126)	(112)	(126)
Proceeds from the sale of property, plant and equipment	6	5	11
Acquisitions of businesses and assets, net of cash acquired	(81)	(41)	(309)
Other, net	2	1	1
Net Cash — Investing activities	(199)	(147)	(423)
Financing Activities			
Net transfer to former parent	—	(9)	(995)
Issuance of short-term debt	39	13	5
Issuance of senior notes, net of discount	—	—	1,198
Principal payments of debt and capital lease obligations	(2)	(14)	(8)
Purchase of Xylem common stock	(73)	(13)	—
Proceeds from exercise of employee stock options	22	24	1
Excess tax benefit from share based compensation	1	—	—
Payments of debt issuance costs	—	—	(10)
Dividends paid	(87)	(75)	(19)
Net Cash — Financing activities	(100)	(74)	172
Effect of exchange rate changes on cash	4	11	(11)
Net change in cash and cash equivalents	29	186	187
Cash and cash equivalents at beginning of year	504	318	131
Cash and cash equivalents at end of year	$533	$504	$318
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	$51	$53	$—

Income taxes (net of refunds received)	$65	$104	$64

See accompanying notes to consolidated and combined financial statements.

XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED AND COMBINED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(In Millions, except per share amounts)

	Common Stock	Add'l Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Parent Company Investment	Total
Balance at January 1, 2011	—	—	4	37	—	2,682	2,723
Net income to October 30, 2011						220	220
Net income from October 31, 2011			59				59
Other comprehensive loss, net				(118)			(118)
Assumption of accumulated unrealized gains (losses) on postretirement benefit plans				(73)			(73)
Contributed currency translation adjustment				276			276
Change in parent company investment						(1,240)	(1,240)
Conversion of net investment	2	1,660				(1,662)	—
Dividends declared ($0.1012 per share)			(19)				(19)
Stock incentive plan activity		3					3
Balance at December 31, 2011	2	1,663	44	122	—	—	1,831
Net income			297				297
Other comprehensive loss, net				(7)			(7)
Dividends declared ($0.4048 per share)			(77)				(77)
Stock incentive plan activity		43					43
Repurchase of common stock					(13)		(13)
Balance at December 31, 2012	$2	$1,706	$264	$115	$(13)	$—	$2,074
Net income			228				228
Other comprehensive income, net				52			52
Dividends declared ($0.4656 per share)			(87)				(87)
Stock incentive plan activity		47					47
Repurchase of common stock					(73)		(73)
Balance at December 31, 2013	$2	$1,753	$405	$167	$(86)	$—	$2,241

See accompanying notes to consolidated and combined financial statements.

NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

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 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 encompasses all the 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. Xylem Inc. was incorporated in Indiana on May 4, 2011.
On October 31, 2011 (the "Distribution Date"), ITT Corporation (“ITT”) completed the Spin-off (the “Spin-off”) of Xylem, formerly ITT’s water equipment and services businesses. The Spin-off was completed pursuant to the Distribution Agreement, dated as of October 25, 2011 (the “Distribution Agreement”), among ITT, Exelis Inc. (“Exelis”) and Xylem.
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. References in the notes to the consolidated and combined financial statements to “ITT” or “parent” refers to ITT Corporation and its consolidated subsidiaries (other than Xylem Inc.).